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Paradise Lost: The Cost of Removing Tax and Trade Provisions from the Compact of Free Association.

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Introduction

In John Milton's epic, Adam and Eve are cast out of Eden as punishment for acts of their own volition. In perhaps a crueler fate, the Federated States of Micronesia (FSM) never had the chance to enjoy its position as the only legally-recognized tax haven for United States (US) tax payers. Instead, the US Congress unilaterally stripped tax and trade provisions from a bilateral treaty between the FSM and the US known as the Compact of Free Association. In return for the removal of these provisions, \$60 million was made available to the FSM under a program known as the Investment Development Fund (IDF). Only \$20 million of this Fund was ever released, and the FSM has never realized the economic potential originally envisioned by the Compact signatories. Now, ten years after the end of the original Compact of Free Association, and twenty-five years after it was first enacted, this paper makes a renewed attempt to quantify what the FSM lost when the tax and trade provisions were rescinded. Documenting this loss is an important first step for the FSM to make a claim for the remaining \$40 million of the IDF.

As stated in Author (2010):“The United States can trace its history with the islands now known as the Federated States of Micronesia (FSM) to 19th century whaling fleets. However, the truly unique relationship between the two regions began in earnest in 1947 when the United States was delegated to be Trustee for the territory by the United Nations. In 1978 four of the Trustee Districts ratified a Constitution to become the FSM. The Trusteeship formally ended in 1986 at which time the US and the FSM entered into a Compact of Free Association. Under this agreement the United States assumed control for defense of the FSM and provided roughly \$1.5 billion in economic assistance over 15 years.”

Along with its sister state, the Republic of the Marshall Islands (RMI), the Compact of Free Association between the US and FSM created a political bond unique in the world. The Compact of Free Association was intended to provide the US with access to key strategic sea lanes and air ways while simultaneously providing economic assistance to promote the long-term economic health and self-reliance of the FSM. Title II of the Compact provided a budgetary grant to the FSM valued at \$60 million USD over the first five years, \$51 million over the second five years, and \$40 million over the final five years of the Compact. This economic assistance was provided almost entirely free of conditionality save for a stipulation that a minimum of 40% be allocated to a loosely defined “capital account.” In consideration for this economic assistance, in Title III of the Compact the FSM provided the US with rights of strategic denial to its sea and airspace as well as leaving open the possibility of US military bases in the country. Beyond these core economic and security matters, the Compact also established that FSM citizens could live and work in the US without a visa, ensured FSM citizens’ eligibility for US Federal Programs, and enabled FSM citizens to serve in the US military. However, despite these strong linkages, the FSM retains international recognition as a fully sovereign state, having acceded to the United Nations in 1991.

In addition to the unique political arrangement established under the Compact, the treaty also contained a number of tax and trade provisions that would have created novel economic relations between the two countries. While these provisions were agreed to by the US Executive, and were included in the final treaty initialed on 1 October 1982 by representatives of the FSM and US, they were effectively altered or invalidated by sections 401 and 403 of the US implementing

legislation, Public Law 99-239. The replacement for the removal of these tax and trade provisions was the \$60 million IDF.

In the absence of the Compact tax and trade provisions, and with a poorly performing IDF, the FSM economy has largely stagnated. After seven years of modest growth during the late 1980's, while the FSM economy adjusted to the increased economic assistance under the Compact, economic performance has virtually flat lined. In fact, real GDP in FY2009 is only two percent higher than in FY1993 – an average annualized growth rate of 0.14%. The private sector, in particular, is anemic – accounting for no more than 26% of GDP since the statistic began to be recorded in FY1995. The extent of these economic doldrums has prompted observers such as Hezel (2006) to ask “Is that the best you can do?” and to engender claims from him and others, such as Friberg et al (2006), suggesting that the FSM resign itself to life as a MIRAB - migration, remittances, aid, and bureaucracy – economy as coined by Bertram (1985, 2006). An economic overview by Author (2010) suggests that the FSM suffers from a form of “Dutch Disease” brought on by the massive aid flows of the Compact, which have kept tradable production near nil and fueled household-based consumption in the FSM. All of these authors note the paucity of investment in the FSM and the likelihood for continued economic malaise in the absence of significant reform.

The main objective of this paper is to estimate what was lost to the FSM economy with the removal of the Compact's tax and trade provisions. As a counter-factual exercise, I employ two methodologies to quantify the loss. First, I review the vast literature on tax havens and establish the case that under the tax and trade provisions the FSM would have been a “tax haven” of the

“highest class,” as its tax concessions would have been legally sanctioned by the US. Armed with this recognition, I use previously-established quantitative estimates of the impact of “tax haven” status on economic growth to calibrate simulations of the FSM economy from 1986-2001. Secondly, I examine the economic performance of similarly situated entities - American Samoa and the Commonwealth of the Northern Marianas - that had tax and trade provisions that were *less* concessional than those that the FSM lost and extrapolate how these performances could have been mirrored in the FSM under the original tax and trade provisions.

The Tax Haven that Never Was

As noted by a United States Government Accountability Office (GAO 2008, p. 2) report, Dharmapala (2008), and others, there is no standardized definition of a “tax haven.”² The term has, however, traditionally carried a negative connotation and is often seen as a tool for facilitating questionable practices of tax evasion or avoidance (Hines 1997, Devereux 2007). As noted by Dharmapala (2008), the OECD (2004), in particular, has painted tax havens as harmful and distorting to the global economy - sentiments that are echoed by the IMF (2006) or Braithwaite (2005). This negative view driven by a perception that tax havens divert economic activity from non-havens, although the theoretical and empirical bases of this claim have recently been challenged (Desai et al. 2006). A review of the literature identifies a number of characteristics that are common to tax havens. Hines and Rice (1994, p.175) suggested four attributes including low tax rates, legislated banking secrecy, sophisticated communication infrastructure, and “self-promotion as an offshore financial center.” A recurring theme in the discussion of tax havens is that they are often located in small-island states. Hines and Rice

²Caccamise (1987, p. 555) laments the difficulty in noting that “In the United States, as in most Organisation for Economic Co-Operation and Development (OECD) member states, neither a definition of tax havens no criteria to identify them exist in the law.”

(1994, p.153) noted that in 1982 60% of all tax-haven assets, equity and income were located in countries with a median population of 200,000 people. In fact one of the earliest, and most recognized, tax havens was the FSM's island neighbor to the south, Vanuatu or New Hebrides. Rawlings (2004, p. 328) highlights the importance of the English common law system in the establishment of New Herbrides as a tax haven in 1970-1971. The tax haven characteristics noted by these authors have been repeated and elaborated upon in subsequent conceptualizations of tax havens and table 1 provides a summary of traits compiled from several sources.

<Table 1 About Here>

A quick review of the characteristics reveals that the FSM shares many attributes with tax haven countries. The FSM is a common law, English-speaking, small island state with sophisticated communications infrastructure and a poor endowment of subsoil resources(US Congress 1984, pp. 53-60). The FSM would have an additional advantage over other tax havens in attracting individual and corporate tax tourists from the US as its legal system explicitly based on US law, and the FSM Supreme Court often looks to US law for guidance. US lawyers are frequently admitted *pro hac vice* to practice in the FSM court system, and, in fact, two of the four FSM Supreme Court justices who sat on the bench during the Compact period were US citizens trained at US law schools. With regard to institutional characteristics, the table above provides conflicting information as to whether tax havens are characterized by poor or good governance. The GAO (2008) report, drawing substantially from prior OECD (2004) studies, tends to describe tax havens as those whose governance provisions and capabilities allow tax liabilities to be hidden from foreign tax authorities. However, substantial empirical work by Dharmapala (2008) and Dharmapala and Hines (2009) suggests the opposite is true. Their analysis suggests a strong association between good governance and tax haven status, and notes that instances of

poorly-governed tax havens are very low. Accordingly, the generally high governance scores, as measured by the World Bank's Governance Indicators, assigned to the FSM should not hurt, and in fact enhance, the FSM's tax haven characteristic profile.

The characteristics that do not apply, *a priori*, to the FSM during the Compact period - no or nominal tax, self-promotion as an offshore financial sector, and affluence with a high concentration of wealthy individuals - are those which would have immediately or plausibly followed implementation of Sections 254 and 255 of the Compact.³ Section 254 would have provided explicit individual tax relief for US taxpayers unlike any other jurisdiction in the world, where upon becoming resident in the FSM, US citizens would be relieved from their entire US tax obligation.⁴ Thus, it is not out of the realm of possibility that a significant number of affluent US citizens would have established residency in the FSM to avoid their US tax liability, establishing the characteristic in Table 1 of "Relatively affluent with a high concentration of wealthy individuals." Section 255 would have extended Section 936 provisions of the Internal Revenue Code (IRC) to the FSM. This section essentially exempts corporations from paying US corporate tax as long as they pay any and all applicable taxes in the possession/territory/nation

³Where those Sections read: "...any individual resident of ... the Federated States of Micronesia who is subject to tax by the Government of the United States ... shall be relieved of liability to the Government of the United States for tax which, but for this subsection, would otherwise be imposed by the Government of the United States... (Section 254(a) US Public Law 99-239 – Jan. 14, 1986) and: "... provisions in the United States Internal Revenue Code that are applicable to possessions of the United States as of January 1, 1980 shall be treated as applying to ... the Federated States of Micronesia." (Section 255 US Public Law 99-239 – Jan. 14, 1986).

⁴While Section 254 did specify a 183 day residency requirement to claim FSM residency this does not appear to have been a significant challenge to the "no requirement of substantive local presence" in Table 1. In addition to the inherent draw of being of the most naturally beautiful chains of tropical islands on earth, US Congressional (1982, p. 40) testimony suggests the the residency requirement would have been difficult to enforce:

Mr. de Lugo (Ron de Lugo, Representative, American Virgin Islands): "How will the U.S. verify actual residence in the freely associated states...?"

Mr. Shay (Steve Shay, US Department of State): "I am not sure – let me just take a hypothetical. If you have a U.S. –"

Mr. de Lugo: "I might make use of this answer. [Laughter.]"

Mr. Shay [continuing]: "If you have a U.S. tax law – wait until you hear the answer. [Laughter.]..."

that has been granted Section 936 status.⁵ Section 936 is clearly a huge enticement to business and has widely credited as a contributing factor to the number of major US firms that operated in Puerto Rico and other US possessions during the Compact period (Davidson 1987, GAO 1996).

Finally, and perhaps most substantially, the tax provisions under Sections 254 and 255 of the Compact would have been coupled with the trade provisions under Sections 242 and 243. Section 242, in particular, would have granted to the FSM the same preferential access afforded to US territories under what is known as “Headnote 3(a).” This designation would have given firms based in the FSM duty free access to the US market for a broad range of goods, including clothing, canned tuna, and buttons. As will be discussed at greater length below, “Headnote 3(a)” has been attributed as a significant factor in promoting the tuna and textile industries in the American Samoa and the Commonwealth of the Northern Marianas Islands (CNMI), respectively.

Thus, in addition to possessing the physical, institutional, and demographic characteristics of tax havens presented in Table 1, the FSM would have been a jurisdiction with preferential tariff access to the US, a US-modeled legal system, and had favorable corporate tax incentives in a tax regime that was a vestige of US Trust Territory administration. The combination of these factors would have almost certainly have made the FSM as attractive a “tax haven” to US citizens and corporations as any other jurisdiction in the world. Accordingly, although still a counter-factual exercise, it is entirely reasonable to extrapolate the plausible economic performance in the FSM

⁵ Where Section 936 provides corporations a tax credit that is: “...equal to the portion of the tax which is attributable to the sum of the taxable income from sources without the United States, from the active conduct of a trade or business within a possession of the United States...” (Internal Revenue Code, Section 936(a)(1)).

had these provisions been in place, based on empirical evaluation of other tax havens during a similar time period.

What the FSM Lost

Accepting that the combination of Sections 242, 243, 254 and 255 of the Compact of Free Association would have effectively established a legally-sanctioned “tax haven,” I extrapolate economic performance, and subsequent loss, based on empirical evaluations of tax havens during the same period by calibrating results from studies on tax havens and economic growth to the FSM and then simulate GDP growth in the FSM during the Compact period.

There are several papers that evaluate the impact of tax haven status on growth. Perhaps the most frequently cited empirical study is that of Hines (2005). Hines’ (2005) approach is a cross-country, panel regression on the annual real per capita GDP growth rates of 119 countries from 1982-1999. Hines estimates simple log-linear, lagged-dependent variable models that include log population and a “tax haven” dummy for those countries identified as tax havens. Hines estimates two models, one including first, and the other including second and third, order effects, and estimates a “tax haven” impact on the per capita GDP growth rate of 2.3% and 1.5% respectively.

Building on Hines (2005), Blanco and Rogers (2012), using an instrumental variable (IV) approach, control for the non-random assignment of tax haven status, broaden their sample to 155 countries and extend the period from 1982 to 2003 – covering the entirety of the Compact

period. Their two-stage least squares (TSLS) and treatment effects models and find the tax haven impact on average GDP growth to be 2.9% and 3.4%, respectively. Other, non-quantitative, studies make similar (if implicit) arguments for the “tax haven” impact on growth. Hampton and Christensen (2002) suggest that countries face an economic dependence due to their reliance on tax haven related revenues. Likewise, Palan (2002) explores the “commercialization” of state sovereignty wherein tax haven states secure economic gains through the “renting” of their jurisdictional residence. Despite any normative implication, both of these papers imply that tax haven status brings additional revenue and economic benefit to the state, at least in the immediate term.

These findings provide strong support for a positive impact of “tax haven” status on economic growth. In order to estimate what growth could have been in an FSM tax haven, I use the results from the Hines (2005) and Blanco and Rogers (2012) papers to calibrate a Monte Carlo simulation of FSM GDP from 1986 to 2001.⁶This real GDP growth path, with its 95% confidence interval, is presented alongside the actual GDP growth path in Figure 1.

<Figure 1 About Here>

The simulations presented in Figure 1 and in Table I.i in Appendix I show the economic loss in the FSM as a result of the removal of the tax and trade provisions that would have made it a sanctioned US tax haven. Using the mean growth rate, I estimate that the FSM would have accumulated over \$700 million in additional GDP from 1986 to 2001. Under this scenario, the projected GDP in 2001, at the end of the Compact, would have been \$334.52 million: \$100

⁶ In order to simulate growth I first simulate 100,000 Monte Carlo, normal distribution, real per capita GDP growth paths using the four regression coefficients and their reported standard errors. These four growth paths are then averaged and combined with the actual FSM real per capita GDP growth rate. This growth rate is used to calculate real per capita GDP from 1986 to 2001 and multiplied by population in each year to estimate real GDP. Table I.ii in Appendix I presents these full simulated results, alongside actual real GDP performance.

million, or 44% higher than the actual 2001 GDP of \$231.98 million. The 95% confidence interval of the total economic activity lost from 1986 to 2001 is \$336.6 million to \$1,055.90 million. Thus, even under the most conservative simulations of FSM GDP growth as a tax haven, the FSM lost over \$335 million during the Compact period. Assuming a tax collection rate of 10% of GDP, this translates into a mean estimate of \$71.6 million in lost tax revenues, with a conservative estimate (97.5% probability) of *at least* \$33.6 million in lost tax revenue. These figures make clear that had the FSM performed as well as other tax havens during the Compact period, the resulting economic gains would have far outstripped the compensatory value of the IDF authorization. I also note that these estimates are imminently plausible. To achieve real GDP of \$334.52 million in 2001, the FSM would have needed to average steady-state real GDP growth during the Compact period of just over 6%, high, but not unrealistic given the performance of other developing countries during the same period.⁷ Furthermore, real GDP of \$334.52 million in 2001 implies a real per capita GDP of only \$3,118, a figure that is still conservative as compared with better performing economies in the region such as Palau who reported a per capita GDP of \$6,351 in that same year, or American Samoa with a real GDP per capita of roughly \$8,000 in 2002.

The Pacific Experience

As alluded to in the introduction, there are several instructive cases in the Pacific that can be utilized to approximate what the FSM might have looked like under the Compact's tax and trade

⁷The average growth rate in the GDP simulations (which account for the observed business cycle) is 4.77%. 13 of the 94 countries classified by the World Bank as "low" or "lower-middle" income achieved average real GDP per capita growth rates of 5.6% or higher from 1986-2001. Source: <http://databank.worldbank.org/data>. American Samoa, used in a qualitative comparison below, had average steady state real GDP growth of over 7% from 1977 to 2001. Source: American Samoa (2008), US Bureau of Labor Statistics, Author's calculations.

provisions. While neither of the examples given below is perfectly analogous to the FSM situation, they can be viewed as instructive of how a Pacific-island economy can respond to favorable tax and/or trade regulations.

American Samoa

American Samoa has been a formal US possession since 1899 and remains an unorganized, unincorporated territory. American Samoa is smaller than the FSM, at less than one-third the landmass and slightly more than one-half the population. Beyond land area, the FSM has an exclusive economic zone (EEZ) that is substantially larger than American Samoa's, as the FSM's EEZ extends from over 600 points of land, while American Samoa is comprised of just a handful of islands. American Samoa has both a governor and a bi-cameral legislature that largely oversee affairs of the territory (CIA 2011).

The economy of American Samoa performed markedly better than the FSM's from 1986-2001. This divergence in performance is largely due to the significant presence of the US tuna industry in American Samoa. In addition to long-line and purse seine fishing in the waters of American Samoa, the country was also host to large scale tuna processing operations – specifically tuna canning. Exports of canned tuna from American Samoa averaged over \$300 million from 1986 to 2001, achieving a zenith of \$485 million in 1993 (American Samoa 2006). The location of this industry in American Samoa is almost certainly due to the rich pelagic fish stocks surrounding in the waters of American Samoa's exclusive economic zone (EEZ) combined with

the special tax and tariff status American Samoa is afforded under Section 936 and Headnote 3a (Campling and Havrice 2007).

As FSM waters are also rich in pelagic fish the only significant difference, in terms of the tuna industry, between the American Samoa and the FSM between 1986 and 2001 is the tax and trade provisions afforded to the former, but largely denied to the later.⁸ Therefore, it is reasonable to assume that some of the tuna processing capacity built on American Samoa during this time would have been located in the FSM. Based on the comparative size of the FSM's population, land area, and EEZ, the FSM's proportionate share of the industry would have been at least two thirds of the total activity. However, in order to account for the fact that the cannery industry was already established in American Samoa, and the fact that there may be other unobserved geographic, socio-economic, and/or institutional factors that would provide American Samoa with a comparative advantage in tuna-processing vis-à-vis the FSM, I conservatively posit that 25% of the tuna cannery processing activity would have located in the FSM.⁹ This assumption implies that the FSM would have had an average of an additional \$75 million in annual exports, and subsequently (roughly), GDP. Over the Compact period this activity would have translated to \$1,125 million dollars in additional GDP, or \$112 million in additional government revenues.

American Samoa's success in attracting tuna processing investment suggests that the FSM would have attracted similar investment had it had Section 936 and Headnote 3a status. Again, while it is impossible to prove that there would have been investment in the FSM tuna processing

⁸ While Section 401(2) of the Compact retains a small portion of duty-free tuna access for the FSM it effectively bars any large-scale commercial operation capable of competing with the American Samoa or South-East Asian canneries (Campling and Havrice 2007, p. 215).

⁹ 25% of the processing activity is an educated assumption that discounts the FSM's substantial size and EEZ advantage by the pre-existence of cannery facilities in American Samoa.

industry, there are a number of facts that are illustrative of this possibility. First, such a move was explicitly discussed during US Congressional (US Congress 1984, US Congress 1985) hearings on the Compact, with officials from the US National Oceanic and Atmospheric Administration, US State Department, and the US Tuna Industry asserting that the tax and trade provisions in the Compact would lead to investment in the FSM's Tuna Industry.¹⁰ However, the case for tuna investment choosing the FSM as an alternative to the American Samoa is made most explicitly by Fofu I.F. Sunia, the US Congressional delegate from American Samoa who stated:

“I am talking about a cannery, and I think, well, it is such a massive thing, who is going to move that cannery around the Pacific? ... I will tell you, it isn't hard to put up a cannery. Van Camp is putting up a cannery in American Samoa now ... put up in around 3 or 4 months. That is no problem to move these canneries around, and that is why I can assure you that I am concerned; I am almost certain that there will be shifts, and they will come soon, too, because it is not hard to pack up a cannery and move it around the

¹⁰Excerpts from US Congressional (US Congress 1984, pp. 74-45, US Congress 1985, pp. 20-22, 29-33) testimony. Mr. Lagomarsino (Robert J. Lagomarsino, California Representative): “... there is at least a potential for Micronesia fishermen in the area?”

Mr. Gordon (William Gordon, Assistant Administrator for Fisheries, NOAA, US Department of Commerce): “The potential is there. The problem is the tremendous capital investment ... It might well come through foreign investment...”

Mr. Lagomarsino: “Under section 242 of the compact ... duty-free imports can be brought into the United States ... How do you view that as a potential threat to the U.S. tuna industry?”

Mr. Gordon: “I think it is of major concern to the tuna industry. I was in American Samoa early last week and found U.S. canners there extremely concerned that foreign investments will be used to ship tuna duty-free into the United States....”

Mr. Lagomarsino: “Mr. Berg, would you care to comment on this aspect?”

Mr. Berg (James Berg, Political and Economic Adviser, Micronesian Status Negotiations, US Department of State): “... Finally, with respect to the tuna industry, I know that there is concern in the industry, but there is also interest ... in investing in the area (Micronesia)”

Statements from the US tuna industry also indicated the potential:

Mr. Walsh (James P. Walsh, Washington Counsel, American Tunaboat Association): “Secondly, I have concern about the duty-free treatment provisions of the Compact. Allowing new tuna plants based in the Compact islands duty free entry ... is very threatening ... Obviously there is a major trade-off here ...”

Mr. Burney (David G. Burney, Counsel, Tuna Foundation): “...foreign governments could set up processing facilities and transshipping points in Compact nations in order to export tuna products into the United States duty free”

Pacific.” (US Congress 1985, pp. 31-33).

Beyond these explicitly-voiced concerns there are indications that the American Tuna industry was “waiting to see” if the FSM would receive Headnote 3a status. From an annual average of 8,296 cases of exported canned tuna from 1984-1986, production in the American Samoa more than doubled to an annual average of 18,733 cases from 1987-2001 (American Samoa 2006). Employment in the tuna industry saw a similar uptick, adding 5,938 jobs from 1977 to 2002 (American Samoa 2008). Beyond this, while no additional canneries were built in American Samoa during the Compact period, the two canneries that had been in operation since the 1960s were upgraded and expanded in the 1980s (Douman 1985). This increase in the production capacity of the American Samoan tuna industry is at least consistent with an interpretation that producers may have been waiting on the final Compact provisions prior to making additional investments. Based on the similarities discussed above, the American Samoa experience is instructive as to how the FSM could have looked given the same preferential tax treatment and market access.

The Commonwealth of the Northern Marianas Islands

The Commonwealth of the Northern Marianas Islands (CNMI) is the second illustrative case, and shares even more in common with the FSM than American Samoa. The CNMI and FSM both belong to the geographic and ethno-cultural region known as Micronesia and the CNMI had entertained joining with the FSM in a much larger Federation that was discussed during the dissolution of the Trust Territory. At 464 sq km, the CNMI is about two-thirds the size of the

FSM with a population that is less than half of the FSM's 102,000 citizens. Like American Samoa, the CNMI also has a governor and bi-cameral legislature that govern island life (CIA 2011).

Unlike American Samoa, textiles and tourism were the main vehicles of economic growth in the CNMI during the Compact period. Again, using its preferential arrangements under Section 936 and Headnote 3a, the CNMI was able to establish a significant garment manufacturing industry. Although annualized data is unavailable, CNMI (2002) statistics gathered at five-year intervals show that the earnings from manufacturing (primarily garments) increased from \$58 million in 1987 to \$264 million in 1992 to \$772 million in 1997. Assuming a linear growth rate from 1986-1997, and earnings averaging \$772 annually from 1998-2001, this amounts to total manufacturing activity of over \$6.5 billion, compared to perhaps some \$30 million in the FSM during the same period, whose manufactures averaged some \$2 million annually from 1995-2001 (FSM 2009).

Once again, the main substantive difference between the CNMI and FSM as would pertain to garment manufacturing is the Headnote 3a and Section 936 status afforded to the former but denied to the latter through a complete removal of duty-free textiles access under Section 401(3)(c) of US Public Law 99-239.¹¹ Given the relative size and population, one could expect that at least half of the garment manufacturing activity in the CNMI during the Compact period could have been located in the FSM. However, I once again conservative assumption that only 25% of the over \$5 billion in garment manufacturing would have been located in the FSM due to

¹¹ Although the CMNI does have a generous local tax-rebate system which, when combined with Section 936 status, creates individual tax conditions that are comparable to what the FSM would have had to offer under Section 254 of the Compact (Rogers 1988, p. 55).

unobserved geographic, socio-economic, or institutional factors. However, this still implies an additional GDP realization of over \$1.25 billion during the period, or over \$125 million in additional government revenues. Like American Samoa, and as shown in the figures above, the garment industry only expanded rapidly in the CNMI *after* implementation of the Compact, timing that once again suggests that additional investment in the garment industry in the CNMI was conditioned based on the absence of Headnote 3a provisions in the Compact.

However, textiles are not the only industry that experienced rapid growth in the CNMI during the Compact period. Largely using revenues derived from the garment industry, the CNMI was able to attract and build the necessary infrastructure for developing a substantial tourism industry, averaging over 450,000 tourists expending some \$431 million per year from 1986 to 2001 (CNMI 2002). The FSM, by comparison, averaged no more than perhaps 20,000 tourists per year during the same period, averaging 17,000 annually from 1996-2001 (FSM 2009). While this tourist activity cannot be directly linked to the removal of the tax and trade provisions, it is illustrative of how the CNMI was able to use revenues garnered under Headnote 3a activities to invest in expanding and diversifying its economy. While the FSM is slightly further from the East-Asian tourist markets compared to the CNMI, it is plausible to assume that given similar investment levels in tourist infrastructure the FSM could have seen a substantially larger influx of tourists during the Compact period.

Thus, compared to its US insular sisters, the FSM's weak economic performance seems attributable, at least in part, to its lack of preferential tax structure and tariff access. Conservative estimates of the economic loss sustained by the FSM compared to the CNMI or

American Samoa are over \$1 billion. Comparing this to the estimates of GDP loss above suggests that the FSM's economic performance could have been in the top of tax haven country performance during the Compact period. This is not unreasonable given that the FSM would have been a legally sanctioned individual tax haven, a status missing in the US territories. As such, American citizens could have set up fish processing or garment operations in the FSM and paid nominal personal income tax on profits earned on the venture but also on *any US earnings*. This would have arguably made the FSM an even more enticing locale for investment, vis-à-vis the CNMI and American Samoa, and could have potentially propelled the FSM to economic heights beyond those two territories.

Conclusions

The preceding analysis suggests that the FSM economy suffered substantially when the tax and trade provisions were removed from the Compact of Free Association. While it is of course impossible to say with certainty what “might have been,” I have attempted to estimate what was lost through both economic estimates and case-study assessments. These findings, summarized in figure 2, show that the FSM lost hundreds of millions of dollars in GDP from 1986-2001, vastly outstripping the \$60 million IDF. Again, these estimates are based on the performance of “normal” tax haven countries and the US Pacific insular territories. Arguably, the tax and trade provisions that would have been extended to the FSM under the Compact would have made the FSM an even *more* attractive locale and as such these estimates may be understated.

<Figure 2 About Here>

Given what was lost to the FSM during the Compact period, it is unlikely that it can ever fully recover to the growth path that might have been. However, the scope of this loss provides a strong impetus for releasing the remaining \$40 million of the IDF to spur productive development in the FSM.

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Appendix I

<Table I.i About Here>

Table 1: Tax Haven Characteristics

Characteristics	Source
No or nominal tax	Hines and Rice (1994), Hines (2005), Dharmapala (2008), GAO(2008), Dharmapala and Hines (2009)
Lack of effective exchange of tax information with foreign tax authorities	GAO(2008), Dharmapala (2008)
Lack of transparency in the operation of legislative, legal, or administrative provisions	Hines and Rice (1994), GAO(2008)
No requirement of a substantive local presence	GAO(2008)
Self-promotion as an offshore financial center	Hines and Rice (1994), GAO(2008)
Small populations	Dharmapala and Hines (2009)
Political stability, good governance	Dharmapala (2008), Dharmapala and Hines (2009)
Island countries	Dharmapala (2008)
Sophisticated communications infrastructure	Hines and Rice (1994), Dharmapala (2008)
Relatively affluent, high concentrations of wealthy individuals	Blanco and Rogers (2010), Dharmapala (2008), Dharmapala and Hines (2009)
Poorly endowed with natural resources	Dharmapala (2008)
British legal origins	Rawlings (2004), Dharmapala (2008)
English as official language	Dharmapala (2008)
Parliamentary System	Dharmapala (2008)

Table I.i – Actual and “Tax Haven” Real GDP (Millions USD) – GDP Approach

Year	Actual GDP	“Tax Haven” GDP	2.5% Simulation	97.5% Simulation	Loss
1986	167.54	167.54	167.54	167.54	0.0
1987	170.93	177.00	171.20	182.77	6.1
1988	181.07	185.18	176.40	193.72	4.1
1989	182.87	200.97	189.32	212.01	18.1
1990	190.69	206.05	192.09	219.25	15.4
1991	201.65	220.19	203.56	235.75	18.5
1992	210.80	238.51	218.71	256.61	27.7
1993	224.63	255.38	232.33	276.30	30.7
1994	226.63	278.70	251.81	302.97	52.1
1995	232.53	283.51	254.37	309.54	51.0
1996	227.19	298.07	265.82	326.85	70.9
1997	211.78	298.86	264.78	329.07	87.1
1998	216.99	286.26	251.68	316.65	69.3
1999	219.89	300.60	262.89	333.34	80.7
2000	230.04	312.16	271.61	347.47	82.1
2001	231.98	334.52	289.68	373.31	102.5
Total	3327.21	4043.50	3663.77	4383.13	716.3