**UNITED STATES**
**DEPARTMENT OF THE INTERIOR**
**OFFICE OF INSULAR AFFAIRS**

# A Private Sector Assessment for The Commonwealth of the Northern Mariana Islands

## 2006 Island Fellows


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# Table of Contents

# EXHIBITS

# I. Foreword

This report is designed to be helpful to the CNMI's policymakers who are looking for ways to make the CNMI more hospitable for private sector economic development. We don't pretend to have all of the answers; we're just trying to make a constructive contribution to the conversation. This report analyzes policy from the perspective of impact on the business climate. We realize that policymakers don't have the luxury of examining policy from that perspective alone, and that social and political factors also have to be taken into account. We believe that it would be presumptuous of us to try to evaluate local policies from a social or political perspective, and respect the prerogative of local leaders to perform that analysis.

We would like the readers of this report to keep a couple of important things in mind. First, this report is designed to focus on areas where the business climate might be improved. The report may therefore appear to present a more negative picture of the business climate in the territory than is warranted. While the U.S. territories are not perfect, their business climates are arguably much better than those in the many developing economies that routinely attract outside investment. All of the territories benefit from the protection of the U.S. flag and the U.S. legal system, duty-free access to the U.S. market, safety (including U.S. military protection), U.S. financial support, use of the U.S. dollar, an English-speaking workforce that is well trained by the standards of the developing world and infrastructure that is good by the standards of the developing world. Each of the territories has its own particular competitive advantages as well.

The reader should also keep in mind that this report is based upon conditions as we found them in the summer of 2006. It is always possible that subsequent events could have a significant impact on how one might analyze the business climate of the commonwealth.

This report was created by two MBA students and reviewed and edited by the staff of the Office of Insular Affairs. We therefore consider the report to be a product of OIA. It is offered with the greatest humility out of the desire to be of service. We recognize that the future of the CNMI belongs to the people of CNMI, and that the role of the Federal Government is to provide our best information and analysis to help island leaders make informed decisions about their future. We hope that this report will be put to good use, and will help the people of CNMI to navigate their way to a strong, prosperous future.

*David B. Cohen*
*Deputy Assistant Secretary of the Interior*
*Washington, D.C.*
*December 2006*

# II. Introduction

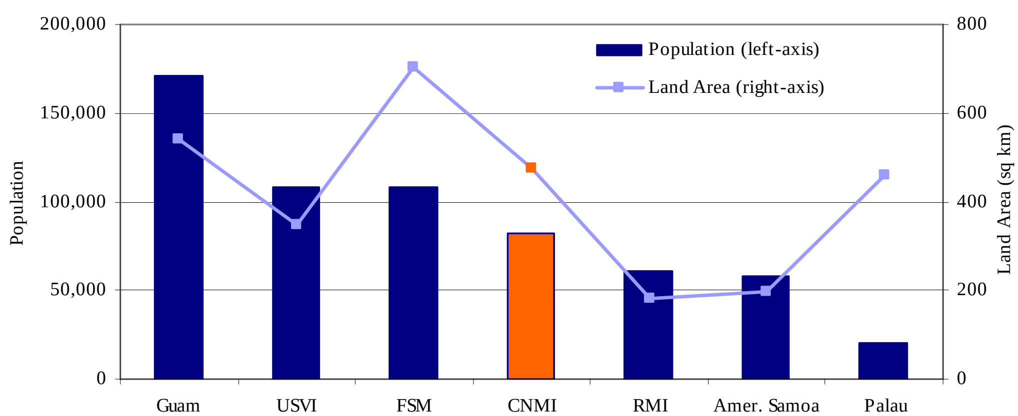
## A. Purpose and Methodology

The private sector drives economic development and serves as the bedrock of dynamic, prosperous economies. At the direction of the Department of the Interior, the Island Fellows embarked on a ten-week assessment of the climate for private sector development in the Commonwealth of the Northern Mariana Islands (CNMI). The Fellows met with business and government leaders to discuss issues affecting the business climate in the CNMI, including taxes, labor, infrastructure and land issues.

## B. Economic Climate

The CNMI, located 1,500 miles south of Japan and 1,500 miles east of the Philippines, consists of 12 islands populated by an estimated 83,000 people, of which 34,000 are non-resident workers.[1] Like most island jurisdictions in the Pacific, the CNMI is small and remote. A comparison of populations and land areas for the seven U.S. insular areas is illustrated below in Exhibit 1.

**Exhibit 1: U.S. Insular Area Comparison**




The CNMI presents unique and substantial opportunities for private sector development. A developed legal and financial infrastructure facilitated economic growth throughout the 1990s, slowed only by the Asian currency crisis in 1997. GDP is estimated to be $900 million in 2005 and largely driven by garment manufacturing, tourism and government employment. GDP per capita is estimated at $12,500.[2] A selective analysis of economic trends pertaining to the overall state of the economy is displayed in Exhibit 2.

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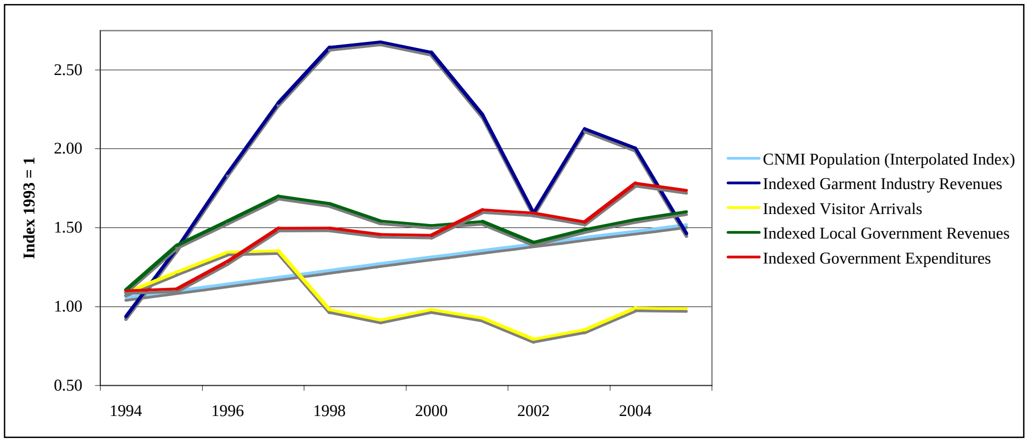
[1] 2006 Population estimates consist of 49,000 local residents and 34,000 non-resident workers.
[2] Source: CIA World Fact Book.

**Exhibit 2: Economic Data for the CNMI**[3]




Unfortunately, a "perfect storm" of factors in more recent years has given rise to serious economic challenges. These factors generally are beyond the control of policymakers in the CNMI. However, CNMI policymakers can mitigate the impact of these external factors and create the environment necessary for economic growth by making wise decisions with respect to factors that are within their control.

Based on the Fellows' observations, land, infrastructure and taxation pose the most opportunities for reform that might help stimulate private sector development. Within these areas, the CNMI could benefit from:

- Land ownership reform that is conducive to long-term investment and stability while remaining cognizant of traditional values and a respect for the law.
- Transparent, strategic management of infrastructure before, during and after privatization initiatives.
- An evaluation of the current tax structure and incentives, leading to a restructuring of current policies to enable the fulfillment of their intended purpose of stimulating investment and growth in the local economy.

[3] Source: CNMI Department of Commerce, Department of Finance, Marianas Visitors Authority.

# III. Land

## A. Introduction

Land is sometimes described as the CNMI's most valuable asset, given its unique topography and climate. Consisting of 477 square kilometers, the CNMI's land is divided amongst private land held by individuals of Northern Mariana Islands descent and public land held by the Mariana Public Lands Authority, an autonomous agency of the government. Current limits to fee ownership of real property may hinder economic growth in the Commonwealth of the Northern Marianas Islands. It would be quite legitimate for the CNMI to decide to retain those limits on ownership for the sake of preserving the local culture. However, it is important that CNMI policymakers approach decisions regarding land issues with a full cognizance of the economic tradeoffs involved and how they might be mitigated.

Future decisions regarding land use in the CNMI can be easily incorporated into the existing legal and commercial framework. The CNMI government has created strong and efficient titling and registration systems, facilitating the efficient transfer of property and security of property rights, which would help the CNMI get the greatest value out of its most valuable asset.

## B. Background

Article XII of the CNMI Constitution limits fee ownership of real property to individuals of at least 25% Northern Mariana Islands descent (NMDs), and (since January 1986) to corporations entirely owned and controlled by NMDs. As amended in 1985, the CNMI constitution currently allows privately-owned land to be leased for a period of up to 55 years. Article XI of the CNMI Constitution limits public land leases to a period of up to 25 years with a 15-year renewal option. In 2011, Article XI and XII may be subject to a vote by NMDs to repeal, renew or rewrite these laws, subject to interpretation of the CNMI Constitution..[4]

The land ownership provisions in Article XII are some of the most stringent of the U.S. territories. For example, a lease cannot include a provision requiring the lessor to "buy back" improvements to the land at the end of the lease term. Such "buy back" provisions are permitted in American Samoa, which has the reputation of having the most traditional land tenure system in the U.S. territories. Some argue that a "buy back" clause would essentially require the lessor to renew the lease in the event that the lessor cannot afford to buy back improvements at the end of a lease. For example, a landowner who could not afford to buy a hotel constructed by the lessee might, with a buy back clause, be compelled to renew the lease. From the other perspective, though, an investor may not be willing to build a hotel if there is a risk of losing the land rights before the investor has had the chance to realize a reasonable return on the investment. The tradeoff of such landowner protections is that they typically come at the expense of protections that might be necessary to motivate businesses to invest in the CNMI.

## C. Cultural Importance

We understand that the CNMI's current restrictions on land ownership are rooted in cultural values. Throughout the Pacific, societies have been working to reconcile the need to preserve

[4] Section 805 of the Covenant legally authorizes a non-alienation of land provision for 25 years after the full implementation of the Constitution, which occurred in 1986.

the culture with the need to provide for the material needs of the people. To the extent that inconsistencies sometimes arise between these two important objectives, it is up to each society to find the balance with which it is comfortable. Our purpose here is not to take a position on important cultural issues that belong to the indigenous peoples of the CNMI. Rather, our purpose is to try to be helpful by providing perspectives on (a) how cultural issues regarding land might be reconciled with the imperative of economic development and (b) the tradeoffs that occur when the two cannot be fully reconciled.

### D. Costs of Maintaining Current Policies

Current CNMI land policies have unintended economic costs, even for people of Northern Mariana Islands descent (NMDs). Given a limited number of available landowners and large landholdings by a small number of families, the illiquid land market is subject to severe price volatility. For example, poorer NMDs who sell land to quickly raise capital in an emergency are at the mercy of a limited number of available buyers who are not only NMDs, but also have sufficient capital at the time to make the purchase. While quick sales always carry a penalty, in a truly efficient marketplace, the original landowner would be able to sell property for the highest price, not to the most capitalized buyer.

Furthermore, depressed prices skew the prices of nearby properties. If a landowner sells property at a depressed price, subsequent neighboring sales of properties would be based on that price. Thus, the downward pressure on land values that results from a limited pool of buyers can tend to spread and exacerbate itself.

Evidence supporting the existence of structural problems with the local land market comes from local banks, which are inclined to quickly sell property obtained via foreclosure and report that the available market for property buyers is small. Obtaining a fair market price for property is reportedly difficult, even when using auction methods. In some cases only one or two buyers bid at depressed prices for valuable pieces of property. Other evidence comes from the real estate services market, which is tiny relative to the CNMI's property market size. Few active agents and appraisers exist, which suggests a low number of transactions.

Current land use policies also have the potential to reduce value and increase costs for investors, as there can be some uncertainty involved identifying whether individuals are of NMI descent. While most indigenous people in the CNMI are legally defined as being of NMI descent, exceptions occur and may be unknown even to individuals who believe they qualify to own land in the CNMI but in fact do not. No mechanism exists to provide certification of NMI descent other than review of birth certificates and church records.

The need to delegate ownership of land to NMDs also adds additional costs for outside investors. Many investors would be unwilling to place such trust in unfamiliar hands without legal protections that are prohibited by the CNMI constitution. Investors are generally averse to not having direct control because it adds another layer of risk to their ability to secure long-term cash flows from improvements.

The lack of clear zoning policies may also cause some investors to hesitate to commit capital to the CNMI, because investors generally want assurances that surrounding properties will not be used in a manner that is incompatible with the uses of their property. In Garapan, for example, a deer farm sits in the middle of a shopping district.

## E. Alternatives

There are alternatives that CNMI policymakers could consider to enable the CNMI to more fully realize the economic potential of its land. In order to create an efficient market for land in which the full economic benefits of real property could be realized by society, it would probably be necessary to remove the Article XII restrictions on land ownership. If that step is not taken, local policymakers might alternatively consider increasing the maximum term of leases from 40 years to 75 or 99 years and clarifying policies governing lease renewals. The policies currently in place do not permit a clear option for lease renewal, especially given a large amount of litigation surrounding Articles XI and XII. This uncertainty can cause concerns for investors. Without a clear option for lease renewal, investors may hesitate to commit capital to the CNMI; if a lease term is too short and cannot be renewed, investors may not be able to achieve a worthwhile return on investment, and thus forego investments in the CNMI. Simply lengthening permissible lease terms may not fully mitigate concerns financiers have about financing development projects.

Any adjustment of Article XII would also benefit from a simultaneous effort to improve zoning. Improved zoning is especially important in an area like the CNMI, where the preservation of its traditional identity and natural beauty are critical. Zoning is not currently part of development planning in Saipan. A zoning board was recently formed, but it has not yet had an opportunity to test its new authority. Resolving these questions would add value both to the CNMI and to potential investors, which tend to be hesitant to invest in markets in which zoning has been poorly defined and the likelihood of a change in policies is high.

The attached case study shows one situation where complicated questions of land ownership and zoning were successfully addressed to the benefit both of the landowners and the community as a whole.

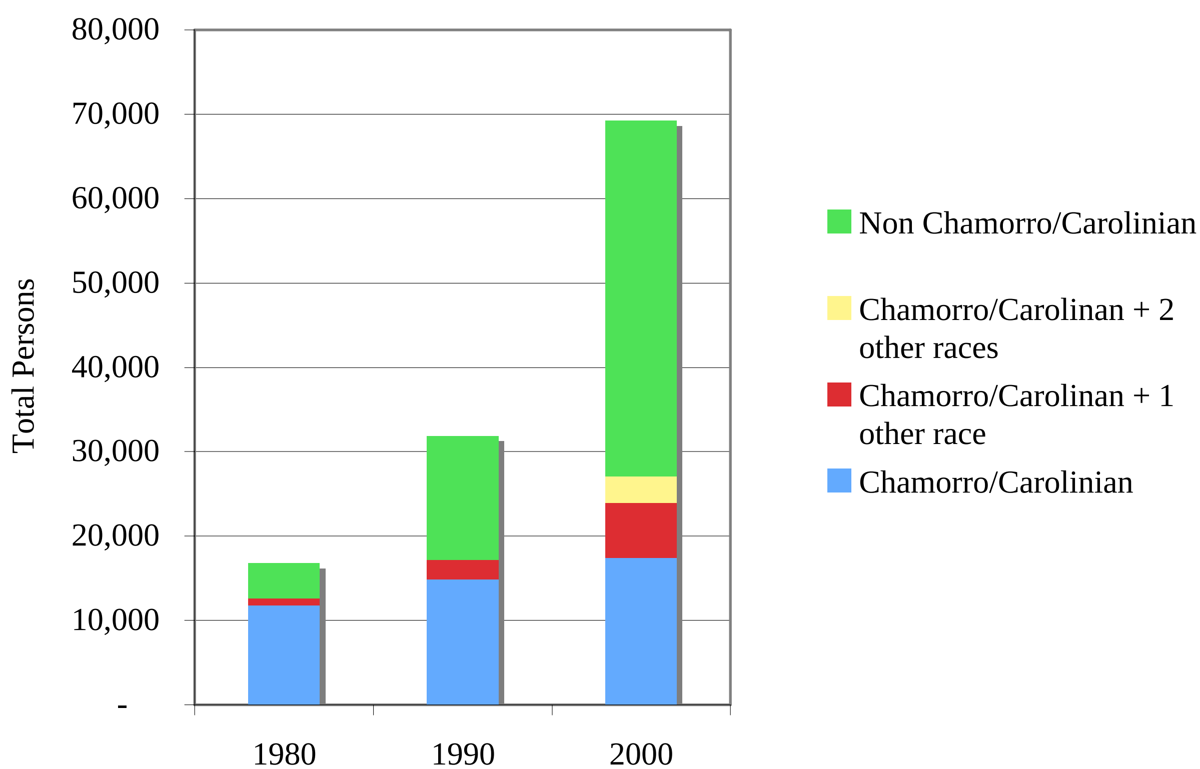
| Case Study: Land Ownership |
|---|
| Waterfront areas typically possess some of the most beautiful and valuable real estate in the world. After the Queen of England bought parcels of U.S. waterfront farmland in the 1700s, a large portion of the land was deeded to an Episcopalian Church that continues to exist to this day.<br><br>Since the 1700s, the Church has entered into long-term commitments to lease land to developers who possess the capital to develop the area. As of 1997, the Church and its subsidiary real estate company owned 45% of commercial property within a large commercial district, amounting to more than 5.5 million square feet of office space. Given the success of this downtown area, it is difficult to argue that land ownership is necessary for developing land. The ability to enter into and renew long-term contracts can bridge a landowner's desire to develop land with a developer's desire to commit capital. However, the role of government to facilitate these contracts is critical in terms of enforcing regulations (such as building, housing and zoning codes) and ensuring contract laws are upheld and leases can be easily renewed. |

## F. Additional CNMI Land Questions

Any laws that continue to require 25% NMI descent could cause further issues in the land market in as little as two generations (40 years) that are unrelated to issues of investor confidence but likely to be of critical interest to citizens of the CNMI. Intermarriage rates between between non-NMDs and NMDs is high, especially since 75% of residents are non-NMDs and a large number of young people enter the military or move to the mainland U.S. As of the 2000 Census, 17,400 residents of the CNMI claimed to be of only Carolinian or Chamorro origin; but a more predictive statistic is that 6,510 residents listed themselves as being of either Carolinian or Chamorro origin and an additional race. An additional 3,095 listed themselves as Carolinian or Chamorro and two more races. (Exhibit 3) The NMD birth rate does not exceed both the death rate and intermarriage rate.

The economic impact could be substantial. In one scenario, children who are of less than 25% NMI descent would be forced to sell their inherited property to a shrinking pool of available NMD buyers, at larger than usual discounts in price. Land could then be accumulated by a small number of large landowners, exacerbating current conditions in which a handful of families collectively own a large percentage of private land. Subsequently, landowners could charge above-market prices for renting and buying land, raising costs for businesses and residents alike.

**Exhibit 3: Ethnic Makeup of the CNMI[5]**




There is a likelihood this issue could become more complicated as the number of available buyers shrinks. Today's political leaders have an opportunity to envision and enable secure and steady growth for their children and grandchildren. Without reform, the future of the CNMI land market is uncertain.

[5] United States Census: 1980, 1990, 2000

# IV. Infrastructure

## A. Introduction

Slow development of infrastructure and the high cost of utilities have had an impact on new private sector activity in the CNMI, exacerbating a slowdown of the tourism and garment industries. The lack of adequate infrastructure, including reliable power and potable water, results in a competitive disadvantage relative to neighboring economies.

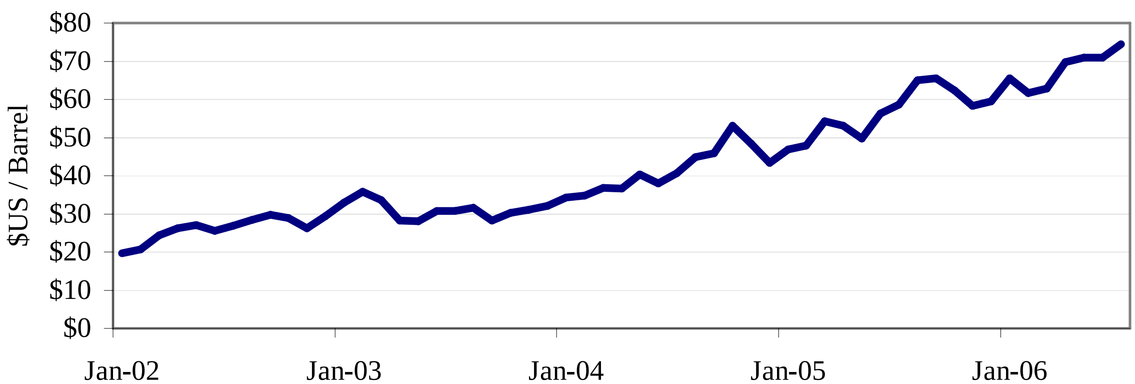
## B. Background

Utilities are under the control of the Commonwealth Utility Corporation (CUC), a semi-autonomous government agency.[6] A lack of consistent and reliable utilities causes the private sector to outlay additional expenditures for a service expected in the developed world. The CNMI can more effectively promote private sector development and compete with other Pacific economies if it offers sound infrastructure to residents and businesses, a fact that the current leadership has repeatedly publicly emphasized.[7]

### Electric

The CNMI relies exclusively on petroleum fossil fuels for energy. Without diversified methods of power production, the CUC is unable to hedge against rising oil prices or access sophisticated financial instruments.

**Exhibit 4: Recent Oil Price Increases**[8]




Currently, only two oil companies, Shell and Exxon-Mobil, service the CNMI, and both use the same oil tanker. Higher fuel prices have created cash management challenges and caused the CUC to defer routine maintenance as it has had to prioritize fuel purchases to meet energy demand.

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[6] As of July 2006, the CUC payroll comprises of 384 employees.

[7] Saipan Tribune, April 24, 2006, quote from Lt. Gov. Timothy Villagomez (former CUC manager)

[8] Spot WTI Price, Dow Jones & Co.

The lack of audited financials since 2004 may hint at internal financial management issues at the CUC. Cashflow management has been hindered by a lack of qualified staff and high turnover. The reluctance to raise electric rates has also undermined CUC's ability to be self-sufficient. Recent increases in base electric rates have been the first since 1989, with the exception of a fuel surcharge added in 2005. These new rates,[9] while more than double the earlier level, still do not offset the utility's cost of producing and distributing its electricity. CNMI electric rates are greater than those of most other Pacific islands, as seen in Exhibit 6. Price differences appear to stem from CUC's operational inefficiencies as well as the various methods used to produce power (e.g. coal vs. diesel) in the islands.

**Exhibit 5: CUC's New Tiered Electric Rates**

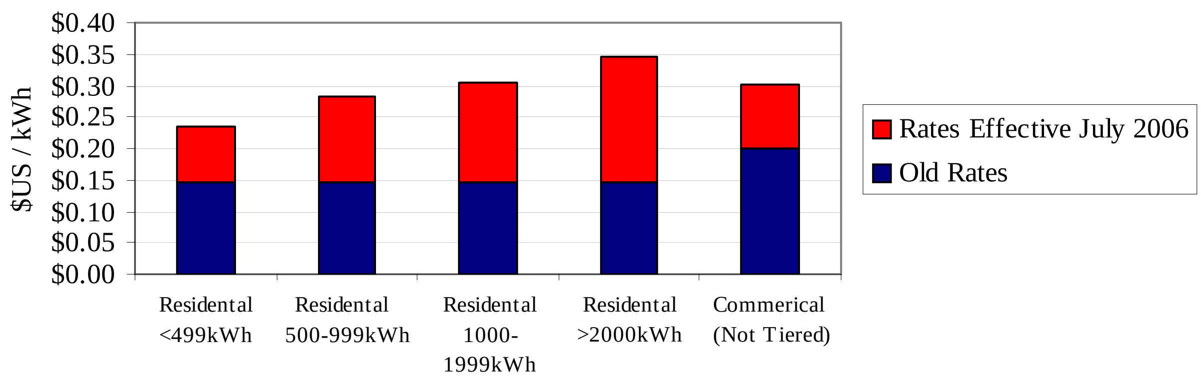
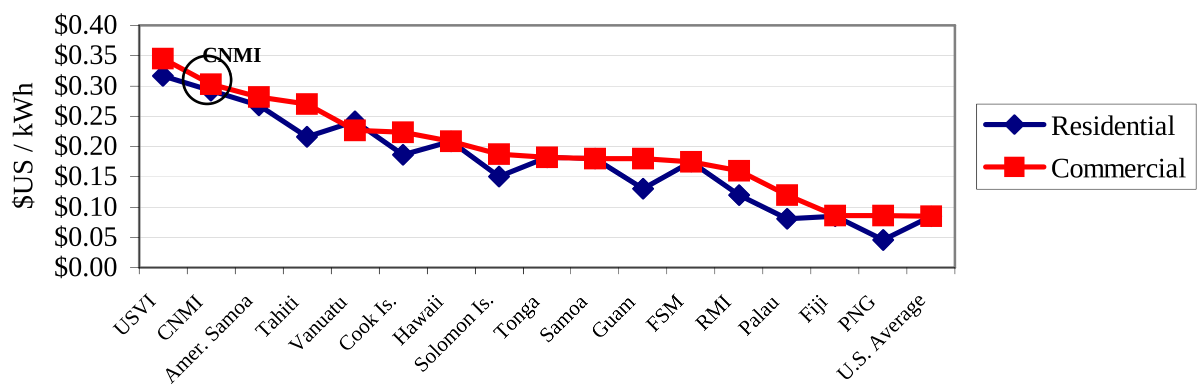



**Exhibit 6: Comparison of Pacific Island Electric Rates[10]**




Unreliable CUC electricity has caused most CNMI large businesses to supply their own backup generator power during frequent island blackouts. Current policies do not allow excess power from these privately run generators to be sold to the CUC. The purchase price of the generator is

[9] Figure 5: CUC's New Tiered Electric Rates
[10] Source: Pacific Power Association under grant from the U.S. Department of Interior.

not a main concern, but businesses do worry about the exposure to variable fuel prices.[11] Routine maintenance and noise pollution, a problem for tourist hotels, are additional concerns.[12] Repeated power surges and blackouts have required desktop computer owners to purchase Back-UPS® battery/surge protectors, which add to the cost of doing business. Typical protectors range in price of $100 per desktop to approximately $500 per server.

There are various other issues relating to electricity in the CNMI. Currently, not all buildings connected to the CUC power grid are metered or charged for their usage. (A similar problem exists for water service.) For example, the legislature, unlike the public school system, does not pay for electric fees out of its own budget unlike the public school system. Until recently, government subsidies have been available and the consequences of CUC operating at a loss were not as dire as they would be for a private company. Economies of scale generally dictate that utilities should produce electricity more efficiently than smaller, privately owned generators, but this seems not always to be the case in the CNMI: some large hotels claim they produce electricity more cheaply than the CUC and prefer self-reliance.

### Water

More than half of the CNMI's businesses and residents receive water for only a few hours a day due to the lack of pressurized water service. Most users have resorted to installing large water storage tanks that fill during the hours they receive pressurized water.[13] Others who live in areas not connected to the municipal water system have found it necessary to dig their own private wells for access to water.

A large portion of publicly supplied water consumers are not metered and only charged a flat fee. This fee structure leads to wasteful consumer habits, and can deprive the water utility of funding for infrastructure improvements and regular maintenance. Brackish water leads to the widespread purchase of 5-gallon jugs of drinking water.[14] Large hotels have built their own desalination (reverse osmosis water) systems, a considerable investment for providing basic amenities to guests.

## C. Potential of Privatization

A deep body of research shows partial or complete privatization of public utilities can lead to greater efficiency.[15] For-profit private enterprises drive performance in ways that government usually cannot; private enterprises have greater incentives to trim redundancies and increase productivity.

Complete or partial privatization is a legitimate consideration for increasing the performance and quality of CUC services. This may take place in the form of corporatization, long-term outsourcing or asset sales. The main benefits from privatization tend to be maximizing performance efficiencies, increasing service quality, and lowering prices for consumers.

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[11] As of July 2006, diesel fuel in Saipan averaged about $3.40/gallon which is approximately 50 cents higher than the U.S. national average.
[12] Maintenance includes filters, lubricants and parts maintenance.
[13] Some large hotels only receive water service between the hours of 4am and 9am daily.
[14] Reusable 5-gallon jugs cost about $2 per refill for self-pickup or an extra $2 for delivery.
[15] World Bank Guide to Privatization. http://www.privatization.org

Choosing which services to privatize will take some consideration; the focus should be on those which provide the largest potential for savings, are the least complex and controversial, and provide the most reliable outcome.

Corporatization would entail reorganizing the CUC along business lines, requiring it to pay taxes, raise capital through financial markets (without government backing), and be governed by generally accepted financial principles. This structure would allow the CUC to focus on maximizing profits and achieving a favorable return on its investments. Other essential requirements of corporatization would be to free the CUC from government personnel and budget restrictions.

A public private partnership (PPP) involves bidding out operations to the private sector for fixed periods through competitive management contracts. PPPs are the most common method of privatization, because they allow governments to retain specified powers.

An advantage of the sale of publicly owned assets, as opposed to corporatization or outsourcing, is the revenue generated by the sale of the asset (i.e. power plant or waterworks). Estimating the value of the asset may be difficult and it should be stressed that transparency of the valuation and sale is key to lessening controversy, as should the tradeoff that exists between charging a higher price for the asset and higher consumer prices after the sale. The capital raised by the sale of any government-owned asset will be relatively large and could be used for non-controversial investments, such as reducing the CNMI's overall debt. Regulatory policies could allow the government to maintain certain controls to reassure local consumers.

After privatization, the CUC would likely display increased productivity, efficiency and reliability. Private managers and owners have profit incentives and motivation to provide quality services. Experienced operators will also transfer knowledge in the form of innovation and the variety of services offered. The real measurement of effective privatization will be lower consumer prices and reliable service.

### D. Alternatives in Addition to Privatization

i. The government could create a public utility board in which some board members are elected and others are appointed. This board would oversee the operations of the CUC to help address inefficiencies, and adopt a more holistic strategy for the future utility needs of the CNMI. A partially elected board could ensure the participation of highly qualified individuals that have the benefit of mitigated pressures from constituents.

ii. The CUC may also consider hiring a CFO with specific qualifications and additional authority to balance the CUC budget, reduce theft, and most importantly, ensure that the price charged to consumers reflects the cost of producing and distributing its services. This will be particularly important if the government chooses to no longer subsidize the CUC. A CFO could also ensure a financial strategy is developed and implemented. There are local examples of similar policies; Guam's power authority specifically requires a CFO be appointed who has a CPA or professional equivalent qualifications.

iii. The government and the CUC may consider metering all consumers, including public buildings, and appropriately bill by usage to eliminate losses and theft and encourage conservation.

iv. The government could consider allowing surplus electricity from privately-owned generators to be sold back to the CUC grid, an activity known as net metering. Net metering would further motivate businesses to rationalize the financing of environmentally friendly energy sources such as solar panels and wind generators. If privately run generators produce power more efficiently and at a less expensive rate, then the CUC could benefit from purchasing back surplus energy, reducing demand on CUC facilities and generation, allowing for a reduction in rolling blackouts, preventative maintenance, and most importantly, lower fuel consumption.[16]

v. Educating consumers about long-term energy efficiency is key to reducing consumption, which in turn relieves pressure on CUC's infrastructure. The Energy Star program utilized in the U.S. is a good example. Consumers can be induced to pay more attention to the Energy Star labels when purchasing new appliances. Switching inefficient incandescent light bulbs for low cost fluorescents, switching to Liquefied Petroleum Gas (LPG) cooking stoves, instead of costly electric powered stoves, and switching to solar hot water heaters, instead of electric ones, are easy ways for consumers to save on energy expenses, which has the added benefits of stimulating new activity in the local private sector and (again) lowering demand on CUC's existing infrastructure.

[16] Some legal issues may be involved with respect to U.S. Federal laws permitting net metering.

# V. Taxation

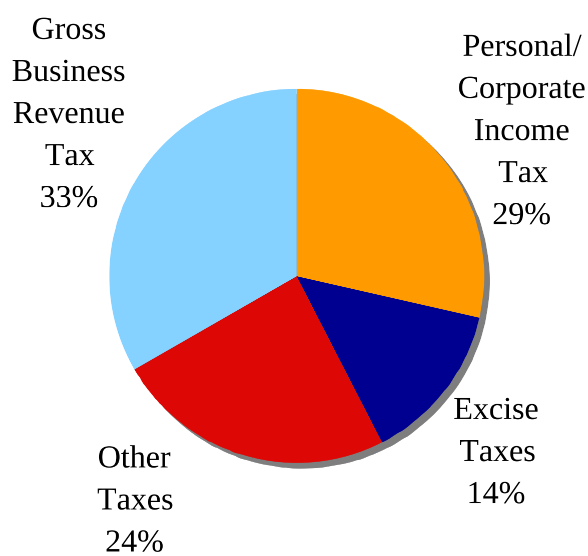
## A. Introduction

The CNMI has one of the lowest effective corporate income tax rates in the world and attractive tax incentives, which at first glance makes it difficult to understand why more investors have not committed capital to the territory. However, there are some indications that the low tax rates may not be equally available to all businesses and that the tax structure actually penalizes businesses as they become less profitable.

## B. Doing Business in the CNMI – Corporate Tax Rates

The government relies extensively on corporate taxes for revenue. Of the $230 million in revenues to the general fund of the CNMI government, 29% was realized via income taxes and additional 33% was realized via the Gross Business Revenue Tax.

**Exhibit 7: 2005 Government General Fund Revenues**[17]




The CNMI government has tried to develop a favorable tax climate. Personal income taxes are capped at only 9% at the highest tax bracket ($50,000+) and corporations in the CNMI pay the Northern Marianas Territorial Income Tax (NMTIT), which is a mirror of the U.S. income tax code. However, all income taxes (corporate and personal) are rebated on a sliding scale of 50-90%.

[17] CNMI Department of Finance

**Business Gross Receipts Tax**

| Revenues | Tax Rate |
|---|---|
| $5,000 | 1.5% |
| 20,000 | 1.5% |
| 50,000 | 2.0% |
| 100,000 | 2.5% |
| 250,000 | 3.0% |
| 500,000 | 4.0% |
| 750,000 | 5.0% |
| 1,000,000 | 5.0% |

**U.S. Corporate Income Tax (NMTIT)**

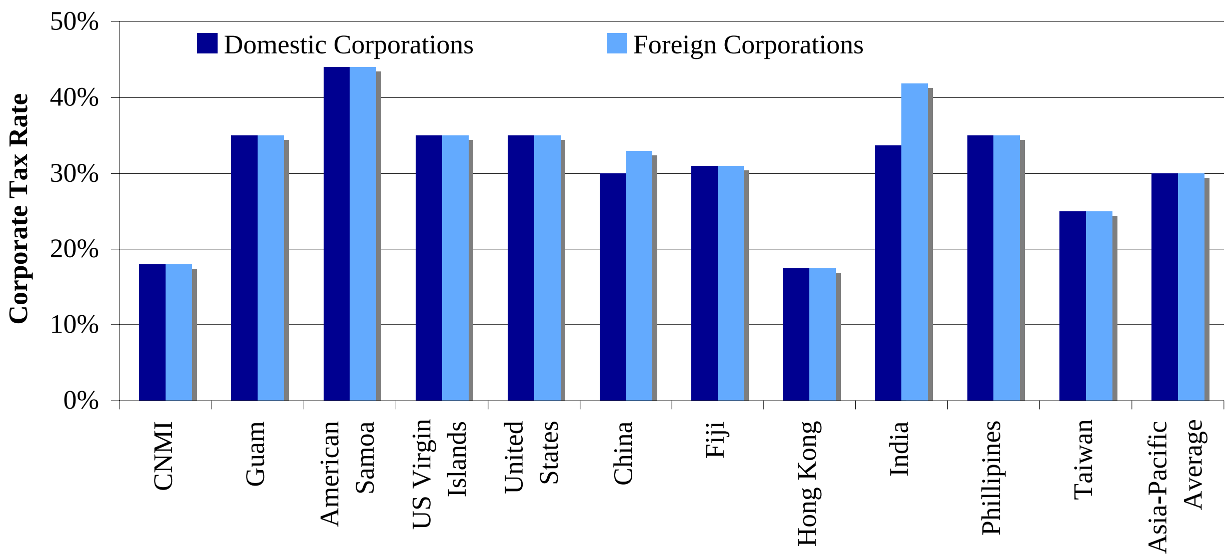
| Net Income | Tax Rate |
|---|---|
| $50,000 | 15% |
| 75,000 | 25% |
| 100,000 | 34% |
| 335,000 | 39% |
| 10,000,000 | 34% |
| 15,000,000 | 38% |
| 18,333,333 | 35% |

**NMTIT Corporate Rebate Schedule**

| Rebate Base (NMTIT Owed) | Amount of NMTIT Rebated |
|---|---|
| $0-$19,999 | 90.0% |
| $20,000-$99,999 | $18,000+70% over $20,000 |
| >$100,000 | $74,000+50% over $100,000 |

CNMI's taxes are very competitive when compared to other jurisdictions.

**Exhibit 8: Comparative Corporate Income Tax Rates**




| Country/ Territory | Domestic Rate | Foreign Rate | Notes |
|---|---|---|---|
| CNMI | 18% | 18% | Businesses are rebated 50-90% of U.S. corporate income mirror tax on a sliding scale. Businesses are subject to a 5% tax on business gross receipts. |
| Guam | 35% | 35% | 35% is highest rate in progressive tax structure. U.S. mirror. |

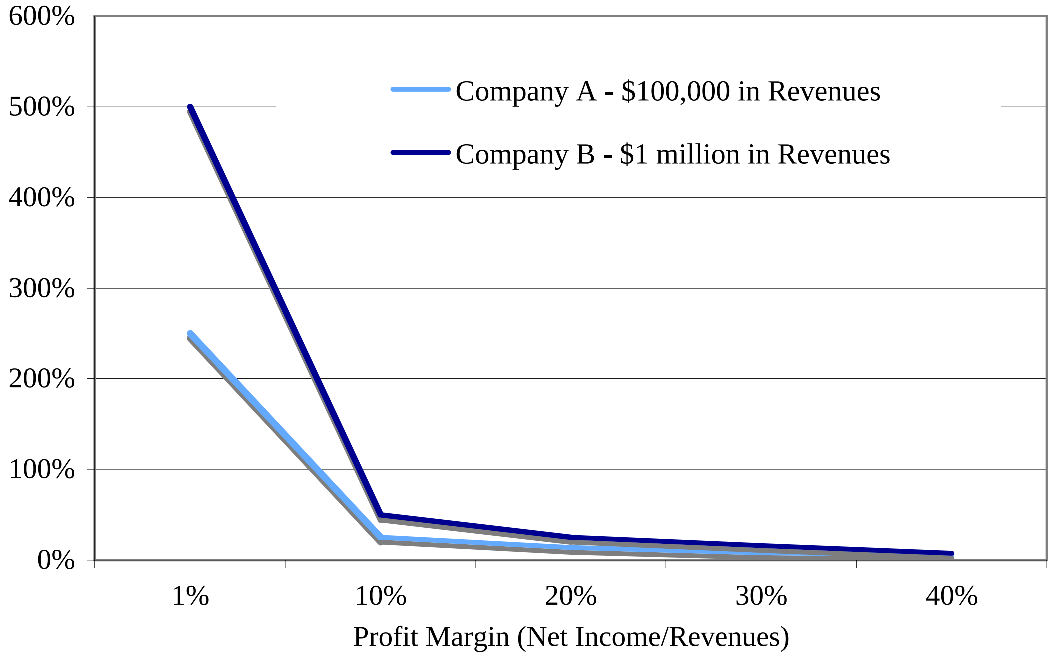
| | | | |
|---|---|---|---|
| American Samoa | 44% | 44% | Progressive Tax Structure: > $650K is 44%, $75-650K is 34%, $50-75K is 25%, <$50K is 15%. |
| U.S. Virgin Islands | 35% | 35% | 35% is highest rate in a progressive tax structure. |
| United States | 35% | 35% | 35% is highest rate in a progressive tax structure. |
| China | 30% | 33% | State Tax 30%, Local Tax 3%. |
| Fiji | 31% | 31% | N/A |
| Hong Kong | 18% | 18% | The 17.5% rate applies to Hong Kong sourced profits that are derived from a business carried on in Hong Kong. Offshore profits, capital gains, dividends and most bank deposit interest income are exempt from taxes. |
| India | 34% | 42% | The effective tax rate for domestic companies is 33.66% (30%, plus surcharge of 10% of the tax, plus education of 2% on tax and its surcharge). Foreign companies are taxed at 41.82% (40%, plus a surcharge of 2.5% of the tax, plus education of 2% on the tax and its surcharge). |
| Philippines | 35% | 35% | After a four year start-up phase, domestic corporations and resident foreign corporations are subject to a 2% minimum corporate income tax (MCIT) based on gross income if the MCIT is greater than the corporate income tax determined by applying the 35% corporate income tax rate to the net income. |
| Taiwan | 25% | 25% | Maximum rate in tax structure, on income over $TW 100,000. |
| Asia-Pacific Average | 30% | 30% | N/A |

Source: CNMI, American Samoa, Guam, U.S. Virgin Islands taxation departments. KPMG Asia-Pacific Tax Analysis January 2006

### Nominal vs. Effective Taxe Rates

Although nominal tax rates are low, for some businesses, effective tax rates are very high. The business gross receipts tax (BGRT) assesses a 5% tax on gross receipts (revenue). This tax "cascades," as the tax assessed is based on the gross amount of any transaction and does not account for the tax already paid. Since the NMTIT corporate tax owed is net of any BGRT paid, the effective tax rate of a corporation rises as profit levels drop. Thus, if there is a 5% tax on a transaction where the profit margin is only 1%, the effective tax rate on that profit is nearly 500%. The exhibit below demonstrates the impact of this cascade.

**Exhibit 9: Effective Corporate Income Tax Rate in the CNMI***




**Effective Corporate Income Tax Rates****

| | | Gross Revenues (in thousands $US) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 5 | 20 | 50 | 100 | 250 | 500 | 750 | 1,000 | 5,000 |
| Profit Margin | 50% | 3% | 3% | 4% | 5% | 2% | 6% | 3% | 3% | 3% |
| | 40% | 4% | 4% | 5% | 6% | 5% | 10% | 8% | 8% | 8% |
| | 30% | 5% | 5% | 7% | 8% | 10% | 13% | 17% | 16% | 16% |
| | 20% | 8% | 8% | 10% | 13% | 15% | 20% | 25% | 25% | 25% |
| | 10% | 15% | 15% | 20% | 25% | 30% | 40% | 50% | 50% | 50% |
| | 1% | 150% | 150% | 200% | 250% | 300% | 400% | 500% | 500% | 500% |

*Income tax rates refer to profit margin on sales, not investment.
**Assumptions: 34% US corporate income tax rate, current CNMI NMTIT rebate structure and BGRT structure for general corporations. Effective tax rates are only estimates. A number of variables could lower or raise a corporation's effective tax rate significantly.

## C. Tax Incentives

The CNMI offers tax incentives in the form of abatements and rebates, which provide another other issues for exploration. Many respected economists agree that tax incentive schemes throughout the world tend to be not effective, as they attract little additional investment.[18] Surveys of investors indicate that tax incentives do not affect location decisions of most foreign direct investment; rather, a reasonable tax environment and the overall package offered by a region is more important. Investors are typically more concerned with basic infrastructure, political stability and availability of labor.[19]

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[18] The World Bank Group: The Foreign Investment Advisory Service
[19] Joel Bergsman, "Advice on Taxation and Tax Incentives for Foreign Direct Investment", May 1999, International Finance Corporation, http://www.ifc.org

In addition to the small return, incentive programs come with high potential costs. The tax drain on government may be significant, the process is sometimes counterproductive because incentive procedures are too complex, and large discretion built into a system can lead to dishonest behavior. Incentives provided to businesses are competitive by nature. As a result, the CNMI may be forced to offer incentives to several companies after offering incentives to a competitor. Incentives create a race to the bottom as they (i.e. competition based on incentives) favor multinational firms at the expense of the jurisdiction and the welfare of citizens. Any competitive incentive advantage tends to be competed away quickly and results in a smaller tax base for the economy. While some successes do exist, e.g. Singapore, most countries have not had success – heavy users of tax incentives include Bangladesh, El Salvador, Jamaica, Mexico, Pakistan, the Philippines, and Turkey[20].

The World Bank suggests that if incentives must be given, it is preferable to tie them to specific activities (e.g. faster depreciation on certain investments and/or tax credits for labor training). To improve targeting, multilateral organizations suggest incentives should activate only after action is undertaken, not for promises. Governments should also ensure that incentives are offered to locals as well and not just foreigners – otherwise businesses will often devise "fronts".[21]

## D. Background of CNMI Incentives

Established to compete with Guam's Economic Development Agency in 1985, the Commonwealth Development Agency (CDA) was intended to be the primary source for generating outside business interest and investment in the territory. Charged with this mandate, the CDA offers tax incentives via loans to U.S. citizens and Qualifying Certificates (QCs). However, despite the significantly wide discretion the CDA board of directors has in awarding incentives, only12 companies have been awarded Qualifying Certificates in the last five years.

Qualifying Certificates are tax incentives awarded to potential investors who meet certain criteria, which usually include minimum investments and local hiring requirements. Tax abatements can include (but are not limited to) the abatement of income, alcohol, business gross receipts and excise taxes. These abatements are commonly in effect for a minimum of 10 years, but as many as 25 years.

Of the 12 QCs approved, three companies walked away from their incentives, two surrendered their incentives after some time and two have yet to make any investment in the CNMI. Of the five businesses currently relying on QCs, three had already invested and started operations in the CNMI prior to the establishment of the QC program. Based on data available, it appears that in the past five years, the CDA has attracted only two completely new investors to the CNMI, totaling $5.7 million dollars of investment, at an estimated cost of $25-100 million dollars in revenue to the government over the life of the program.[22]

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[20] Jacques Morisset, "Tax Incentives" Viewpoint, January 2003, Note number 25x

[21] Foreign Investment Advisory Service, http://www.fias.org

[22] Estimate generated using estimated tax abatements for first five years of QCs awarded. Tax abatements estimate is calculated by using revenue and income projections supplied by QC applicants

An analysis of procedures involved in a QC application combined with conversations with potential investors who have gone through the process suggest that the application process may not clearly define what incentives are awarded and for what reasons, which can have negative implications for a potential investor's ability to determine whether the CNMI is a good place to do business, and create the perception that QC decisions may be politically motivated. [23]

The CDA internal staff does a thorough job of evaluating QC applications and applying its methodology, though some businesspeople have indicated that the staff evaluate applications using unverifiable and unreasonable company projections and market studies that incorporate opinions of an investor's potential competitors. Once the internal staff reaches an incentive package recommendation to pass on to CDA board members for approval, however, the final packages granted by the board are occasionally different, which has led some applicants to go as far as asking the governor to not enact incentives given burdensome requirements the board imposes as conditions to receive incentives.

The governor appoints the board, with two representatives each from Saipan, Tinian and Rota. Decisions at the board level appear to be made on one calculation, the amount awarded in incentives as a percentage of total investment, but this benchmark calculation varies widely from QC to QC.

### E. Quantifying Additional Costs of Incentives

Paradoxically, some businesspeople have suggested that because the CNMI provides incentives, all businesses face unfair competition and barriers to entry. Tax incentives hurt existing businesses by forcing them to compete with new businesses that do not have to pay taxes. Even if incentives were directed towards only attracting new industries, the government may inadvertently create monopolies that can only be broken by providing subsequent investors the same incentives. The garment industry is an example of an industry attracted to the CNMI because of unique tax incentives. Subsequent potential garment investors entered the CNMI, contingent on receiving the same incentives the first garment companies received. As a result, the garment industry proliferated, but at the cost of losses in government revenues.[24] The government already provides government services at a low cost, one that all businesses must bear. New and existing business would appreciate facing the same costs on an even playing field.

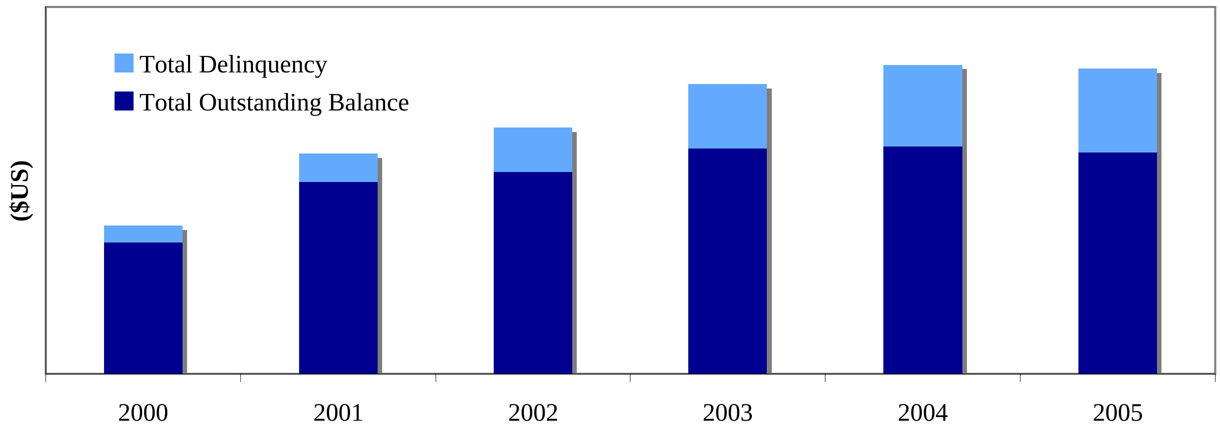
Creating an incentive process can also increase costs by delaying the investment process. For example, the process of preparing for and soliciting a QC can take as few as three months, but as many as six. One hundred twenty days is perceived as excessive in a territory that prides itself in issuing business licenses within two business days. For a $10 million investment, six months of idle investment funds can cost 5% per annum,[25] or $250,000 in six months. Combined with the effort to produce the necessary reports needed for the process, the cost of pursing a QC can

[23] See Appendix B: Process Flowchart for Qualifying Certificate
[24] Arguably, the garment industry currently pays substantial income and excise taxes. We posit that taxes could have been higher had the garment industry organically developed, without incentives.
[25] A rough estimate of the difference between invested capital and idle capital.

amount to as much as $300,000. Despite these added opportunity costs, investors feel they must pursue qualifying certificates for fear of competitors pursuing QCs as well.

Incentives can also force local companies to compete on an uneven playing field with foreign investors. Despite the existence of a CDA loan program meant to assist local businesses as a lender of last resort, there is a widespread perception of politicization of the program. With nearly 86 of 219 outstanding loans in default, investors have lost faith in the ability of the CDA to fairly assess credit; this perception has spilled over to and damaged the credibility of the incentive process as well.

**Exhibit 10: Outstanding CDA Loans**




## F. Alternatives

The CNMI offers significant natural incentives, tax and otherwise, to attract viable industries to the CNMI. The CDA staff can adequately guide investments in a focused, methodical manner. The resilience of the tourism industry, which is comparatively free of incentives, politics, and government involvement, is a testament to the strength of free market investment. Only an industry fundamentally grounded in sound business principles but with a supporting government could withstand the Asian currency crisis, recent economic issues and continue to compete in a highly competitive tourism industry. If the government continues to provide sound financial and legal infrastructure, investors will continue to be attracted to the CNMI. The following suggestions examine ways in which the CNMI could explore refinements of its natural incentives, which were created to foster economic growth in the first place.

i. If a Qualifying Certificate program is needed, the government could consider a moratorium on incentives until a more rigorous methodology is developed and implemented. There is some uncertainty about what incentives are awarded for what reasons, and this perception of wide discretion by the board can cause political pressure on board members from both businesses and constituents. A transparent, published methodology can create guidelines that the board can easily follow and communicate decisions more clearly to investors, as well as relieve concerns of potential investors created by the perceptions of the program.

ii. The discretionary power of the board could also be re-examined. For example, the board currently imposes ad hoc local hiring minimums, which may create tensions within the Executive branch, and any inconsistencies in applying policy, no matter how small, could hurt the CNMI economy by causing new investors to compete with requirements local competitors do not face.

iii. The suggestions for the QC program also apply to the loan program; applying existing loan requirements and pursuing defaults and opportunities with equal energy would add value and strength to reputation of the program.

iv. The government could consider exploring ways it could help protect the CDA board from political pressures. The board could be partially appointed by the governor, partially elected by business, and partially elected by the population at large, assigned to staggered four-year terms, thus decoupling the work of the board from extraneous political cycles and creating a sense of continuity and investment in the work of the board in all of its stakeholders.

v. The government may examine opportunities for making its tax policy, which was designed to be business-friendly, even more so. Some options that the government could explore include substituting the business gross revenue tax with a value-added tax (VAT). The CNMI could also look to phasing out the import excise tax and replacing it with a sales tax or, again, a VAT, as competing countries in the Pacific are joining regional trade groups and eliminating customs and tariffs with member countries. There are some implications to consider when deciding whether to implement a VAT, including:

- It can be expensive and difficult to administer and collect a sales tax or a VAT. It appears that American Samoa tried to implement a 2% sales tax in 1988; however, it was found to be inefficient and ultimately was discontinued. American Samoa found it impractical to require large numbers of business establishments to maintain proper records, and the government estimated that the sales tax was collected on less than 40% of the estimated sales transactions. However, the incremental costs of collection are mitigated, since the CNMI already has a tax collection system based on transactions in the BGRT,
- The VAT depends upon businesses to keep good and honest bookkeeping which may increase an organization's costs and require costly oversight by the tax office. Furthermore, businesses can easily avoid becoming registered taxpayers, which leads to further fraud and tax evasion.
- In cash-driven economies, businesses can easily avoid taxes by not recording sales. It is easier to collect taxes at points of entry.
- If unsuccessful, the CNMI may be viewed as having unstable tax policies, which will make it even less attractive to businesses.

Despite these challenges (which apply as well to a BGRT regime), a VAT mertis consideration for the CNMI. Currently, VATs are in place in more than 120 countries and have been more successful than other types of taxes where income tax collection is weak, as it is in the CNMI. (See Tax Auditing Analysis) Most countries have implemented the VAT with success and it serves as a major source of revenue wherever it has been adopted. The average share of VAT in total revenue in Pacific

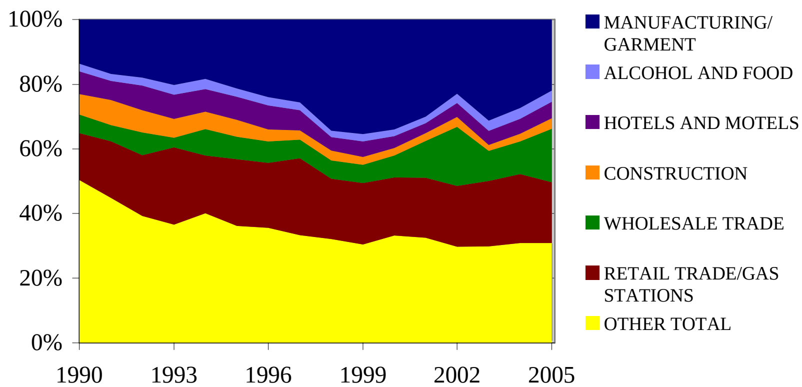
Island countries is 32%, which is higher than the world average.[26] Many positive externalities could result from the CNMI implementing a VAT:

- A VAT may encourage more organization and systematic transactions within the Department of Finance and spur more accurate record keeping by businesses.[27] It can only be beneficial for businesses to maintain better bookkeeping. Encouraging more accurate bookkeeping is not only important to the government, but enhances the CNMI's credibility as a place where businesses are law-abiding members of the community.

## Analysis: Tax Auditing

The Tax and Revenue auditing office staff consists of eight employees, none of whom have achieved any professional accounting training (i.e. CPA certification). In 2005, of the nearly 2,000 business and 45,000 personal tax filings, auditors flagged 77 cases and closed 57. Tax compliance is estimated at 60%, but this number is overstated given that non-resident workers must file taxes to receive worker permits. Despite significant revenues from the BGRT, auditors lack training to evaluate moderately sophisticated tax returns. CEOs of large businesses in the CNMI repeatedly voiced concerns of tax evasion by small businesses and which places legitimate, law-abiding audited businesses at a disadvantage.

**Business Gross Receipts Tax Breakdown by Industry**




- A VAT relieves new businesses of having to pay taxes up front, permitting them to use their resources to further develop their business.
- While full compliance in a cash economy is not likely and avoidance of taxes is also likely, implementation of a VAT will still allow the government to capture at least some of the "value" added in the supply chain, which is not likely to be less than other types of taxes.

[26] Asia-Pacific Tax Bulletin, Page 15
[27] Grandcolas, Christophe, *VAT in the Pacific Islands*, Asia-Pacific Tax Bulletin, January/February 2004.

- Difficulties administering a VAT can be overcome by the CNMI's allocation of resources to develop legislation, administrative procedures, proper training, registration and taxpayer education.[28]

[28]Asia-Pacific Tax Bulletin, Page 22

# VI. Labor

## A. Introduction

The CNMI economy has been dependent on cheap, non-resident labor[29] as a chief input. Strong growth in the economy and a limited resident labor force has required the use of a non-resident labor force to conduct most business. It is difficult to conduct a cost-benefit analysis of various labor and immigration policies and those calculations are not a focus of this section. Rather, our goal is simply to identify how policies may limit competition and business activities.

## B. Background

Based on the most recent available labor statistics, the labor force in 2004 was 58,000, of which approximately 14,000 were U.S. citizens[30] . There were approximately 33,000 non-resident workers and 11,000 workers who permanently resided in the CNMI who were non-U.S. citizens.[31] This data does not include businesses who fail to report employees, residents who have exited the labor force, or illegal immigrants. In aggregate, the size of this unaccounted labor force may range from 8,000 to 15,000. For purposes of this discussion, the unaccounted labor force will not be included.

Immigration policies were developed to foster industries dependent on cheap unskilled and semi-skilled labor. Despite the CNMI government's desire to have non-resident workers available for low-skill occupations only, businesses broadly introduced low-wage non-resident workers at all skill levels, competing directly with skilled, higher wage local workers. Low wages have been floored by a CNMI-controlled minimum wage that is lower than the federal minimum wage.

## C. The Economics of an Imported Labor Force

Efforts to eliminate the non-resident labor pool quickly, including the imposition of federal immigration laws, would probably have a negative impact on the CNMI economy. Investors have entered the CNMI economy with the intention of establishing businesses under favorable labor policies. A sudden shock such as a reduction in the imported labor force could magnify the decline in the economy. There are not enough resident workers to fulfill the demands of the current labor market at current wages. A change in policy would also create additional uncertainty to labor laws and may discourage potential investors.

The CNMI government, which is forbidden by law to hire non-resident workers, pays on average 2.4 times the amount paid to private-sector workers. In 2004, CNMI government employees earned on average $22,677 while the private sector paid employees on average $9,427.[32] This does not account for part-time employees and that government jobs tend to be skilled positions; both factors skew relative private sector pay levels lower. This rudimentary and inexact analysis

[29] Throughout this assessment, the terms foreign, non-resident and guest workers are used interchangeably. These terms refer only to individuals working and living in the CNMI with non-resident work permits.
[30] Measured by W-2 statements filed with the Department of Finance along with Department of Commerce data.
[31] Source: Department of Labor
[32] Ibid

suggests that though government employees are not paid market wages, government employees are overpaid or private sector employees are underpaid. If, hypothetically, the government were examined as one business among the thousands in the CNMI, it would be paying wages similar to those in the private sector. However, it appears this is not the case as, for example, accountants in the government are paid more than accountants in the private sector.

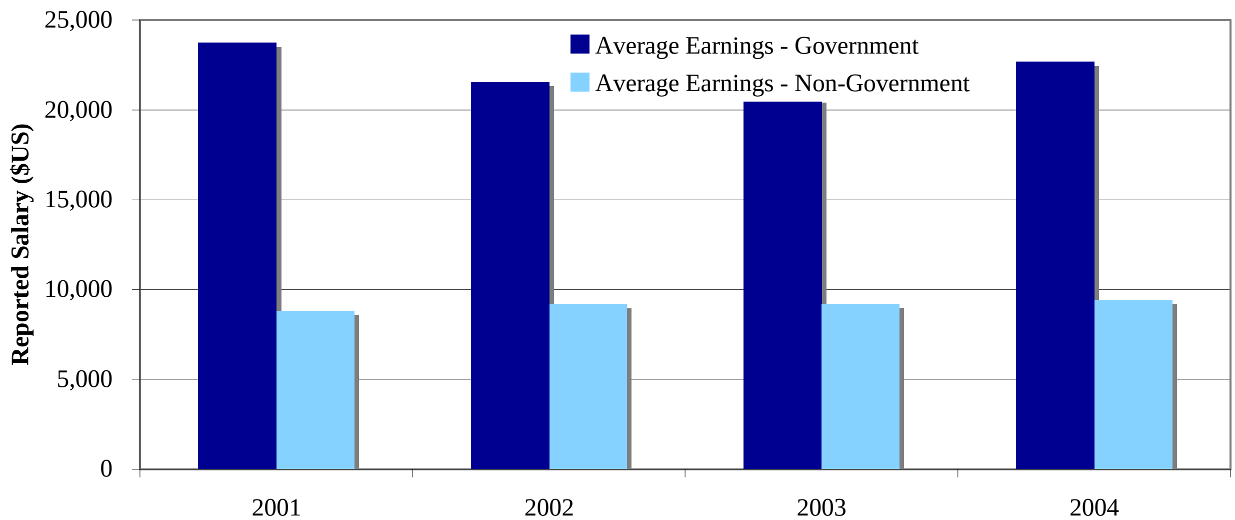



**Exhibit 11: Reported CNMI Earnings**[33]

### Garment Industry

Businesses have argued that cheap labor is the only way to remain profitable and is the CNMI's competitive advantage. Companies, particularly in the garment industry, started their businesses in the CNMI because of easy access to cheap labor. Other businesses (i.e. supermarkets and gaming establishments) have also taken advantage of the availability of cheap labor, lowering demand for resident workers. As a result, overall wages for the private sector have declined given the seemingly unlimited supply of cheap labor.

The current decline of the garment industry has lowered the demand for labor, depressing wages. In an efficient labor market, a declining economy would cause the non-resident workers to return to their point of origin, given a lack of viable opportunities. Rather, in the CNMI, the non-resident garment workers have instead sought entry into other sectors of the local economy, increasing competition for (previously)higher-paying positions. Businesses appear to have shown a tendency to prefer non-resident workers.

[33] CNMI W-2 Statistics

## D. Current Immigration and Labor Policies versus Current Practices

The CNMI government has imposed a moratorium on new guest worker permits. In practice, however, government officials pointed out the law contains loopholes that allow employers of record to permit foreign workers to work in nearly any job, and new permits are readily available. Employers admit to using this privilege and a large number of guest workers are "rented" or transferred to meet demands of other employers. To quote one individual, "the moratorium is a non-moratorium moratorium." Evidence supports this statement: in 2005, the Department of Labor issued a total of 36,405 non-resident worker permits, including renewals, a 9% *increase* from 2004, despite business closures and the moratorium. From a business perspective, the CNMI continues to facilitate access to cheap labor.

Current laws also require companies to maintain at least 20% of their workforce from the resident labor force. The law, however, is widely ignored and unenforced by an understaffed and under funded Department of Labor. Instead, fictitious paper names (ghost workers) are reportedly widespread throughout business. If the 20% resident worker law were enforced, a separate market would have developed for local workers, with increased demand causing wages for resident workers to increase, causing higher costs for businesses. This has not been the case. Instead, employers are routinely given exemptions to hire non-resident workers after advertising jobs for residents at $3.05. Larger businesses that strive to obey the law often feel they are placed at a disadvantage.

Given the higher standard of living expected by most resident workers, many qualified residents are unwilling to accept low wages and have exited the labor market. Residents face direct competition at entry-level jobs, which pay wages below a "living wage". As local workers become locked out of entry-level jobs, the opportunity for businesses to access more skilled workers locally becomes limited. This reinforces the tendency to seek lower-wage non-resident workers, despite the more laborious processes involved.

### Labor Conditions

The garment industry has been under public scrutiny for some time for its labor practices, which have left an unfortunate black eye on the CNMI. The CNMI government has gone to great lengths to improve the labor climate and businesses should now face fewer instances of competition by businesses with unsavory labor practices.

The government has made tremendous strides in writing effective labor laws but the government's lack of resources has impeded the enforcement effort. Under-funded, understaffed and uneven enforcement can impede easy access to labor (local or non-resident) and can also create an uneven playing field, which can discourage potential investors. Providing better resources to the Department of Labor may improve not only the business climate for existing business, but also attract new businesses to a labor market in which all businesses compete for the same pool of labor under the same circumstances.

## E. Labor and Immigration Policy Costs to Business

Foreign workers are often given benefits, some of which, housing and food, do not compare to actual costs for local residents. Most of the workers who are provided room and board are required by the employer to pay the employer up to $100 per month for housing and up to $100 per month for food, not to exceed the actual cost of providing those benefits. For example, guest workers have been willing to live in barracks, which are less expensive than houses local residents live in. Given a Chamorro and Carolinian cultural tradition of family support, local residents shoulder bigger burdens in supporting their local families than, for example, non-resident workers do in supporting their foreign families in China or the Philippines, where the cost of living is lower. Our estimate of the effective minimum wage for non-resident workers is $4.26,[34] These benefits are not available to resident workers, creating a further disincentive to accept lower-paying entry level private sector positions. Exhibit 12 below outlines this estimate.

**Exhibit 12: Non-Resident Effective Minimum Wage**

| | High | Base | Low |
|---|---|---|---|
| Weekly Hours | 40 | 40 | 40 |
| Weekly Overtime Hours | 20 | 17 | 5 |
| Total Weekly Hours | 60 | 57 | 45 |
| Yearly Hours | 3120 | 2964 | 2340 |

| **Wages** | High | Base | Low |
|---|---|---|---|
| Hourly Wage | 3.05 | 3.05 | 3.05 |
| Overtime Wage | 4.58 | 4.58 | 4.58 |
| **Total Weekly Salary** | **$ 213.50** | **$ 199.78** | **$ 144.88** |

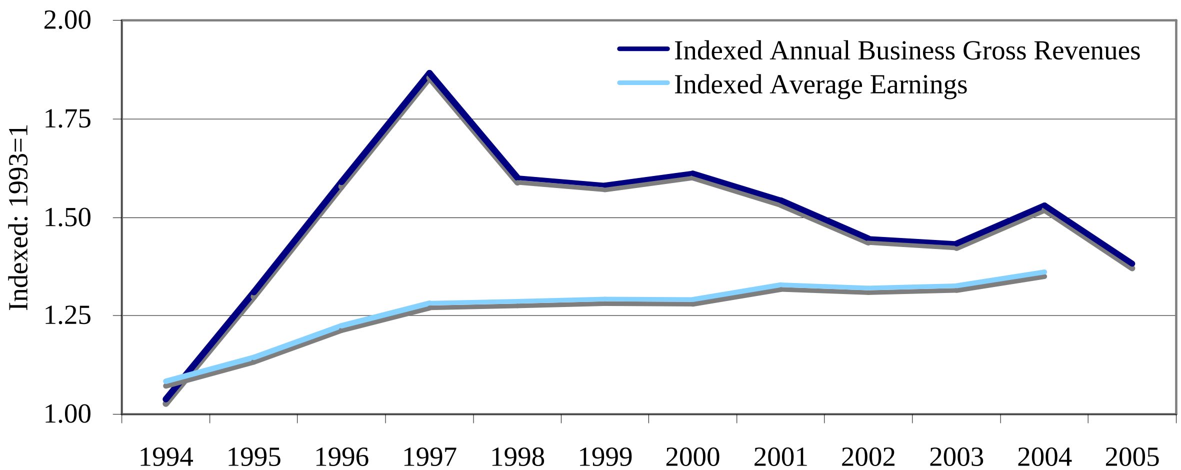
| **Monthly Benefits/Expenses** | High | Base | Low |
|---|---|---|---|
| Food | $ 100 | $ 100 | $ - |
| Housing | 400 | 300 | 200 |
| Health Insurance/Medical | 125 | 100 | 50 |
| Immigration Fees | 23 | 23 | 23 |
| Medical Check | 3 | 3 | 3 |
| Transportation | 150 | 95 | 100 |
| Overhead/Finder's Fee | 200 | 150 | 100 |
| **Total Monthly benefits** | **$ 1,001** | **$ 771** | **$ 426** |
| | | | |
| Total Monthly Costs(Salary+Benefits) | $ 1,214.75 | $ 971.03 | $ 571.13 |
| **Hourly Effective Wage** | **$ 5.06** | **$ 4.26** | **$ 3.17** |

Food and housing figures shown represent the net amount borne by employers after a $100 payroll deduction. For example, the assumption is made that in the High Scenario, food costs amount to $200, but that $100 is recovered by the employer, creating a net benefit of $100.

Exhibit 13 demonstrates average earnings in the territory (1993 index=1) have not kept pace with sharp growth in gross business revenues, further evidence that access to a low cost labor pool has been maintained.[35]

[34] Estimates made on anecdotal survey of 20 businesses in Saipan
[35] Source: CNMI Government

**Exhibit 13: Earnings Growth and Revenue Trends**




## F. Alternatives

Generally, the private sector in the CNMI is able to obtain low cost labor to compete on a global level. Access to labor is adequate and is accompanied by an unexceptional government bureaucracy. Most economists suggest governments should play a minimal role in regulating the labor market. However, given responsibility for immigration policies, the CNMI government could potentially have a large impact on the labor market. Some concern has been voiced regarding the availability of resident labor versus non-resident labor. The focus of this section is not to examine this issue specifically; instead, the authors seek to examine the availability of labor as an input to business. That said, however, there are some issues that could be explored as the CNMI government seeks to refine its immigration and labor policies:

i. The CNMI could decide on the number of guest worker permits the local economy needs and enforce the limit. Allowing an excess number of permits lowers the prevailing market wage. Restricting the number of permits could raise wages and may cause businesses to train and more readily accept local labor, which in the long-term may be more beneficial to the development of a skilled labor pool (as well as mitigating any potential shocks brought on by any policy changes at the Federal level). The permit mechanism has a far greater impact on overall wages and productivity than the minimum wage, and is a commonly-used best practice for managing labor pools. Managing the minimum wage creates a direct effect of increasing wages but will likely not create the desired strategic effect of providing more opportunities for local residents and (from the business perspective) a more efficient and sustainable labor supply.

   If the CNMI implements a system to limit the number of workers, the government may want to consider an auction for workers' visas. The employers who are prepared to pay the most for a work permit are likely to be the ones using non-resident labor most effectively, which is important, as there are several indications that this workforce is not being used as productively as possible.

ii. The CNMI could consider lifting any rules that require employers to fund healthcare expenses for non-resident workers, to compensate for any rise in overall cost of labor. However, the government would likely be cognizant that uncovered healthcare costs would be largely borne by taxpayers, placing stress on government finances and (indirectly) the economic health of the territory.

iii. Another possible compensating measure that the CNMI could explore would be to alleviate housing burdens that currently impose large costs on businesses. This would require the creation of an efficient real estate market. By focusing on enforcing existing housing codes (which are adequate) and zoning regulations (which are in their infancy), the government would facilitate the development of a whole new housing market, generating immense value for the CNMI and especially CNMI residents. The legislature could empower an appropriate executive branch department to deal with these issues and impose punishments directly. Imposing steep fines and punishments for substandard housing could promote guidelines that would raise the quality of life for non-resident workers, increase local private sector participation, and remove significant burdens from businesses that are generally not in the business of providing housing. Active and visible enforcement would in any case promote economic activities and raise land values. Potential investors would be particularly impressed by the government's seriousness in preserving the sanctity of land and claims.

This is a step that should be made with careful consideration, however. There is a valid and serious concern that the CNMI housing stock is limited. By removing any impetus for businesses to bear housing costs, a sudden increase in private housing demand may raise the cost of legal lodging for both locals and foreign workers.. The CNMI could also face the creation of illegal "shanty-towns" or unreasonable housing conditions that could have side effects for the other major industry in the CNMI, tourism.

iv. Eliminating the 20% resident requirement could also be considered. Currently, businesses admit to ignoring this rule and finding loopholes, and cite serious concerns in hiring and maintaining resident employees at market wages. If the government enforces non-resident work permit quotas, given the low supply of trained local labor, local workers will compete at market or perhaps even above-market wages for jobs. Federal policy changes that may limit immigration may force businesses to train and utilize local workers for all positions, at even higher wages; therefore, both the government and private sector may want to explore other alternatives to better integrate local workers into the private workforce before such a shock takes place.

Eliminating the 20% rule also mitigates the "free-rider" problem. If employers are forced to employ residents, they will want to employ them for low wages in occupations with little room for growth, especially since they cannot retain skilled workers at wages that do not compete with government wages or wages in the U.S. mainland (see Analysis, below). Employees, knowing employers must meet a quota, are less productive. In some cases, there is evidence that employers simply pay residents to have resident names on their payrolls. As a result of these factors, the 20% rule appears to limit business productivity.

v. In addition to continuing its ongoing efforts on immigration and labor regulation, the CNMI may want to explore raising the immigration application and renewal fee and dedicating additional funds to enforcement, which would bolster the Departments of Labor and Immigration. The cost borne by government to permit non-resident labor should continue to be borne by the businesses that employ them, and though the fees would increase, this added cost would still be such a small fraction of overall wages that would not materially diminish the competitive advantage.

### Analysis: Competition for Skilled Resident Labor in the CNMI

The private sector regularly voices an inability to attract and retain skilled resident workers at current market wages. Current immigration polices and the labor market both locally and globally reinforce this situation. For a resident entering the CNMI labor market, he/she faces 3 alternatives:

A. Migrate to the U.S. mainland to earn higher wages (average U.S. wage $37,870[36]).

B. Work for the CNMI government and earn $22,000 on average.[37]

C. Work in the CNMI private sector and earn $15,000 (average CNMI U.S. Citizen wage).

Skilled CNMI residents make the same choices non-resident skilled workers make. All workers want to pursue higher wages. The private sector competes with options A and B. The most skilled residents will pursue the highest wages in the mainland. The next most skilled workers will pursue government jobs. As residents cascade down a proverbial labor waterfall from options A to B to C, the least skilled residents become available to the CNMI private sector, reinforcing concerns by current business leaders. Lower wages also reflect lower productivity levels of that labor force.

Finally, the average government wage may be understated. Wages do not reflect superior benefits government workers enjoy, including but not limited to guaranteed pensions, 75% paid healthcare, paid vacation, and job security. Most private sector resident workers do not receive any of these benefits, and (especially if they are hired to fulfill quotas) know there is little room for growth in their positions. This can lead to low productivity and little incentive to seek professional growth that would add value to the employer as well as the employee.

[36] Department of Labor, Bureau of Labor Statistics. http://www.bls.gov Annual wages have been calculated by multiplying the hourly mean wage by a "year-round, full-time" hours figure of 2,080 hours.
[37] Department of Finance, CNMI

# VII. Legal System

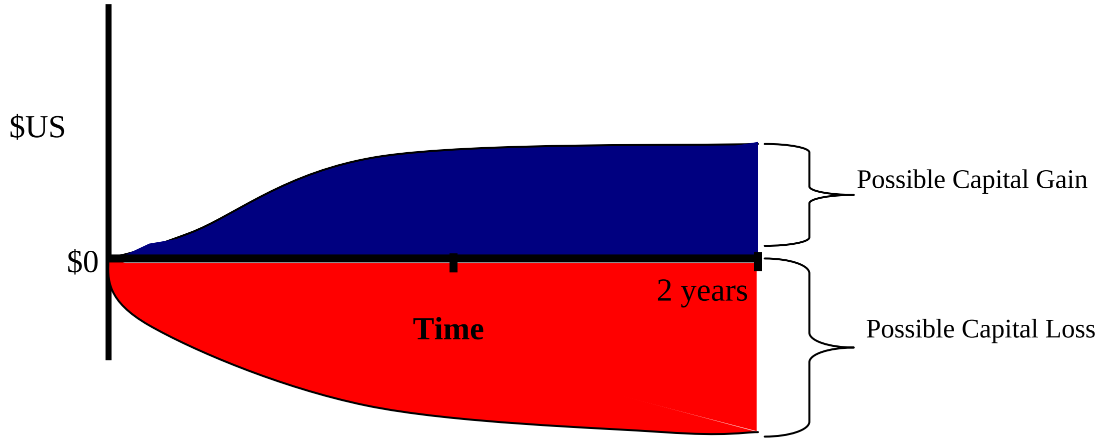
## A. Foreclosure and Property Transfer

The current process for foreclosure and property transfer takes on average 18 to 36 months; the processing time of cases by the Commonwealth Superior Court is comparatively slow when measured against US standards. Financial institutions, lawyers and even landowners themselves have also suggested that judges are overly sympathetic to debtors and will often give three to six months additional time for defaults to be cured before declaring foreclosure. Obtaining a writ of execution takes reportedly an additional six months to process after a foreclosure declaration. Furthermore, in the case of mortgage defaults, the mortgagor has the right to redeem property from the purchaser within twelve months after the date of the sale.

The costs to the economy are large, as landowners face increased exposure to interest rate, real estate and general economic risks. Time spent in the foreclosure process is an added cost, as is the cost of capital tied to the property, offsetting any appreciation in value the land may realize.

As the graph below illustrates, landowners, (either the government or NMDs) face potentially large losses given an inefficient property transfer process; this is not an issue of concern only to potential investors. The graph illustrates that the longer creditors must wait to process foreclosures, the more likely they will end up at a net loss, as the opportunity cost of tying up capital is significant. If creditors have capital tied up in the foreclosure process, capital that could have been invested in other opportunities, creditors will likely lose money, even if land values were to rise during the foreclosure process.

**Exhibit 14: Potential Gain/Loss of Lengthy Foreclosure Process**




**Alternatives:**

i. The government could consider setting aside a specific day each month to process foreclosing properties, such as every third Friday, as is done in some jurisdictions. This would reduce demands on a busy judiciary and allow the necessary agencies to clear any backlog of cases more rapidly. Writ of executions could be automatically issued after a certain amount of time as well, taking into account the dictates of due process.

ii. The government could consider altering laws that require a mortgagor to wait three months from a declaration of foreclosure to apply for a writ of execution, as in most jurisdictions no wait time exists. The right of a mortgagor to redeem property within 12 months after the date of sale is also unusual and can cause uncertainty in landowners, who often feel reluctant to lease the land until that period has passed, which further ties down potential assets that could otherwise be applied towards economic activity.

## B. Mechanics Lien

Current CNMI mechanics lien laws may discourage banks from providing construction loans. The mechanics lien law provides for no statute of limitations, which means no expiration period exists for the amount of time a lien can be claimed, thereby exposing contractors to claims for an indefinite period of time. Banks remain averse to entering into this exposure. The government may consider amending these laws in order to foster construction investment.

# VIII. Financial Infrastructure

## A. Non-FDIC Insured Banks

The Federal Deposit Insurance Corporation (FDIC) does not regulate two of the five largest banks in the CNMI.[38] Existing laws do not prohibit most CNMI government agencies from depositing their funds in non-FDIC member banks,[39] though at the time of this writing the CNMI government does not directly have deposits with any non-FDIC insured banks. Some autonomous agencies do, however.[40] In 2004, CNMI House Bill 14-066 called for all banks to become FDIC insured by 2014, recognizing that the recent weakness in the Commonwealth economy has the potential to impact local banks. The Department of Commerce currently oversees the unregulated banks, but admits to lacking the financial resources and technical expertise to regulate banks as effectively as the FDIC. This in any case is a role that the federal government could readily and more efficiently absorb.

The presence of unregulated banks may also create impressions to potential investors (especially financial institutions) about the nature and political strength of the CNMI government. The government has pressed for all banks to become FDIC insured since 1998, but some banks have not heeded those calls. These impressions are not specific to the CNMI, but are a more general reflection of current world developments. In a post 9/11 environment, especially with the passing of the Patriot Act and the requirements it imposed, financial institutions are extremely wary of any activities at and with unregulated banks, in addition to the unfair competition they present. The existence of unregulated banks may mar the image of the CNMI as a business-friendly location, and the ongoing efforts by the local government to bring the remaining local banks into compliance with FDIC requirements are important.

### Alternatives

The CNMI government could impose the requirements of the FDIC to ensure its own solvency and mitigate risks that even one unregulated bank may pose to a small economy. Additionally, imposing FDIC requirements would transfer most costs of regulation to the Federal government, at a significant savings to local public coffers.

## B. Surety Company Liquidity

Surety companies in the CNMI play a key role in the process of obtaining a non-resident guest worker. CNMI law requires companies to post bonds representing a repatriation ticket, unpaid medical expenses and wages in the instance the business is unable to continue to support a non-resident guest worker. Most surety companies in the CNMI are undercapitalized, however. The insolvency of even a few companies that continue to do business in the CNMI can cause unease with potential investors, who are wary of operating in an environment in which risks cannot be effectively transferred.

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[38] Bank of Saipan, CityTrust Bank. The Bank of Saipan reported in 1999 and again in 2004 that it was "on track" to become FDIC insured. – Saipan Tribune October 12, 1999.

[39] Office of Public Auditor Report, http://www.opacnmi.com

[40] Conversations with high-ranking government officials.

Bonding companies (generally part of the insurance industry) are in the business of transferring risk, and uneven capitalization or insolvency can create uncertainty in the local market. In one extreme example, a local bonding company currently maintains the government-mandated minimum $100,000 in cash reserves. However, this company reportedly possesses in excess of $20 million in bonding liabilities. The Department of Commerce has introduced limited regulations which would require a certain percentage of the premium paid to be held in escrow as a reserve (currently 20%, increasing to 50% by 2008). This requirement is inadequate given the low premiums paid (averaging $50 for a single labor bond) and may not support a wave of immigrants leaving the CNMI.

Bonding is necessary because employers of non-resident workers are required by law to deposit funds in escrow or deliver a bond equal to the cost of return transportation, six months' wages, $6,000 for medical expenses and at least $3,000 for medical referral, embalming and transportation back to the country of origin. The Director of Labor is to annually certify that the bond is acceptable and regularly does so.[41] Bonding companies are certified by the Department of Commerce, which claims to be handicapped by inadequate authority to promulgate insurance regulations and a lack of expertise in this topic area. Uneven enforcement and weakness by some of the companies in a market can both create unfair competition, as well as create negative impressions about the insurance climate in a jurisdiction, both of which could present a deterrent to investment.

**Alternatives**

i. The Executive branch examine options to develop and impose capital adequacy requirements for bonding companies that are more consistent with U.S. practices. The Department of Commerce would have to carefully consider whether to impose strict reserve requirements quickly, or ease reserve requirements; the tradeoff would be between forcing some existing bonding companies out of business and a rise in premiums on the one hand, and prolonging potential investor concerns about the state of the insurance market on the other. The first case is likely in any scenario, as current premiums are too low to support existing liabilities.

ii. The Legislature may consider examining the power of existing laws that govern the regulatory powers of the Department of Commerce. Explicit authority by the Department of Commerce would greatly facilitate more secure risk sharing in the insurance industry, by allowing even faster action on any future areas of concern. Limited authority would correspondingly limit the Department of Commerce's ability to regulate appropriately.

iii. The government could consider placing escrowed funds into the receivership of a private bank. This would serve as a transparent means of managing money intended to secure obligations of the private sector. While banks would not serve as the enforcement arm, they would ameliorate concerns about stability inherent in any insurance industry. This would have the side benefit of relieving the government of burdensome collection and processing costs, and provide an additional source of business to the local private sector.

[41] Public Law 9-42

# IX. Transparency

### A. Government Procurement

The people of the CNMI have a history of being very family- and community-oriented in all areas of their lives. While economists recognize that a certain amount of informality between business and government is helpful in overcoming obstacles and lowering transaction costs, businesses that do not have the same status may be at a disadvantage in their dealings with the government. As in many localities where these relationships are key to doing business, there is the impression that the procurement climate is non-transparent.

### B. Background

Government procurement can often be susceptible to political influence given the size and discretionary nature of sourcing goods and contracts; this issue is hardly limited to the CNMI or even the territories as a whole. Nonetheless, there are concerns that government officials can influence the bidding process for government contracts, and that businesses with personal relationships are more likely to win bids.

Although the CNMI has a regulatory framework[42] to protect the procurement process from undue influence, many businesspeople in the CNMI still report a common perception that current practices continue to circumvent or entirely ignore the framework. Some reported issues include the following:

i. Requests for proposals (RFP) are often published with little notice; businesses that have relationships with government officials tend to be notified earlier and have more time to prepare for the request.

ii. Some believe that without a close relationship with any officials of the proposal-issuing department, bids may not be seriously considered.

iii. Results of the bidding process are not always provided and justified to the public or to the bidding businesses, nor are initial guidelines for awarding bids followed.

iv. Potential conflicts of interest are sometimes perceived to exist and seemingly ignored or deemed unimportant in the decision-making process.

The authors were not in a position to fully verify reports of the above practices or to determine how widespread they were, but even the perception of the existence of these issues could discourage businesses from investing in the CNMI economy. .

The CNMI Office of the Public Auditor has made important strides in improving ethics, transparency and accountability within the CNMI government. Recognized as one of the most effective and efficient public auditor offices in the insular areas, the office has made a major impact. Many of the issues and perceptions surrounding the procurement process could be remedied with still further increased enforcement of existing regulations and by further increasing the transparency of the procurement process.

[42] CNMI procurement webpage: http://www.dof.gov.mp/procure/procure.html
Dept. of the Public Auditor webpage: http://www.opacnmi.com/ethics.html

## C. Alternatives

Further improvements to procurement practices are possible, and the results can be dramatic. As an example, the Buenos Aires city government was able to cut its procurement budget by $200 million in one year following procurement system reforms. This included opening the bidding process to more competitors, using benchmark prices on goods and services being procured, making purchase details available to the public using an internet database, and centralizing the payment system so contractors were paid promptly (and contractors could no longer use delinquent payments as a justification for overcharging).[43] Many Federal agencies such as the U.S. Navy and states such as Virginia are turning to the internet to increase public awareness of bidding opportunities and allowing bids to be submitted electronically after the firms have registered.

The CNMI already has regulations in place to combat perceptions of favoritism toward certain businesses. These further steps could be considered:

i. The government could focus special attention on confirming that the regulation requiring requests for proposals to be made available with ample time for eligible businesses to prepare a responsive bid is consistently enforced.

ii. The government could also consider focusing additional resources on ensuring that regulations requiring delegated procurement officers to state conflicts of interests and ties to bidding businesses to the chief procurement officer (and recuse themselves from the procurement transaction when appropriate) are aggressively applied.

iii. Requiring public justification for accepted bids that are not the lowest cost or within 10% of the lowest cost. This can be particularly important in helping to eliminate the perception that having a low cost bid is not as important as strong government ties, which can have a negative impact on perceptions of the process as a whole.

iv. Exploring a system of benchmark costs for procured items or services against regional or international standards.

v. Publicly announcing bid winners and the amounts of the bid, and briefing non-winning bidders on how they could improve their future bids. This could help bidders more effectively tailor their bids to the needs of the government, as well as facilitate competition.

vi. Designing and implementing procedures allowing businesses to submit objections about the bidding procedures, to be investigated by an entity separate from the procuring department. This is a type of self-policing mechanism that can help alleviate the perception that bidding procedures are not transparent.

[43] Paul Constance, "Lousy Deal," and "Come See for Yourself! The Buenos Aires City Legislature Hopes the Internet Will Erase Doubts About How It Spends Taxpayer Money," *IDB América,* May/June 2000. http://www.iadb.org/idbamerica/Archive/stories/2000/eng/JUN00E/e600e1.htm.

# X. Business Practices

## A. Introduction

The CNMI deals with foreign direct investment in a fairly efficient manner. Saipan's business and permitting center recently streamlined its process by moving all agencies involved to one central location. Basic procedures for obtaining a license are the same whether or not the investor is a CNMI resident.

## B. Background

While visiting the one-stop permitting office, an interested investor will receive a complimentary "Guide to Investing in the CNMI," which is sponsored by the government's executive branch. Firms wanting to make a substantial investment may also visit the CDA to apply for tax incentices through a qualifying certificate. The CDA also provides a more detailed "Setting up a Business Guide" upon request at their offices or through their website.[44]

Documents needed to obtain a permit are:

1.) Application for a business license

2.) Letter of compliance/tax clearance

3.) Workers' compensation clearance

4.) A sketch of the business location

The average turnaround time for approving a business permit from the licensing office is one to five days. Costs for licensing and renewals range from $5 for roadside vendors to $12,000 for poker machine operators.

| Case Study: Poker Machine Licenses |
|---|
| The poker machine license is the most expensive business license, priced at $12,000 per machine, renewed yearly. With an estimated 950 legal poker machines in the CNMI, government revenues from poker licenses add up to nearly $12 million a year, or 6% of the CNMI's total revenue. Anecdotally, the majority of the poker licenses are paid using credits cards to benefit from the accumulation of frequent flier miles for every dollar spent. Currently credit card companies charge up to a 3% merchant fee to the CNMI. This costs the CNMI government an estimated $360,000 assuming all poker licenses are paid via credit cards. |

To legally reside in the CNMI, non-residents must invest a minimum of $100,000 into the CNMI economy to be eligible for the long-term business entry certificate. Although the minimum investment requirement may seem extraordinary, it is actually quite modest; the equivalent visas in Guam, Hawaii, and the rest of the US mainland (EB5 entrepreneur visa) require at least a $1,000,000 investment.

[44] CDA Website: http://www.cda.gov.mp/

## C. Alternatives

Although the licensing and permitting process is reasonably efficient in the CNMI, the process could be further streamlined. Processing license renewals and fee collection electronically via the internet would compliment the new one stop permitting center. Furthermore, new business license applications could be submitted electronically, and cut time spent collecting and sorting through paperwork. Municipalities around the world have been using internet technology efficiently and effectively for nearly a decade, so there are many models that the CNMI could examine.

The number of documents needed for a business license could also be reduced to just a single application. With additional zoning laws and enforcement, a sketch of the business location would not be necessary. The process of verifying workers' compensation and tax clearances with signed letters from the Department of Labor and Department of Finance respectively could be removed entirely by allowing links between the computer systems of all three agencies.

# XI. Conclusions

There is significant potential for private sector growth and development in the Commonwealth of the Northern Mariana Islands. The authors of this report hope that the information presented may be helpful to the people and leaders of the CNMI in the challenges and opportunities they face each day.

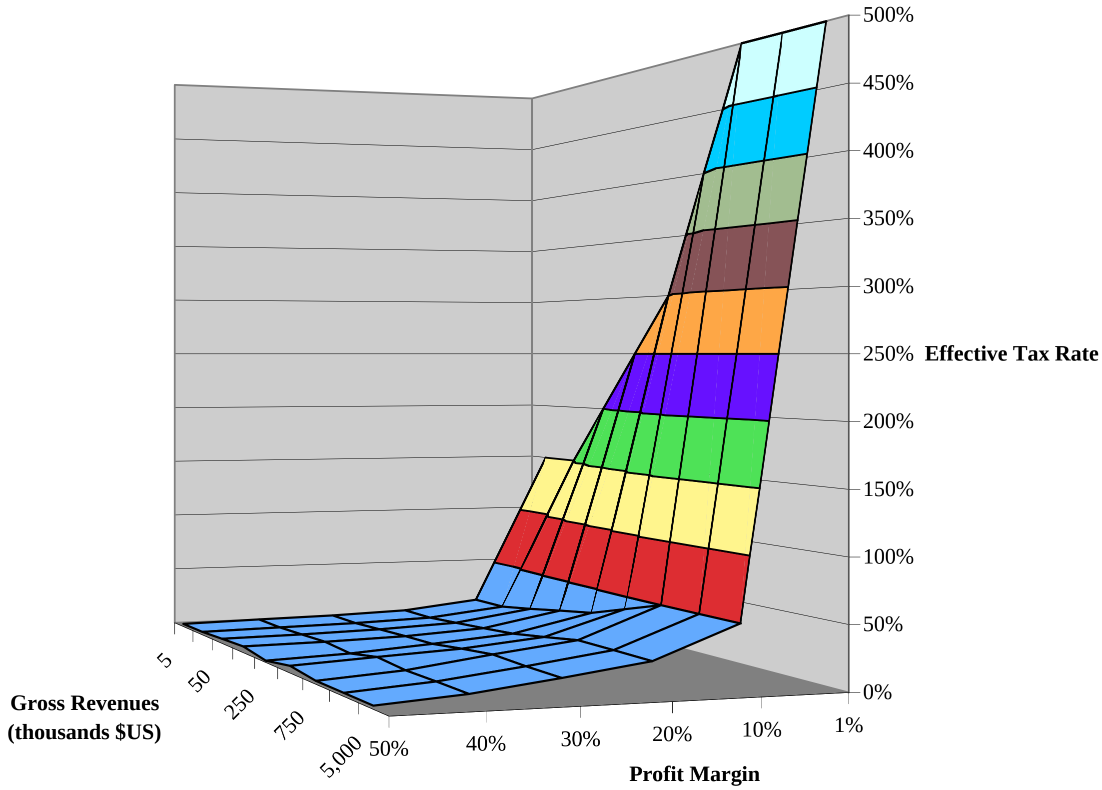
While this report has broadly examined a host of topics, the areas of land, infrastructure and tax continue to possess the most opportunity for discussion. In summary, the CNMI could explore its options (within those broad categories, that would allow it to better accomplish the following:

- Land ownership policy conducive to long-term investment and stability, cognizant of traditional values and a respect for the law.
- Transparent, strategic management of infrastructure before, during and after privatization initiatives.
- An evaluation of the current tax structure and incentives, with an eye towards identifying any potentially inhibiting policies.

Notwithstanding the very serious challenges that it is now facing, the CNMI continues to have great potential. It is up to the leadership of the CNMI to continue to develop and maintain its own vision to sustain an economy driven by the private sector and governed by sound legal principles.

# XII. Appendices

## A. Effective Corporate Income Tax Structure



## B. Process Flowchart for Qualifying Certificate