Figure

Annex

Statistical Appendix

I. RECENT ECONOMIC DEVELOPMENTS[1]

A. Background

1. **Situated in the western Pacific, the Federated States of Micronesia (FSM) is made up of 607 islands that extend 1,800 miles across the Caroline Island chain.** Its population is about 110,000 persons; increased emigration, mainly to surrounding U.S. territories, has lowered the annual population growth rate from 2.0 percent in the early 1990s to 0.2 percent in recent years.[2]

2. **The FSM was established in 1979 from the union of four districts of the former United Nations Trust Territory of the Pacific Islands** (TTPI), administered by the United States since the end of World War II.[3] The districts—Chuuk (then Truk), Kosrae, Pohnpei (then Ponape), and Yap—combined to form a self-governing federation under a new constitution. In 1986, the FSM gained independence and signed a Compact of Free Association (Compact) with the United States, under which the United States has full authority and responsibility for defense and FSM nationals may emigrate freely to the United States and work there. Against this historical background, the U.S. dollar is used as the domestic currency.

3. **There is a national government and four state governments.** The national Congress has 14 members, who are elected from each state; the President is chosen from these congressmen. The four states are highly autonomous in policy making, each with its own constitution, legislature, and governor. In addition, they have considerable leeway in setting expenditure and revenue policies. Each formulates its own budget, receives a share of income and import taxes collected in the state, and imposes other taxes locally, notably state sales and excises taxes. Moreover, each state has its own language, although English is the official language and is widely spoken. Under this decentralized structure, policy coordination among the states has been a major challenge. Against this background, economic developments have differed markedly across states. For example, Yap's per capita GDP is more than two and half times Chuuk's.

4. **Since achieving independence in 1986, the FSM has received sizable grants from the United States under the Compact.** Grants, including smaller non-Compact ones, were

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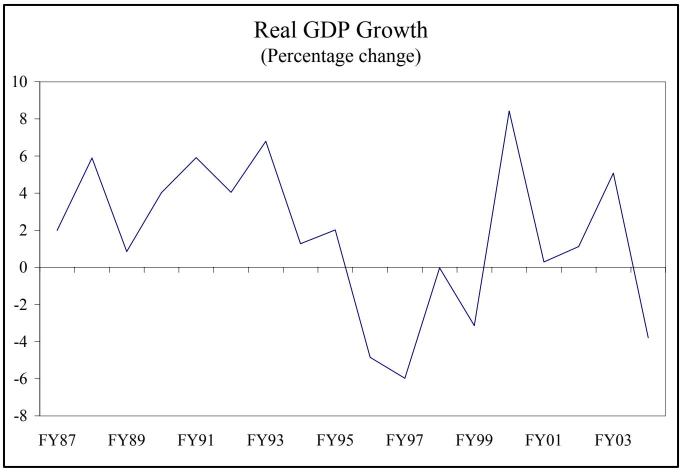
[1]Prepared by Takuo Komori (ext. 37613), Brian Christensen (ext. 39356), and Edimon Ginting (ext. 38733).

[2]In 1999, the United States Department of the Interior estimated that about 12,000 people from the FSM—more than 10 percent of the population of the country—emigrated to Guam, Hawaii, and the Commonwealth of the Northern Mariana Islands (CNMI). By another estimate, about one-fourth of the FSM's population lives in the United States.

[3]Three neighboring trust districts, which also belonged to the TTPI, separately formed the Republic of the Marshall Islands (RMI), Republic of Palau, and CNMI.

equivalent to about 100 percent of GDP in 1986, but fell to about 50 percent as Compact I (FY1987–2001) included stepdowns in financing in FY1992 and FY1997. Between Compact I and Compact II (the renewed Compact covering FY2004–23), the United States provided interim financing during FY2002 and FY2003, which brought a considerable increase in grants relative to FY2001, known as the “bump-up” funds. Compact II entails an immediate stepdown, followed by gradual declines in grants over time. In addition to the Compact, the United States provides other assistance such as deposit insurance and emergency management aid.

5. **Economic developments over the past 20 years have been largely affected by Compact assistance** (Box I.1). Between FY1986 and FY1995, the economy grew steadily at an average annual rate of 3½ percent. Private sector growth was fueled by an emerging cash economy as production expanded to meet increasing demand and as resources in the subsistence sector entered the modern economy. The private sector grew faster than the government, and its output surpassed government output (Statistical Appendix Table 2).[4] The 1992 stepdown in Compact funding had little impact on the economy, partly because the authorities issued medium-term notes backed by future Compact flows to offset its impact. However, faced with the second and larger stepdown in FY1997, the authorities had to make large structural adjustments and downsize government activities, including employment. As a result, between FY1996 and FY1999, the economy shrank at an average annual rate of 3½ percent.



6. **The public sector has been dominant in the economy.** Even with past downsizing, government expenditures still accounted for 60 percent of GDP, and governments still employed nearly one-half of hired workers. Many private businesses exist to meet demand of the governments and their workers, and other businesses such as tourism are underdeveloped.

7. **Development of the private sector is an important policy challenge,** given the prospective decline in external assistance. In the absence of other major resources, developing the tourism sector is seen as particularly desirable (Box I.2). Meanwhile, subsistence production still accounts for 15 percent of GDP and remains an important part of the economy, particularly in the outer atolls. Commercial agricultural and fishery production, in contrast, plays a very limited role. The FSM’s largest export item is fish, but export revenues are only 15 percent of imports. In most past years, the huge trade deficit has been offset by official transfers.

[4]FSM national accounts are measured on a production basis.

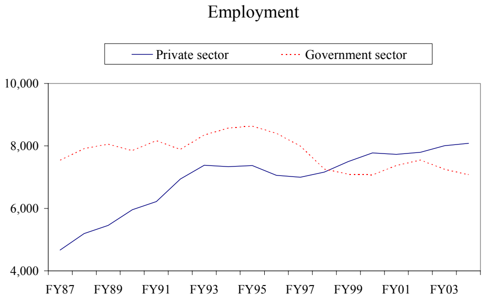
Box I.1. Economic Development, FY1986–FY2003

Since independence the private sector has gradually grown in importance. The two financial stepdowns of Compact I led to a contraction in government output of 0.2 percent a year, while the economy as a whole grew at an annual 2 percent rate. In contrast, although private nonfinancial enterprises have been heavily reliant on government, they grew at an annual 3 percent rate in these years, and their fastest growth was observed in earlier years as a cash economy emerged.

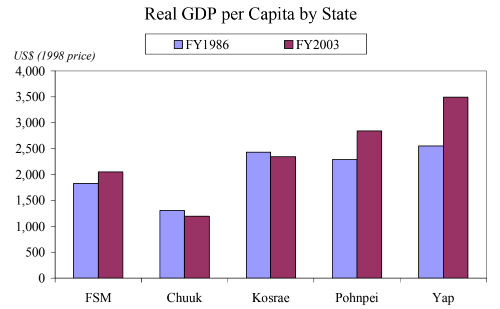
Private sector growth is reflected in employment. While employment in the government sector decreased, particularly after the late 1990s, private sector employment rose steadily, surpassing government employment by the end of the 1990s.

Economic growth has differed among the states, mainly due to differences in the structures of the state economies. Between FY1987 and 2003, Pohnpei and Yap realized positive real GDP per capita growth, while Chuuk and Kosrae recorded negative per capita growth. In addition, the differences of per capita GDP across states have widened. These differences may be related to economic management and individual economic structures. States with higher growth, like Pohnpei and Yap, tend to have a large private sector and a smaller government sector, while those with weaker growth, like Chuuk and Kosrae, tend to have a small private sector and a larger government sector.

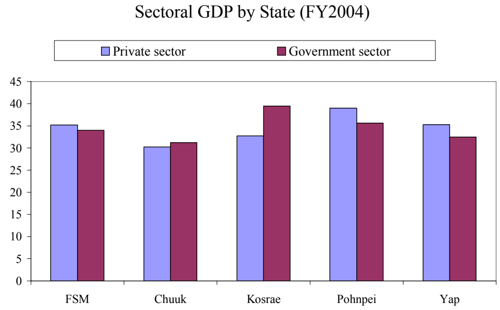
Private sector employment in the states has followed the same pattern. While private sector employment as a percentage of the population has increased in all four states, in Yap private sector employment accounts for the largest proportion of the population and has recorded the fastest growth. In Chuuk, in contrast, the smallest proportion of the population holds private jobs, and its growth was the slowest.



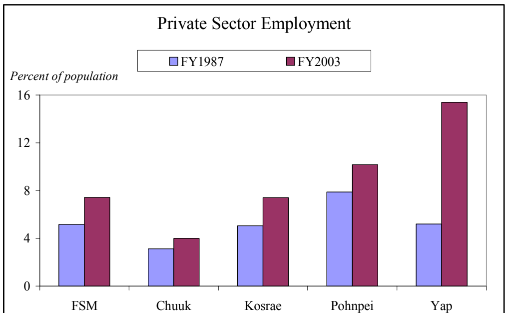
Source: Data provided by the FSM authorities.



Source: Data provided by the FSM authorities.



Source: Data provided by the FSM authorities.



Source: Data provided by the FSM authorities.

Real Growth
(In percent, annual rate)

	1987–2003	1987–95	1996–99	2000–03
GDP	1.9	3.4	-3.5	3.7
GDP per capita	0.7	1.5	-3.8	3.4
Private nonfinancial enterprises	2.9	5.8	-3.8	3.1
Government	-0.2	1.7	-7.4	3.3

Sources: Data provided by the FSM authorities; and Fund staff estimates.

Box I.2. Tourism

As the role of government in the FSM diminishes over time, the private sector will need to play an increasingly important role as a growth engine. In this connection, developing the tourist industry is important for the FSM, and more generally for small island countries, whose constraints to economic growth include geographic isolation, a small population, and a lack of natural resources.

In the past decade, the annual number of visitors to the FSM has stagnated at about 15,000–20,000. Neighbors such as Guam, the Commonwealth of the Northern Mariana Islands (CNMI), and even Palau attract more international tourists. In addition, these richer neighbors, which face some of the same growth constraints as the FSM, rely more heavily on tourism-related sectors for economic growth and employment. For example, about half of employment in Guam is in sectors such as hotel accommodation and food services, travel agencies, and transportation, in which the majority of sales come from visiting tourists.[1]

Among the constraints to the development of tourism in the FSM is its geographic isolation, compared to its more competitive neighbors. These neighboring islands are closer to large eastern Asian countries, namely, Japan, Korea, Taiwan Province of China, and China, and have direct international flights from these markets. Other major barriers include:

- Poor airport infrastructure;
- High air fares, partly reflecting a long-standing monopoly in passenger air transport;
- Poor tourism infrastructure and limited quantity and quality of facilities; and
- A legal and administrative scheme that hampers foreign investment.

While the authorities acknowledge these barriers, some of which may be difficult to overcome, they also recognize the importance of tourism as demonstrated at the third economic summit in spring 2004. This recognition reflects both the envisaged lessening of the government's role in the economy and the absence of other promising resources. As a positive factor, the FSM can boast some attractive attributes, such as Chuuk's world-class diving spots and Yap's unique cultural heritage. The authorities have therefore intensified their efforts to promote the industry: they have facilitated coordination among the states and plan to open tourism branches in major countries. However, more work remains to be done, including associated structural reforms.

Visitor Arrivals, FY2003

	Guam		CNMI		Palau		FSM		RMI[1]	
		In Percent		In Percent		In Percent		In Percent		In Percent
Visitors	856,931		458,443		65,772		18,496		7,195	
Of which:										
From Japan	606,100	71	318,225	69	21,620	33	3,984	22	1,024	14
From rest of Asia	124,419	15	100,310	22	30,688	47	1,842	10	1,704	24
From the US	59,695	7	34,877	8	9,449	14	7,736	42	2,193	30
Memorandum items:[2]										
Land area (square miles)	212		177		170		270		70	
Population	154,805		79,426		19,129		108,021		56,639	
Per capita GDP (US$)	18,766		8,368		6,179		2,096		1,850	

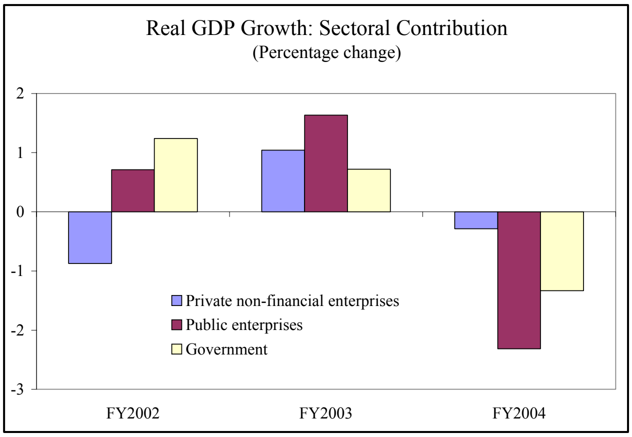
Sources: Data from the FSM authorities; Bank of Hawaii reports; and Fund staff calculations.
[1]Data are for 2003.
[2]Data are for latest available years.

[1]Source: Guam 2002 economic census of island areas (2004) and Fund staff calculations. In a different study, the economic impact of visitor spending on private sector revenues in Guam was estimated at between 50 percent and 65 percent in 1993 (Hiles and Webb, The Economic Impact of Tourism in Guam, unpublished mimeo, U.S. Department of Labor, 1995).

B. Real Sector

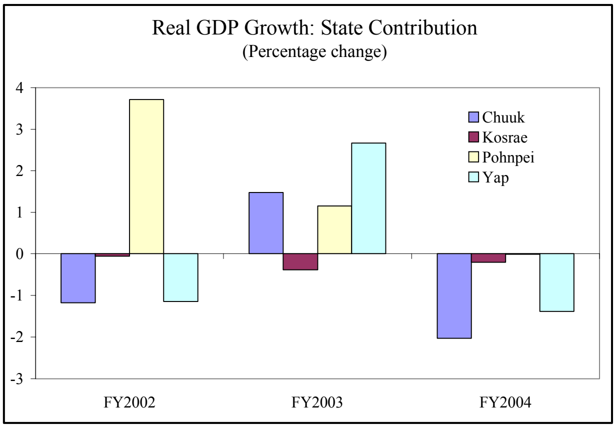
Output

8. **Economic growth picked up pace in FY2002 and FY2003** (Statistical Appendix Table 1). Bump-up funds allowed governments to raise wages and salaries, contributing to GDP growth. In addition, public enterprises' output rose due to good performance by fishing-related enterprises, reflecting favorable fishing conditions in the waters off the FSM. The private sector (nonfinancial private enterprises), in contrast, contracted in FY2002 as uncertainty over Compact II negotiations led private businesses to adopt a wait-and-see attitude. Other contributing factors included a decrease in government capital expenditure to save money for the Compact Trust Fund and a financial crisis in Chuuk. Private sector growth recovered in FY2003 as these conditions eased.



9. **The FSM economy contracted in FY2004,** the first year of Compact II, reflecting a large decline of grants. The government again trimmed capital expenditures and wages, while the private sector, affected by the drop in government capital spending, reverted to negative real growth. In addition, a typhoon in Yap adversely affected the agricultural sector, particularly betel nut production. Public enterprises' production also declined, mainly due to a drop in fishery output from high levels.

10. **Economic performance has varied significantly among the four states in the past three years** (Statistical Appendix Table 3). Although output in most states moved in common directions—down in FY2002, up in FY2003, and down again in FY2004, there were marked differences across states. In particular, Pohnpei, supported by a resilient private sector, realized much higher growth than the other states, while Kosrae was the only state that experienced negative growth in all three years, with a declining private sector.

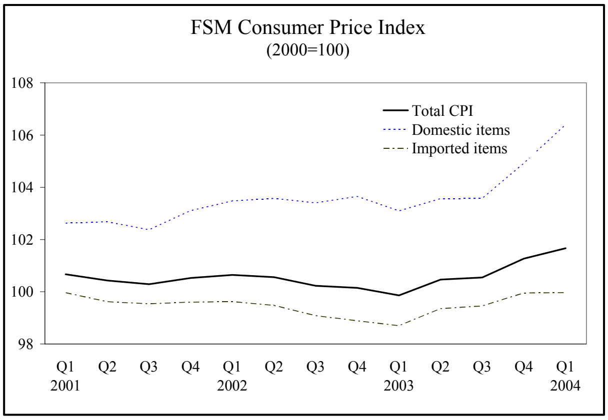


Labor market

11. **A swing in public sector employment has been mitigated by private sector employment growth** (Statistical Appendix Table 4).[5] Public sector employment, which contracted in the wake of the second stepdown of Compact I in the late 1990s, recovered by FY2002. It shrank again amid government downsizing with the onset of Compact II. Private sector employment, in contrast, has grown steadily even in recent years, with wholesale and retail, transportation, and hotel and restaurant industries providing job opportunities. Overall, employment growth has been sluggish in recent years. As for wages, after declining during the second Compact I stepdown, both public and private sector wages increased during FY1998–2003. However, both are estimated to have declined slightly in FY2004.

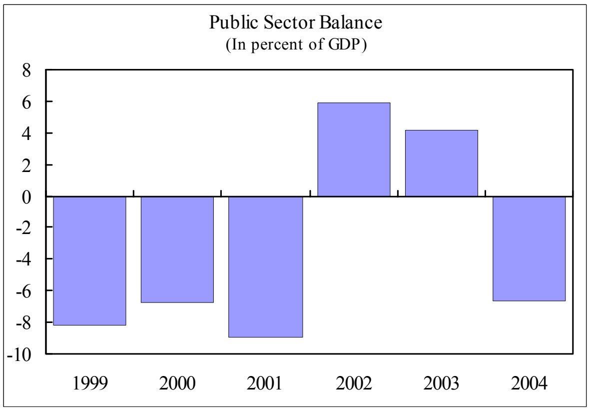
12. **Labor market conditions differ across states.** Private sector employment is much larger than public sector employment in Pohnpei and Yap, while public sector employment is dominant in Chuuk and Kosrae. In Yap, public sector wages are much lower than those in the other states, and the wage differential between public and private sectors is the smallest of any state, reflecting prudent public expenditure management.

Prices



13. **Inflation has remained under 2 percent since FY1998** (Statistical Appendix Table 5). Following mild deflation in FY2002 and FY2003, CPI growth returned to positive territory in FY2004. Inflation is heavily influenced by the prices of imported items, which comprise three-fourths of the price basket. In this regard, hikes in oil and related energy prices contributed to recent price increases, and the prices of both imported and domestic goods have been on the rise.

C. Fiscal Sector



14. **A recent improvement in the fiscal position proved short-lived**. After four consecutive years of deficits (averaging 7¾ percent of GDP), the fiscal balance rose significantly during FY2002–03 with an average surplus of 5 percent of GDP. However, the fiscal position deteriorated in FY2004 to a deficit of 6¾ percent of GDP.

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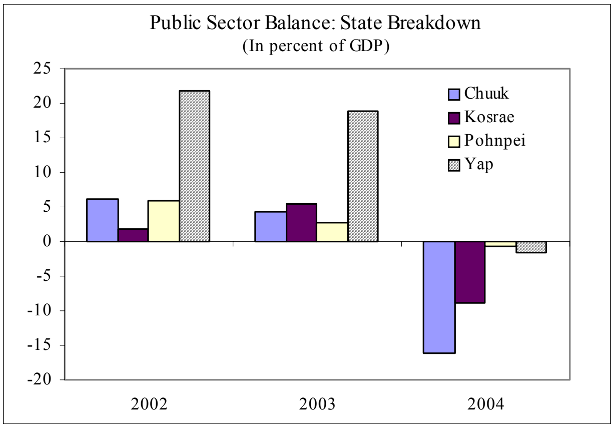
[5] In this sub-section, private sector includes private nonfinancial enterprises, financial institutions, and nonprofit organizations. Public sector includes national and state governments, municipalities, and public enterprises.

15. **The underlying fiscal position remains weak.** The temporary improvement during FY2002–03 reflected the availability of Compact "bump up" funds—an increase of 6¾ percent of GDP over the FY2001 level—and a significant reduction in expenditures; despite a wage bill increase, both current and capital expenditures recorded a significant drop. However, this period of favorable outturns was not used to put in place measures to strengthen the underlying fiscal position; thus, the fiscal performance sharply deteriorated in FY2004 amid a programmed reduction in Compact grants and continued weak domestic revenue performance. Moreover, because a national infrastructure development plan required for disbursement under the Compact had not been prepared, the infrastructure grant was withheld. Although capital spending was cut by half, this was insufficient to offset the sharp reduction in grants from 50 percent to 33 percent of GDP.

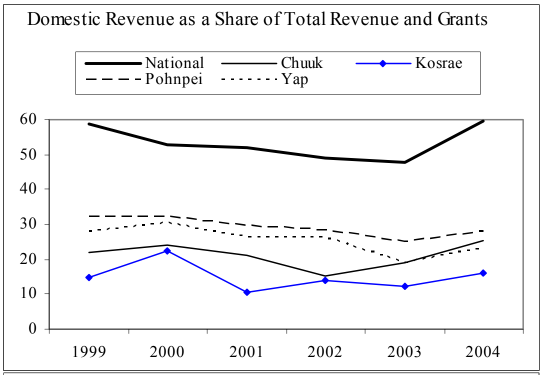
16. **Fiscal performance has varied among the four states** (Box I.3). All the states had budget surpluses in FY2002–03, although Yap continued to outperform the other states. The Compact stepdown and the withholding of the infrastructure grant in FY2004, however, caused all states to register deficits—albeit at relatively modest levels for Pohnpei and Yap, whereas Chuuk again started accumulating arrears.

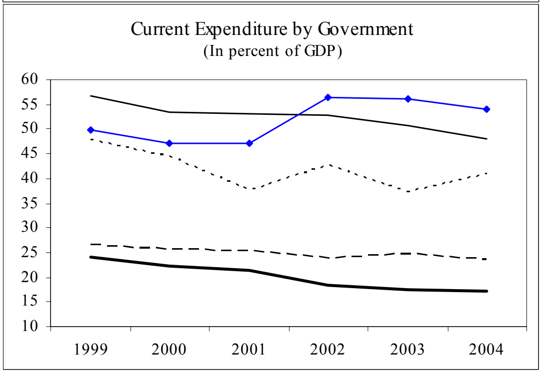


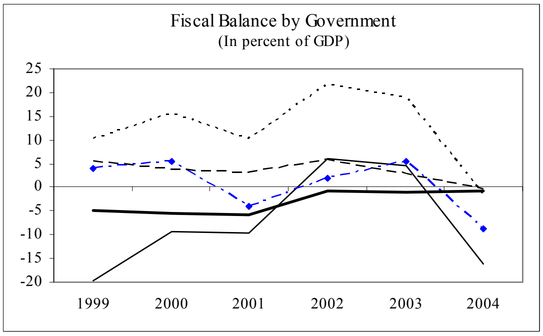
17. **As a result of the weak fiscal position, the consolidated net asset position has worsened.** The budget deficit, and the FSM's $30 million contribution to establishment of the Trust Fund as required under the Compact, sharply reduced usable (uncommitted) government financial assets in FY2004 from 21½ percent to 8¼ percent of GDP. Combined holdings of foreign assets by the five governments were $96.3 million (42½ percent of GDP) at the end of FY2004, but except in Yap, spending appropriations have been made against a large share of these holdings. As government financial assets are the primary vehicle to finance temporary budget deficits, strong efforts will be needed to reduce deficits and absorb shocks without accumulating arrears.

18. **Although no immediate risk for the budget, the financial position of the Social Security Administration (SSA) warrants attention**. In recent years, benefit payments have increased at a faster rate than contributions and the net operating loss (before investment income) has averaged $0.5 million. Recent steps taken by the SSA include strengthened collection efforts to bring down delinquencies and a sharp increase in the ceiling for contributions. However, because benefits are based on a percentage of contributions, the accrued liability of the system has also increased. Based on a recent actuarial valuation, the system's accrued liability and assets at end-2003 stood at $240 million and $37 million, respectively, implying an unfunded accrued liability equivalent to 90 percent of GDP.

Box I.3. Fiscal Performance of the National and Four State Governments, FY1999–2004







Fiscal performance has varied greatly across the National and state governments. The National Government and Chuuk have almost exclusively accounted for the budget deficits throughout FY1999–2003. The sharp drop in grants in FY2004 resulted, however, in deficits for all governments. This varying performance reflects the states' considerable leeway in setting expenditure and revenue policies.

State fiscal performance has been closely linked to developments in Compact and other U.S. federal grants. Domestic revenue is relatively small in all states, and conversely reliance on grants is very high. (Kosrae and Chuuk have relied the most on external support.) Changes in the level of grants, for example as a consequence of sector grants being withheld, have thus had a significant and immediate impact on the states' fiscal performances. The National Government is much less reliant on grants, although they still contribute 40–50 percent of its total revenue.

Although consolidated public expenditure has dropped significantly, the record is uneven, and Chuuk and Kosrae continue to have very high current expenditures. Kosrae is the only state that has increased current expenditure since FY1999, which was partly a result of a rebound in the wage bill stemming from annual salary increases, new hiring and a workweek increase, and the onset of lax fiscal discipline during the "bump-up" period. Chuuk has run very large deficits, notwithstanding a sizeable reduction in current expenditures as a percentage of GDP. A fiscal crisis in 2002 resulted from expansions in state employment and the workweek, as well as poor fiscal discipline more generally. Although fiscal control improved thereafter, there are again indications that the state is accumulating arrears.

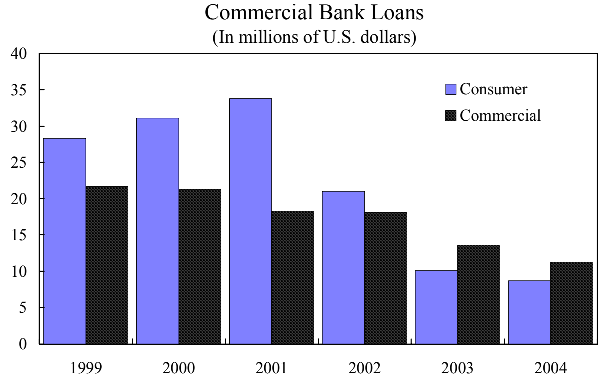
Pohnpei and Yap have performed better, while the National Government has narrowed its deficits. Pohnpei and Yap have demonstrated considerable discipline, and the initial workforce and payroll reductions under the ADB-supported Public Sector Reform Program (PSRP) have largely been maintained. Despite Pohnpei's relatively strong fiscal performance, due to a fiscal crisis in the mid-1990s its asset position is far below Yap's, which is the only state to have built up a relatively strong asset position. The National Government's deficit has narrowed in recent years as a result of a significant cut in expenditures. Eight consecutive years of deficits have, however, sharply weakened its asset position.

D. Monetary and Financial Sector

19. **Domestic credit continues to shrink as the financial sector mainly channels deposits overseas.** Credit to the private sector has been contracting, owing to limited domestic lending opportunities, shortcomings in the legal framework for lending, uncertain fiscal and economic prospects, and the withdrawal of Bank of Hawaii in late 2002 (other banks declined to purchase some of its FSM-based assets). Since FY2003, commercial banks have placed more than 75 percent of their assets overseas. Accordingly, the loan-to-deposit ratio reached a record low of 16 percent in the second quarter of 2004. The commercial banks remain well capitalized and are highly liquid with low nonperforming loans. However, declining domestic loans outstanding have put banks' earnings and profits under pressure.

20. **Domestic lending rates remain high, reflecting the additional risks and costs of doing business in the FSM.** Domestic deposit rates are in line with those in the United States. However, lending rates remain high—around 15 percent for consumer loans and 7 percent for commercial loans.

21. **The banking system also includes a development bank, which accounts for half of domestic credit.** The FSM Development Bank mainly provides loans to start new businesses, with longer terms than those offered by commercial banks. More than 70 percent of its loan portfolio is allocated to fisheries, tourism, and other commercial enterprises. It remains a nondepository institution and relies on the National Government for funding, through annual appropriations.[6] With a risky portfolio, the bank has not made significant profits and hence it pays no dividend to its shareholders.[7] It has a slightly larger nonperforming loan rate than the commercial banks and has received total capital contributions of around $2 million from the National Government in the last three years. Currently, its competition with the commercial banks is limited, as the bank mainly offers loans that commercial banks view as unduly risky.



Source: Data provided by the FSM authorities.

22. **The commercial banking system remains well supervised and regulated.** The two commercial banks—one a branch of a U.S.-based bank—operating in the FSM are licensed and regulated by the Banking Board, and their deposits are insured by the U.S. Federal Deposit Insurance Corporation (FDIC). The 2002 amendment of the Banking Act brought

[6]The FSM Development Bank is not supervised by the Banking Board but is under the oversight of Congress and is subject to both internal and external audits.

[7]The National Government owns 98.7 percent of the bank's shares, and the states of Chuuk and Kosrae own 1 percent and 0.3 percent, respectively.

banking supervision and prudential standards more closely in line with the Basle Core Principles. Recently, Congress passed amendments to the Act that implement changes required under the new Compact in order for the FDIC to continue providing services, as well as changes to allow the Banking Board to require the production of reports, records, and other documents in connection with banking examinations.

E. External Sector

Current account

23. **Following two years of positive balances, the current account position worsened markedly in FY2004.** Historically, the FSM has maintained a large trade deficit, reflecting its narrow export base and high dependence on imports. Like several other small Pacific island countries, it has relied heavily on grants receipts to cover trade imbalances. Owing to the bump-up funds and increases in other grants, the current account recorded a surplus in FY2002 and FY2003.[8] However, following the Compact stepdown and a decline in other U.S. grants, official transfers were insufficient to offset an increasing trade deficit and the overall current account deficit reached 10.8 percent of GDP in FY2004. Official estimates of private transfers from remittances have been relatively small and stagnant (around $5 million), despite significant emigration overseas; however, actual remittances may be much larger.

24. **The trade deficit widened in FY2003–FY2004.** Imports increased by 30 percent, owing mainly to an increased value of petroleum imports and transportation equipment (the former reflecting higher world oil prices). Exports declined, mainly due to lower fish exports and a drop in betel nut exports following a storm in Yap.

25. **The income account surplus improved in the last two years, while the services account deficit was stable.** The national and state governments hold sizable foreign assets, which are invested mainly in U.S. securities. On the services account, an increased number of visitors boosted tourism revenue in FY2004.

26. **The capital and financial account surplus eroded in FY2004 following a delay in disbursement of Compact infrastructure grants.** The Compact stepdown reduced capital transfers from $32 million (received as part of the bump-up funds) to $17.5 million. Infrastructure funds were not disbursed due to the aforementioned failure to meet Compact requirements. In addition, the commercial banks continued to increase their holdings of foreign assets. The flow of foreign direct investment remained insignificant, reflecting economic uncertainties and the unconducive business environment. External debt increased slightly in FY2004, but remained low at 26 percent of GDP. With about half of debt owed to the Asian Development Bank on concessional terms, debt service also remained low at about 6 percent of exports.

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[8] Following a natural disaster in Chuuk, the FSM received around $30 million in U.S. Federal Emergency Management Agency grants in FY2002 and FY2003.

27. **The FSM continues to have a relatively open trade regime, rated "4" on the Fund's index of trade restrictiveness.** While few import items are still subject to high rates of import duty (from 25–50 percent), the rates for food products and general merchandise are 3 percent and 4 percent, respectively. There are no quantitative restrictions on imports or exports and no significant nontariff barriers to trade. The authorities are committed to further liberalization and plan to ratify the Pacific Island Countries Trade Agreement (PICTA) in the near future. The FSM is a member of the Pacific Agreement on Closer Economic Relation (PACER) and currently participates in Economic Partnership Agreement negotiations with the European Union to improve access for its main exports. In addition, the FSM is currently represented in the World Trade Organization by the Pacific Forum as an observer.

II. A Medium-Term Framework for Fiscal Stability and Growth[1]

A. Introduction

1. **Since independence, the FSM has been heavily dependent on assistance from the United States.** At the end of the first Compact, about 50 percent of government revenue consisted of external grants, more than two-thirds of which came from Compact funds. With government expenditure of over 60 percent of GDP, the private sector remains under-developed, functioning largely as a provider of services to the public sector.

2. **However, the situation will change under the amended Compact, in force from FY2004 to FY2023.** Annual grant assistance will gradually decline over the 20-year period, with a corresponding increase in the United States' contribution to the Compact Trust Fund (CTF). The revenue from the CTF is expected to replace expiring grants from FY2024 onward. Under an assumption that the nominal rate of return remains at the historical average of 8 percent (see table), the CTF will be able to generate sufficient revenue to replace the expiring grant in the early post-Compact years (see table). But if the rate of return falls below the historical average, CTF revenue will fall short of the expiring grants. Given its large contribution to the budget, a shortfall could cause significant disruption to the government's finances. Moreover, withdrawing the annual revenue entirely would cause the CTF and its future returns to shrink relative to GDP.

Historical Annual Nominal Rate of Returns for U.S. Stocks and Bonds

(In percent)

	Dow Jones Composite	10-year U.S. Treasury Rate	Combined Assets 1/
Average 1985–03	10.3	6.7	8.9
Average 1994–03	9.4	5.7	7.9

Source: CEIC.
1/ Based on 60 percent stocks and 40 percent bonds.

Summary CTF Returns in 2023 1/

(In millions of U.S. dollars)

	Principal	Return	Expiring Grants 2/
Nominal rate of return			
6 percent	1,001.0	60.1	91.2
7 percent	1,106.1	77.4	91.2
8 percent	1,225.1	98.0	91.2

Source: Fund staff calculation.
1/ The Compact Trust Fund agreement requires that budget support for FY2024 be financed by the CTF assets' return in FY2023.
2/ Grants are adjusted by two-thirds of the U.S. inflation rate (assumed to be 3 percent).

[1] Prepared by Edimon Ginting (ext. 38733).

3. **The vulnerability to fiscal shocks in FY2024 and beyond can be avoided if the CTF is supplemented with additional savings from the current period onward.** To build sufficient savings, the FSM needs to undertake medium- and long-term economic adjustments to achieve fiscal stability as well as to foster the emergence of a private sector to replace the dominant public sector.

4. **The objective of this chapter is to assess the fiscal impacts of three medium-term adjustment scenarios using simple budget and growth accounting.** The chapter also assesses the long-term sustainability of the CTF and fiscal sustainability more generally.[2] The main findings of the chapter are:

- With minimal fiscal adjustment through cuts in capital expenditure, growth would be a relatively weak 1 percent per annum. Public finances would become more vulnerable over time as CTF assets declined relative to GDP.

- Fiscal adjustment alone (without reforms to support private sector development) could avoid cuts in capital expenditure, thereby supporting growth of 1¾ percent. Budget surpluses—around 1 percent of GDP—would increase government assets to supplement the CTF, but would not suffice to achieve long-term fiscal sustainability.

- Fiscal consolidation along with structural reforms to support the private sector could boost economic growth to 2¾ percent. The policy would generate surpluses of about 3 percent of GDP, large enough to maintain long-run fiscal sustainability.

5. **The chapter is structured as follows.** Section B explains the three medium-term adjustment scenarios with different fiscal adjustments and economic reforms to support private sector development. Section C assesses sustainability under the three scenarios. Section D concludes.

B. Medium-Term Adjustments: Three Scenarios

6. **This section describes possible fiscal and growth outturns under (1) baseline, (2) fiscal reform, and (3) comprehensive fiscal and structural reform scenarios.** The following general assumptions are adopted in all three scenarios:

- Renewed Compact grants and trust fund contributions will be disbursed as scheduled during FY2004–23 (see table), with partial inflation adjustments (two-thirds of the U.S. inflation rate). U.S. and FSM inflation rates are assumed to be 3 percent and 2 percent, respectively.

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[2] In this paper, fiscal sustainability is defined as being achieved when returns of CTF and other government assets provide a sufficient level of resources to replace expiring grants and maintain the per capita value of assets in the long run.

- Neither the trust fund nor the income from it is available to finance spending before FY2024.
- No other new assistance is made available during the renewed Compact period.
- Capital expenditure is raised over the near term in line with the requirements of the renewed Compact to spend 30 percent of grants on infrastructure.
- No additional borrowing occurs during the renewed Compact period.

Compact Funding for the FSM

(In millions of U.S. dollars)

Fiscal Year	Annual Grants	Audit Grant	Trust Fund	Total
2004	76.2	0.5	16.0	92.7
2005	76.2	0.5	16.0	92.7
2006	76.2	0.5	16.0	92.7
2007	75.4	0.5	16.8	92.7
2008	74.6	0.5	17.6	92.7
2009	73.8	0.5	18.4	92.7
2010	73.0	0.5	19.2	92.7
2011	72.2	0.5	20.0	92.7
2012	71.4	0.5	20.8	92.7
2013	70.6	0.5	21.6	92.7
2014	69.8	0.5	22.4	92.7
2015	69.0	0.5	23.2	92.7
2016	68.2	0.5	24.0	92.7
2017	67.4	0.5	24.8	92.7
2018	66.6	0.5	25.6	92.7
2019	65.8	0.5	26.4	92.7
2020	65.0	0.5	27.2	92.7
2021	64.2	0.5	28.0	92.7
2022	63.4	0.5	28.8	92.7
2023	62.6	0.5	29.6	92.7

Source: "Compact of Free Association, as Amended, Between the Government of the United States of America and the Government of the Federated States of Micronesia," 2003.

Baseline scenario

7. **This scenario illustrates a case where the needed measures are not taken.** No comprehensive measures to improve tax revenues are introduced. As a result, expenditure cuts bear the brunt of fiscal adjustment to accommodate declining external assistance. Capital expenditure increases in line with Compact requirements through 2007, but remains at 30 percent of Compact grants transfer thereafter. As a result, capital spending declines relative to GDP over time (Figure II.1). With no surplus, the government only accumulates a small amount of assets to absorb future fiscal shocks and supplement the CTF (the increase in assets over time reflects the cumulated return on the assets). As the private sector also fails to take off, the public sector remains dominant in the economy (Box II.1 describes growth assumptions for the three scenarios).

Box II.1. Projection of FSM Growth Under the Three Medium-Term Scenarios

In projecting economic growth, the FSM economy is divided into three sectors, namely government, private sector (financial and nonfinancial business) and other, where "other" includes public enterprises and the subsistence sector. The 'Other' sector is assumed to grow by 1 percent in all scenarios (see table).

Under the baseline scenario, the private sector grows by its recent historical average of 2.9 percent. The output of the government sector contracts as grants and capital spending decline. With capital spending weak, economic growth is about 1 percent.

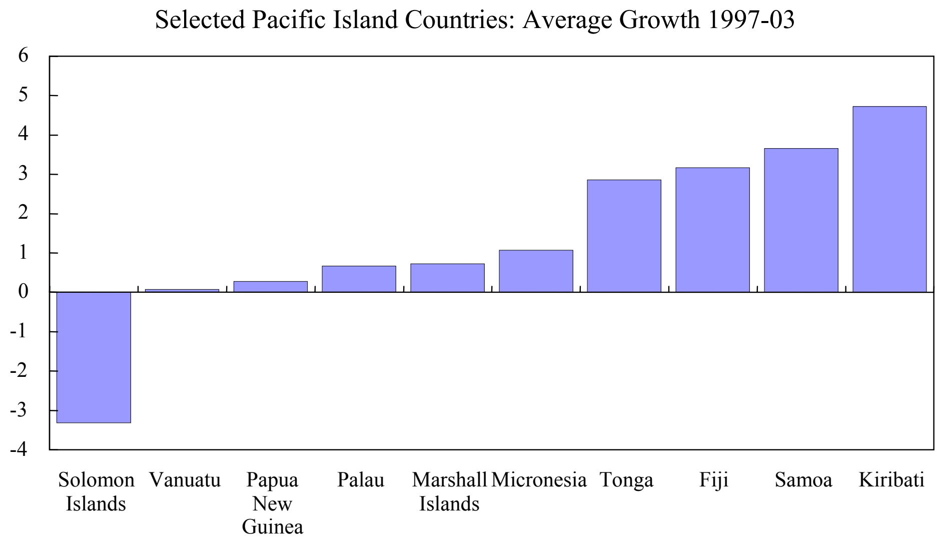
Under the fiscal reform scenario, increased tax revenue facilitates higher capital expenditure, which in turn translates into a modest improvement in private sector growth. Fiscal reforms raise overall GDP growth to about 1.75 percent.

Under the fiscal/private sector development scenario, the economy shifts from government-driven to private sector-driven. Fiscal reforms together with structural reforms raise private sector growth to 6 percent—in line with the growth rate of Yap during the first Compact period. Higher private-sector growth improves overall GDP growth to 2.75 percent, close to the historical average growth in better-performing Pacific island countries. The private sector's share of GDP increases from about 31 percent during the first Compact period to around 52 percent in 2024.

Economic Growth Assumptions for FY2005–23

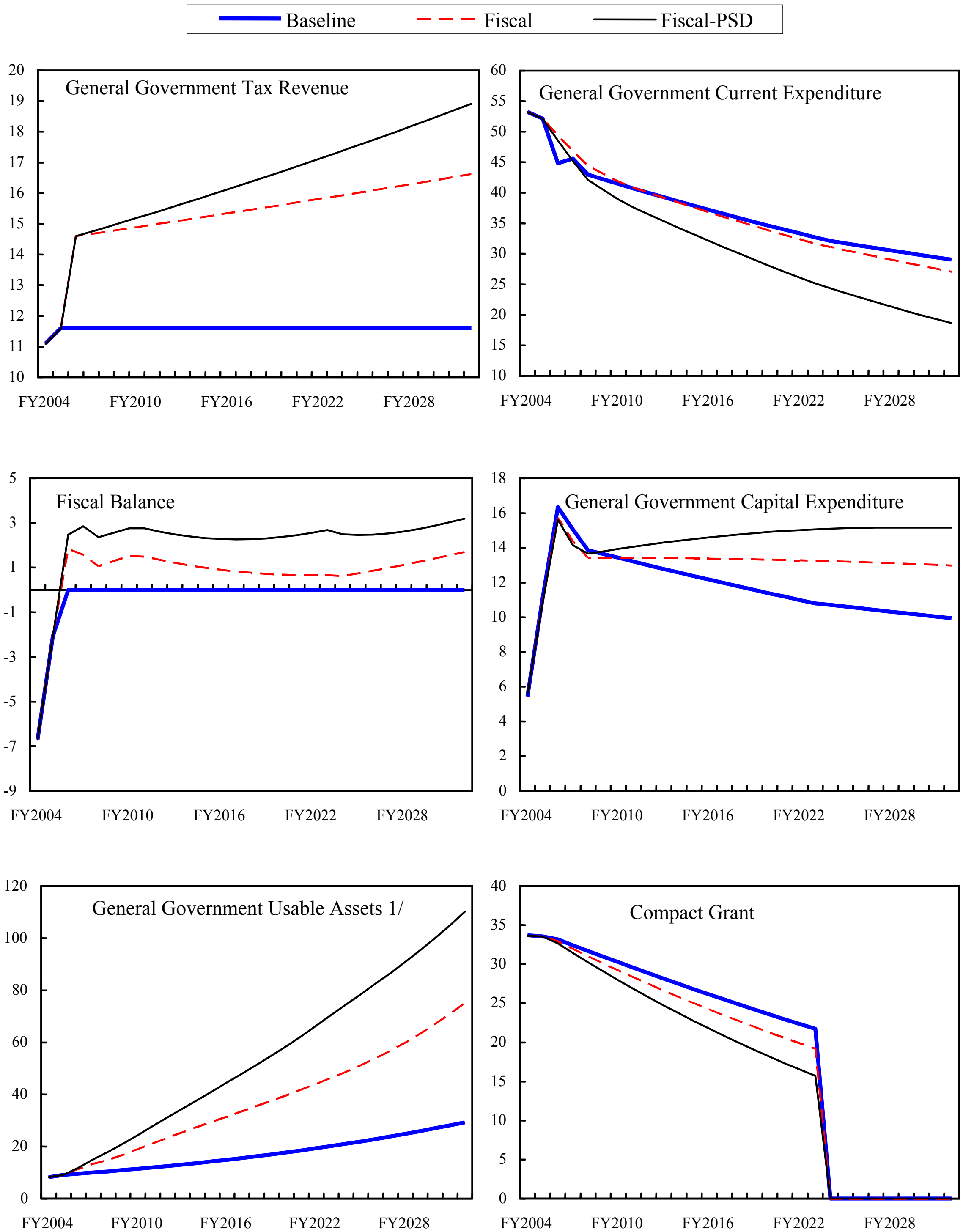
	Baseline	Fiscal	Fiscal-PSD
Government	-0.5	1.5	1.5
Private sector	2.9	3.5	6.0
Other sector	1.0	1.0	1.0
Average economywide	1	1.75	2.75

Source: Fund staff estimates.



Source: Fund staff estimates.

Figure II.1. Federated States of Micronesia: Long-Term Fiscal Adjustment Scenarios, 2004-32
(In percent of GDP)



Source: Fund staff estimates.
1/ Excludes trust fund.

Fiscal reform scenario

8. **The fiscal reform scenario projects the outcome of comprehensive fiscal adjustments.** On the revenue side, it is assumed that the authorities introduce a VAT in FY2006, increasing revenues by 3 percent of GDP. From 2007 onward, continued improvements to tax administration foster a modest gradual rise in taxes relative to GDP (a total increase of 1 percent of GDP). Thus, tax measures increase tax revenue from the current 12 percent of GDP to 16 percent of GDP at the end of the renewed Compact period. On the expenditure side, the current policy to freeze public service wages continues until FY2010, and then wages are indexed to inflation. Travel and other current expenditures are cut by 10 percent over FY2006–08, and then are indexed to inflation. Capital expenditure increases in line with Compact requirements through 2007 and grows by 4 percent thereafter.

9. **The fiscal balance initially rises steeply** after the introduction of tax measures and the cuts in travel and other expenditure, but declines over time to about 1 percent of GDP reflecting the fall in Compact funds. Fiscal adjustments allow assets equivalent to 46 percent of GDP to be accumulated by 2024. Revenue improvements also enable the budget to maintain capital expenditure at about 15 percent of GDP to improve growth prospects. However, without measures to foster private sector development, its growth remains modest.

Comprehensive reform scenario (fiscal-private sector development)

10. **Under a comprehensive reform scenario, further budgetary efforts are taken, as well as structural reforms.** In addition to the above fiscal reforms, under the fiscal-private sector development (fiscal-PSD) scenario the authorities cut travel and other expenditures further, for a total reduction of 5 percent per year during FY2006–08 (or equivalently cut wages and salaries by the same amount while maintaining other current expenditures). This allows the government to achieve surpluses of about 3 percent of GDP. Capital expenditure also increases in line with Compact requirements through 2007 and grows by 6 percent thereafter. In addition, structural reforms to enhance infrastructure, reduce the cost of doing business, make the foreign investment regime more efficient, and improve the lending environment are undertaken to raise private-sector growth. As the share of the private sector in the economy rises, tax revenue improves further to 17.5 percent of GDP at the end of the renewed Compact period. Thanks to better fiscal performance, the government accumulates a higher stock of assets (70 percent of GDP) than under fiscal reforms alone.

C. Government Assets and Long-Run Fiscal Sustainability

11. **After Compact grants expire in 2023, the FSM is expected to be self-sufficient and rely on income received from assets instead of grants.** To meet this objective, assets need to satisfy two conditions: (i) their return after FY2023 must be sufficient to replace expiring grants; and (ii) their long-term value needs to be maintained so they can provide sustainable budgetary support.

12. **The CTF agreement to some extent addresses the above conditions.** It incorporates some protection against market volatility by making provisions for excess annual income (above 6 percent) to be set aside in a buffer account. This account can be tapped after the renewed Compact expires in FY2024 if the fund's return is below the previous year's annual grant assistance. Afterwards, the FSM can also access the account if the fund's return is below the previous year's distribution. To maintain the value of the CTF over the long term, the agreement requires that, at a minimum, the principal of the fund be preserved in nominal terms after FY2023. Except for special needs approved by the Joint Trust Fund Committee, the maximum withdrawal from FY2024 onward is an amount equal to the annual grant in FY2023 indexed by inflation. In addition, the agreement allows for the FSM to make additional contributions to the CTF. This contribution is not part of the CTF principal and the FSM can access this part of the fund to cover future unanticipated shortfalls in the fund's returns.

13. **Whether or not the CTF meets the two conditions hinges heavily on the assets' rate of return.** Under the currently envisaged contributions, the CTF will provide sufficient revenue to replace grant flows if the average rate of return remains at the historical average of 8 percent. However, if the rate of return falls 1 percent below the historical average, the revenue from the CTF will fall short of the expiring grant. Under the current agreement, the FSM could then access the CTF buffer account. But if returns are persistently low, it is unlikely that the account will have sufficient funds over the long term. Moreover, withdrawing the entire annual yield will also deplete the real value of the CTF over time, and hence it will eventually fail to provide sustainable contributions to the budget. As such, Compact-related contributions to the CTF must be supplemented by maintaining substantial fiscal surpluses and building an additional stock of financial savings during the renewed Compact period and beyond.

14. **The long-term sustainability of the current CTF and other government assets can be assessed using the following simple framework:**

$$\Delta A = R + B - W \tag{1}$$

where ΔA is growth in assets, R is return on assets, B is the fiscal balance, and W is withdrawal from asset returns. This relationship underscores the importance of maintaining surpluses to preserve assets relative to GDP or in real per capita terms. To maintain assets in nominal terms ($\Delta A = 0$), assuming a zero fiscal balance, the asset withdrawal for budget support from 2024 onward cannot exceed returns. Holding the nominal value of assets constant, however, implies that assets will decline over time relative to GDP. In addition, assuming a constant rate of return, it implies that assets per capita will also decline over time, which is undesirable from an intergenerational equity point of view. A more desirable approach is to keep the real value of assets per capita constant to maintain intergenerational equity. To illustrate this, equation (1) can be rewritten as:

$$(p + m)A = R + B - W \tag{2}$$

where p is population growth and m is the inflation rate. Equation (2) implies that assets must grow in line with the sum of the inflation rate and the population growth rate.

15. **This relationship suggests two ways of boosting asset accumulation:** the first is by increasing asset returns (R) and the second is by maintaining a positive fiscal balance after FY2023. A larger savings to supplement the CTF under the fiscal-PSD scenario results in significantly larger assets than the other two scenarios (see table). With the same asset rate of return and withdrawal as other scenarios, going forward the rate of asset accumulation will also be higher under the fiscal-PSD scenario. Equation (2) also underlines the importance of maintaining fiscal surpluses, as higher surpluses will produce a higher rate of asset accumulation.

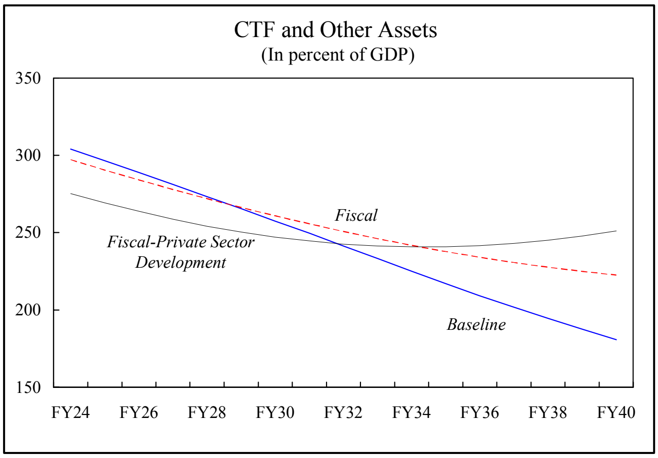
Projected CTF and Other Government Assets in FY2024 and FY2024

(In millions of U.S. dollars)

	Nominal Value		
	FY2024	FY2040	Level Needed to Maintain Constant Real Per Capita Value, FY2040 1/
Baseline	1,321.5	1,399.6	1,964.8
Fiscal	1,470.6	2,162.0	2,186.5
Fiscal-PSD	1,688.4	3,897.8	2,510.4

Source: Fund staff estimates.
1/ Inflation rate and population growth are 2 and 0.5 percent, respectively.

16. **Only the comprehensive reform scenario achieves both intergenerational equity and fiscal sustainability objectives.** Under this scenario, with higher economic growth, the government achieves surpluses of about 3 percent in the renewed Compact period and beyond, and accumulates assets more than twice the size of those accumulated under fiscal reforms alone. Moreover, the real per capital value of assets is maintained, and over time, asset returns remain stable relative to GDP. In the baseline and fiscal reform scenarios, by contrast, both assets and asset returns decline relative to GDP in the long run.

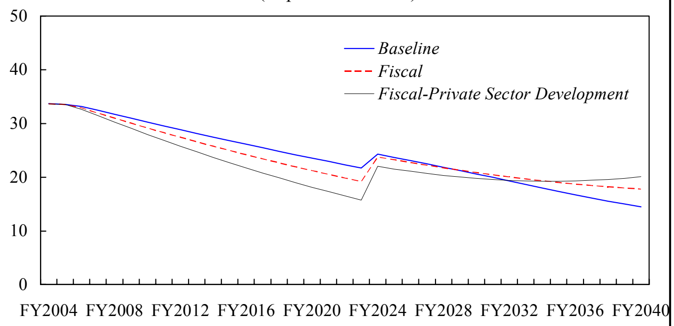


D. Concluding Remarks

17. **The renewed Compact assistance and the CTF agreement provide a framework for the FSM to achieve long-run self-sufficiency, but more needs to be done.** A strong fiscal consolidation effort is needed to build up assets to supplement the CTF and thereby ensure long-term fiscal sustainability. Also, comprehensive reforms to facilitate strong private sector-led growth would both promote a shift from a government-driven economy to a private sector-driven economy and help with the fiscal effort.

Compact Grant and Assets Returns 1/

(In percent of GDP)



Source: Fund staff estimates.

1/ Compact grants 2004-23 and Compact Trust Fund and other assets returns from 2024.

III. Revenue Performance and the Tax Reform Agenda[1]

A. Introduction

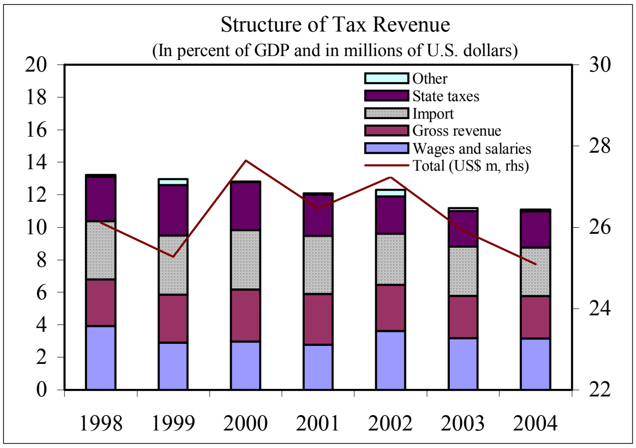
1. **Tax revenue in the FSM is unusually low by regional standards.** At 11–12 percent of GDP, the tax ratio compares poorly to those of other countries in the region, which range from 17 to 26 percent of GDP (see table). While this situation might reflect the availability of substantial grants under the Compact, tax collection in Palau and the Republic of the Marshall Islands (RMI)—the two other Compact countries—is 18 to 19 percent of GDP. Contributing to the low revenue compared to other Pacific island countries (PICs) are the relatively low tax rates and coverage, as well as weak tax administration.

Selected Pacific Island Countries: Structure of Tax Revenue

(In percent of GDP)

	FSM 1/	RMI 1/	Palau 1/	Vanuatu	Kiribati 2/	Samoa 2/	Tonga 2/
	FY2002		2001/02	2002		2001/02	
Income tax	3.6	9.2	4.8	0.0	8.1	4.5	4.9
Tax on goods and services	5.1	3.3	8.8	10.2	0.0	12.4	3.1
Tax on international trade	3.2	5.7	4.5	6.9	17.2	3.9	15.2
Other tax	0.4	1.0	0.0	0.2	0.1	0.5	0.1
Total tax revenue	12.3	19.2	18.1	17.3	25.5	21.2	23.3

Sources: IMF staff reports.
1/ Fiscal year ends in September.
2/ Fiscal year ends in June.



2. **Although some efforts have been made to strengthen revenue administration (Box III.1), the tax ratio has dropped in recent years.** Since FY1998, when tax revenue peaked at 13¼ percent of GDP, revenue performance has gradually declined to an estimated 11 percent of GDP in FY2004. While none of the taxes has performed well, the trends in collection of taxes on wages and salaries and on imports have been particularly disappointing. This is a significant problem given the coming declines in Compact grants.

[1]Prepared by Brian Christensen (ext. 39356).

Box III.1. Reform of Customs Administration

The FSM has made some progress in the last two years in reforming customs administration. In January 2003, an automated customs clearance system was introduced as a basis for modernizing customs procedures and moving toward international standards. Customs is now organized in a single, nationwide administration, clearance procedures have been improved, self-assessments have been introduced (lowering the risk of rent-seeking behavior as opportunities for negotiating duty payments have been reduced), international codes and trade classifications have been put in place, and trade statistics have been improved and become more timely.

However, contrary to the overall objective, revenue from import taxes has dropped in the last few years. This reflects that a number of steps required to detect undervaluation and enforce compliance have not been carried out. Resources need to be set aside to enable the customs administration to undertake post-audit clearance and risk assessments, as well as to strengthen the penalty system. Without these steps, import of significant volumes of goods will continue to be undetected or undervalued.

3. **Given the need for fiscal consolidation, tax reform has been the subject of discussion for a number of years, although with little progress to show.** The debate has largely centered on the introduction of a value-added tax (VAT) to replace a number of existing taxes, and the establishment of a central, nationwide tax administration. This has been broadly in line with measures recommended by technical assistance missions from the Fund and the Pacific Financial Technical Assistance Center (PFTAC). A subsequent FSM-wide Revenue Reform Symposium made a number of recommendations concerning a tax reform strategy. Although later endorsed by the Economic Policy Implementation Council—an advisory body including the President, the four State Governors, and the Speaker of the National Congress—the National Government has not made a firm decision on which steps to take and tangible progress has therefore been limited. In the meantime, the National Congress has passed a number of ad-hoc tax measures, including increasing selected tariffs.

4. **The recent stepdown in Compact grants has triggered a renewed effort by the National Government.** A high-level Tax Reform Task Force, co-chaired by the Vice President and the Chairman of the Ways and Means Committee of the National Congress, has been established with the task of examining proposed tax reforms. However, with no specific time schedule agreed, it is unclear when it will reach conclusions.

B. The Current Tax System

5. **Tax policy coordination in the FSM is complicated by the considerable autonomy of the states in setting expenditure and revenue policies.** Tax policy is made both at the National and state levels, but the influence of the National Government is limited. The Constitution assigns the National Government the responsibility for determining the level and rate structure for income and import taxes as well as for their collection. All other

taxes, including consumption taxes, are exclusively the responsibility of the states.[1] The Constitution also provides that national taxes shall be imposed uniformly across states, although a minimum of 50 percent of revenues collected in a state must be shared with that state.

6. **In FY2004, about 80 percent of consolidated government tax revenue was collected by the National Government, of which 60 percent was shared with the states.** National Government tax revenue is raised from taxes on wages and salaries, gross revenue, and imports (Box III.2). Respectively, these taxes accounted for 28 percent, 24 percent, and 27 percent of consolidated tax revenue in FY2004. The state governments collected 20 percent of consolidated tax revenue and rely largely on sales taxes, excises, and hotel taxes, but at varying rates across states and goods and services. A small surcharge on state sales taxes is collected by the states on behalf of the municipalities.

Box III.2. The Current Tax System[1]

There are **three national taxes**: the wages and salaries tax, the gross revenue tax, and import duties.

The only tax levied on any form of income is the **wages and salaries tax** (WST). Collected at source, the WST is levied at the relatively modest rate of 6 percent up to and including $11,000 per annum and at 10 percent of income in excess thereof. Employees with gross wages less than $5,000 are granted a $1,000 deduction. The tax base is significantly reduced as income tax is not levied on the income of the self-employed, in-kind benefits, housing allowances, and profits or capital gains.

The **gross revenue tax** (GRT) is a tax on turnover payable by businesses with turnover exceeding $10,000 per annum. A flat rate of $80 is levied on turnover below that amount, but is refunded if turnover is below $2,000. Government and wholly owned public enterprises, as well as some export-related activities, are exempt. Although the GRT may have been conceived as a tax on businesses, in lieu of a profits tax, it functions effectively as a sales tax and given the structure of the economy is levied largely on the sale of imported goods.

Import duties accounted in FY2004 for 27 percent of total tax revenue and are applied to all imported goods, including those imported by the government, with a few exemptions for particular usage and for goods to be exported. The general rate is 4 percent, although food is subject to a 3 percent rate and other goods, such as cigarettes and alcohol, are subject to higher rates. Following a recent change to tariffs, which increased rates on a number of goods but also reduced or eliminated certain protective tariffs, the use of protective tariffs is very limited.

State taxes include sales taxes with rates varying from 1 percent to 5 percent, and higher excises on a limited range of products. While each state sets its own rates, they generally use the same base as the import duty. A number of other taxes are also applied by states, including hotel and vehicle rental taxes. In FY2004, state taxes totaled 20 percent of total tax revenue.

[1] See Annex III.1 for a detailed summary.

[1] A constitutional referendum seeking, among other amendments, to grant the National Government and the states the concurrent power to levy a VAT failed in 2002.

7. **Although relatively transparent, the tax system generates far too little revenue.** This can be attributed to design weaknesses in some of the individual taxes, a narrow tax base, and a lack of harmonization among taxes, as well as weak administrative collection, audit and enforcement capacity. Tax rates are relatively low even when accounting for the presence of multiple taxation of the same product as it goes through the production and marketing chain (so-called tax cascades).

8. **The scope for expanding revenue collection is good, but achieving a significant increase in revenue will require revamping the tax system and strengthening tax administration.** Without comprehensive reform, ad-hoc tax measures may increase economic distortions. Merely boosting marginal tax rates may result in reduced compliance without significantly boosting revenue collection. Moreover, piecemeal measures, such as changes to customs duties and certain penalties recently passed by the National Congress, could divert attention from more fundamental tax reforms.

C. Tax Reform Options

9. **Tax reform should aim at increasing the efficiency of the tax system and expanding the tax base, which in turn would improve revenue collection.** In particular, some of the most important features of the current tax system that would need to be addressed are:

- Significant income is escaping the tax net and thus limiting the tax base.
- Tax cascades create economic distortions.
- FSM tax is present in the value of exported goods and services, reducing local competitiveness.
- Lack of harmonization, coordination, and sharing of information between the national and state tax systems complicates collection, audit, and enforcement efforts. This problem is exacerbated by the limited capacity of the national and state tax administrations.

10. **In addition, it will be important that tax reform supports the authorities' commitment to trade liberalization and private sector development.** Ratification of the Pacific Island Countries Trade Agreement (PICTA) is expected in the near future, and the FSM is already a member of the Pacific Agreement on Closer Economic Relation (PACER). While PICTA, which entails liberalization vis-à-vis other Pacific island countries, is unlikely to result in significant loss of revenue—imports from other PICs are negligible—tax reform should be consistent with the need over time to cover revenue loss from tariff reductions. In addition, it will be important that tax reform is designed in a way that not only contributes to fiscal adjustment, but also complements the broader objectives of strengthening the prospects for private sector-led growth, for example by expanding the tax base to keep tax rates down.

11. **Technical assistance in the revenue area has focused on these issues.** Building on earlier advice provided by the Fund, PFTAC has recommended reforms that seek to meet the various aforementioned objectives (Box III.3). The Asian Development Bank-supported Economic Management Policy Advisory Team (EMPAT) has also provided assistance in this area. At this stage, however, the authorities have shifted their focus toward reviewing options, determining the elements of tax reform, and building the necessary support for the required changes through a consultative process. The high-level Tax Reform Task Force will likely include a review of the recommendations emanating from past TA and launch a broader consultation process.

Box III.3. Tax Reforms Proposed by PFTAC

The main principle of the tax reforms recommended by PFTAC is a new nationwide tax system based on self-assessment procedures, and the establishment of an efficient tax administration run by a single nationwide customs and tax administration. Its recommendations are as follows:

- Coverage of the WST would be expanded to include noncash benefits.
- A VAT would replace import duties and state sales taxes. The VAT should be an easy to administer, broad-based tax applicable to goods and services with few exemptions, with a single rate and a high annual revenue threshold for selecting the businesses that would be required to register. At the customs level, all importers, regardless of revenue, would have to pay the VAT. For nonregistered VAT payers, the VAT on imports would be final payment, whereas for exporters, VAT paid on imports would be refundable.
- A net profit tax would replace the GRT for VAT registered businesses. A presumptive tax, similar to the existing GRT, would apply to non-VAT registered businesses.
- Continued use of excise taxes on a limited range of products.
- Import duties would continue to be levied on goods imported from outside trade agreement areas.

12. **Tax reform options include broadening and changing the structure of taxes.** In particular, a broadening of the income tax base could be considered. Although the WST is the largest contributor to revenue, it falls only on cash earnings of employees. The self-employed are subject only to the GRT, which is much lower than the WST, and fringe and noncash benefits such as free housing—an increasingly important form of remuneration—are not taxable at all. As the GRT essentially is a tax on consumption, the introduction of a net profits tax for larger businesses in lieu of the GRT could also be considered. This would eliminate the (inefficient) economic incentive for businesses to integrate vertically and hence escape taxation on transactions between them. Finally, removal of the exemptions of public sector enterprises from income taxation should be considered to avoid distortions in the

pattern of economic activity. While such measures might generate only modest additional revenue individually, together and combined with a strengthened tax administration capacity, they could increase revenue by 1 to 2 percent of GDP.

13. **While introduction of a VAT would be more difficult, it would likely yield more revenue while addressing some of the problems with the current tax system.** Introduction of a VAT could eliminate the inefficient tax cascades and taxation of exports, and reduce the exposure of the system to tax avoidance by collecting revenue throughout the process of production rather than simply at the final stage. Meanwhile, the entry of goods into the FSM would continue to be the single most important—and most easily taxed—stage in the tax chain. There are a number of options that could be explored, but the reforms proposed by PFTAC envisage that the VAT would replace import duties and state sales taxes. The GRT would be replaced by a net profits tax for businesses with an annual turnover above the VAT threshold, while for those businesses that are not VAT-registered, a presumptive tax—similar to the existing GRT—would apply. Experience from other small countries, including in the Pacific, has shown that a VAT can boost revenue (Box III.4). For the FSM, it is estimated that the VAT could yield an additional 2 to 3 percent of GDP in revenue.

14. **The VAT would need to be carefully designed and complemented by improvements in tax administration.** To be effective, the VAT would need to be broad-based and applicable to goods and services with few exemptions and with a single rate. Moreover, by carefully choosing the annual revenue threshold for selecting the businesses that would be required to register, tax authorities could focus their administrative resources on a limited number of taxpayers (it has been suggested that the threshold should be set to require registration of the 200 largest businesses). Given that a relatively small share of businesses account for the bulk of sales, this would still cover the majority of consumption in the VAT. Together with the use of self-assessments and the establishment of a single tax administration with a dedicated unit to focus on the VAT-registered businesses, this should limit the administrative burden.

15. **Securing support from the state governments would be another challenge.** Because state governments have jurisdiction over consumption taxes, the National Government is essentially dependent on the state governments agreeing to introduce a VAT. This would ideally be in the form of a nationwide VAT law, but could alternatively be four identical state VAT laws with a common tax base and rate across states; different bases and tax rates across states would add complexity and increase the collection and taxpayer compliance costs. Although a nationwide VAT would likely be more effective, a key issue from the states' perspectives will be whether such a coordinated approach would limit their ability to determine their own expenditure policies. Conventional practice indicates that VATs are most appropriately assigned to central government given the administrative capabilities required to operate the tax. The states will therefore need to consider whether the efficiency of the tax system and revenue collection are more important than having the ultimate authority to determine the tax rate and tax base. This would not, however, imply that revenue cannot be assigned to the states. It merely suggests that in discussing this issue, the allocation of specific tasks and authority to determine the tax rate and tax base, as well as

administering and collecting taxes, should be done on the basis of who can carry out the tasks most efficiently, with the ultimate goal of securing fiscal sustainability.

Box III.4. VATs in Pacific Island Countries

Tariffs have been a major revenue source in most Pacific island countries (PICs). Accordingly, tax reforms in PICs have aimed at reducing economic distortions from import taxes, and at the same time honoring trade liberalization agreements. In some countries, the ensuing revenue loss has been replaced through the introduction of a VAT and the expansion of excise taxes.

A number of PICs have introduced a VAT. A VAT has been implemented in Fiji (1992), Samoa (1994), Vanuatu (1998), and Papua New Guinea (PNG) (1999)—and is scheduled to be introduced in Tonga in 2005. With the exception of PNG, the VAT is now a major source of revenue in all of these countries with collections ranging from 33 percent of total tax revenue in Samoa to 39 percent in Vanuatu (see table). At 28 percent, the average collection in the Pacific region compares relatively well with experiences elsewhere. With a single rate between 10 to 12.5 percent, VAT collection as a percent of GDP varies between a low 2.6 percent (PNG) to 7.6 percent (Samoa). The efficiency of the VAT in the four PICs compares relatively well with other regional averages (although there are differences among the PICs); this reflects a reasonably sound design as well as the high import content of consumption.

VAT Efficiency Ratios

	PICs					Simple Average Ratios		
	Fiji (2003)	PNG 1/ (2003)	Samoa (2002/03)	Vanuatu (2003)	Simple Average	Asia and Pacific	Sub-Saharan Africa	Small Islands
VAT/total tax revenue (in percent)	33.6	11.7	32.7	39.2	28.0	21.7	28.4	18.0
VAT revenue/GDP (in percent) (1)	6.6	2.6	7.6	7.0	5.6	3.3	3.9	4.7
Standard VAT rate (2)	12.5	10.0	12.5	12.5	11.4	10.4	16.0	16.1
VAT efficiency ratio (1)/(2)	0.52	0.26	0.61	0.56	0.48	0.35	0.27	0.48

Sources: Fund staff estimates; and "The Modern VAT," L. Ebrill et al, IMF, 2001.
1/ Includes the 70 percent national share of VAT revenue only.

A number of lessons can be drawn from the experience in the Pacific and elsewhere.[1] Most importantly, sound design of the VAT is critically important to meeting the revenue objectives. In particular, the VAT should be broad-based with few products and services exempted, a single tax rate should be applied, and exports zero-rated, i.e., exports leave the country free of any VAT. VAT implementation also appears to have been most effective when the threshold for VAT registration has been set sufficiently high to align the number of taxpayers (and hence the administrative burden) with tax administration capacity, taxpayers are required to self-assess their tax liabilities, effective refund and penalty systems are in place, adequate resources for audits are provided, and willingness to take action against noncompliance exists.

[1] "The Occasional Failure in VAT Implementation: Lessons for the Pacific," C. Grandcolas, PFTAC, 2003.