

February 1994

U.S. INSULAR AREAS

Development Strategy and Better Coordination Among U.S. Agencies Are Needed



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

150691

National Security and
International Affairs Division

B-255486

February 7, 1994

The Honorable Bruce Babbitt
Secretary of the Interior

Dear Mr. Secretary:

The United States has supported programs to enhance the economic development of the U.S. insular areas and the Trust Territory of the Pacific Islands for many years.¹ We reviewed the extent to which the federal government has developed goals and strategies for its assistance and mechanisms to ensure coordination among the various federal agencies that provide assistance to the areas.

Results in Brief

U.S. policy overall is to support the economic development of the insular areas. However, the U.S. government has no specific objectives for its development programs; no clear overall strategy to achieve its goals; and no formal mechanism for coordinating the activities of the numerous federal agencies with programs in the islands. While the Department of Commerce reported that U.S. direct federal expenditures or obligations in the insular areas included in our review totaled about \$1.5 billion in fiscal year 1992,² the U.S. government has no consolidated data on federal spending on economic development in the insular areas. The Secretary of the Interior has proposed establishing an interagency committee that would coordinate federal policy and activities. We believe an interagency group focusing on policy, strategy, and U.S. government coordination could play an important role in helping to improve economic conditions in the insular areas and U.S. government management of resources provided to the areas.

Background

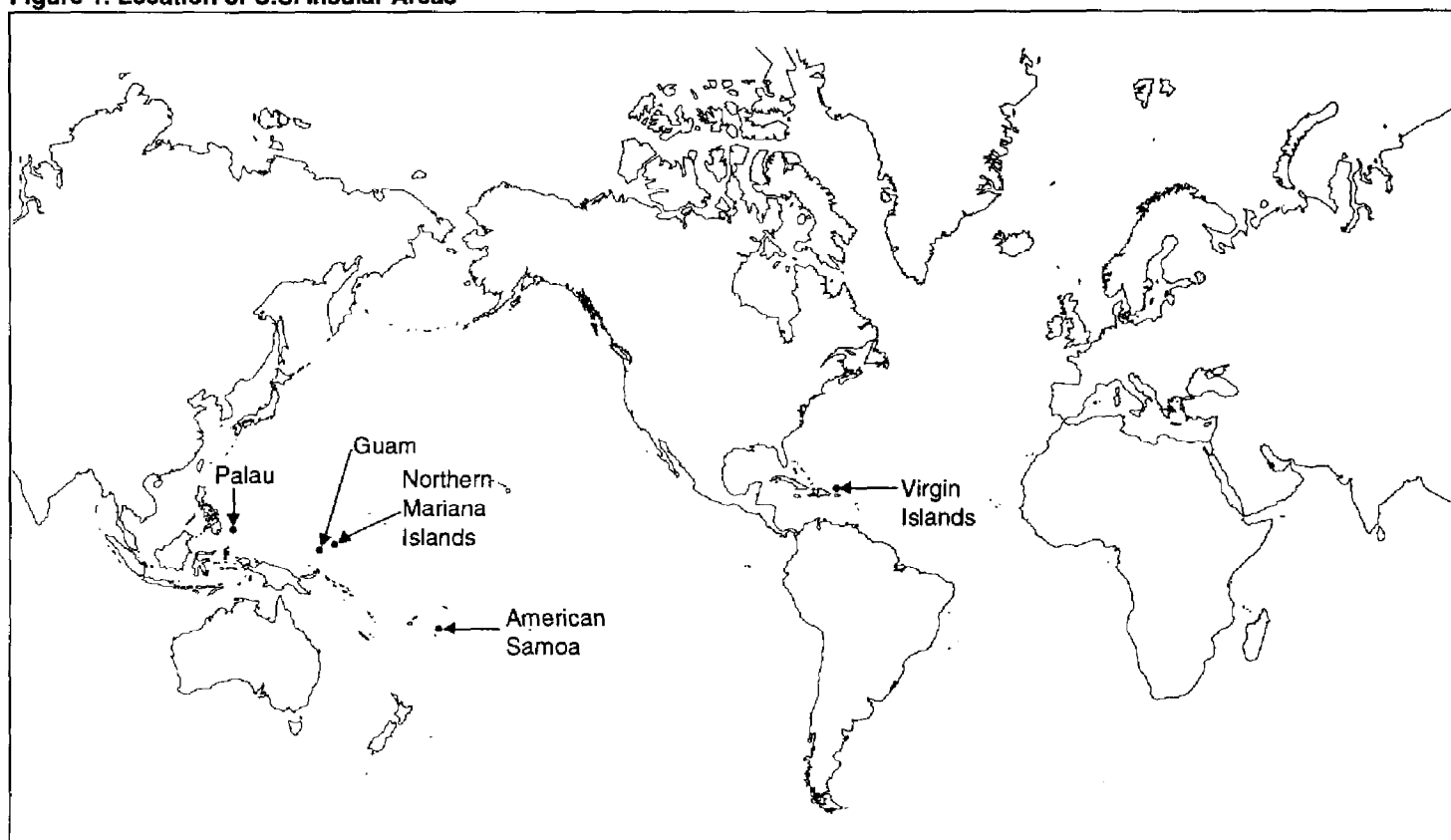
The Pacific insular areas of American Samoa, the Commonwealth of the Northern Mariana Islands (CNMI), Guam, and Palau are between 4,500 and 6,000 miles from the U.S. mainland, closer to Asia than the United States. Their traditional cultures generally emphasize communal living and resource ownership. The Virgin Islands, located in the Caribbean Sea, are

¹Each of the five areas included in this report is generally under U.S. sovereignty and is generally subject to U.S. laws. Each has unique historical and legal relationships with the United States. We use the phrase "insular area" in this report to avoid any implication about these relationships. Palau is the last remaining entity of the United Nations' Trust Territory of the Pacific Islands.

²Consolidated Federal Funds Report for Fiscal Year 1992, Volume I: County Areas, U.S. Department of Commerce, DFFR/92-1.

closer to the United States and have more numerous and diverse linkages to the U.S. economy. The populations of the insular areas are relatively small, ranging in 1990 from 15,000 in Palau to almost 135,000 in Guam. Figure 1 shows the location of the insular areas.³

Figure 1: Location of U.S. Insular Areas



The economies in some insular areas, notably CNMI, Guam, and the Virgin Islands, have grown significantly in recent years, with private sector

³There are 10 other U.S. insular areas that we do not address in this report. The areas are: Puerto Rico and Navassa Island in the Caribbean, and Baker Island, Howland Island, Kingman Reef, Jarvis Island, Johnson Atoll, Midway Island, Palmyra Island, and Wake Island in the Pacific. Puerto Rico was excluded from this review because it is not administered through the Department of Interior. Most of the other islands we did not include are wildlife refuges and uninhabited; however, Johnson Atoll and Midway and Wake Islands support a few U.S. military personnel. The United States also signed agreements of free association with the independent nations of the Federated States of Micronesia and Republic of the Marshall Islands. The agreements, which became law in 1986, pledge U.S. defense of the freely associated states for the 50-year terms of the agreements and financial support for 15 years.

activities and per capita income increasing. American Samoa has been less successful in overcoming development problems. Palau is in the early stages of development, but, according to many observers, has great potential. Efforts to enhance economic development through growth of a private productive sector face numerous constraints. In addition to remote locations, obstacles include lack of resources and workers, and inadequate management of finances by local governments.

The United States exercises sovereignty over the insular areas of American Samoa, CNMI, Guam, and the Virgin Islands. However, since the installation of popularly elected governors, each of these areas is responsible for the administration of local government functions. Palau is the last remaining political entity of the Trust Territory of the Pacific Islands, established by the United Nations in 1947. Because the United States is Palau's administrator, the U.S. government may exercise full administrative authority there and may directly affect the activities of local government. Palauans passed a referendum in November 1993 to accept a Compact of Free Association negotiated with the United States, and administrative steps necessary to terminate the trust territory as it applies to Palau and implement the Compact are beginning. Guam is seeking commonwealth status.

The Secretary of the Interior is charged with (1) maintaining general administrative supervision of federal relations with the insular areas in matters not the direct responsibility of another federal agency, such as the military activities of the Department of Defense and (2) representing the interests of the insular areas within the federal government and directing the provision of federal financial support appropriated by Congress through Interior to the insular areas. These responsibilities have been delegated to the Assistant Secretary for Territorial and Insular Affairs.

Federal funding continues to provide a significant proportion of local government revenues in some insular areas. According to data provided by the insular area governments, the proportion of island government revenue derived from federal funding was 76 percent in Palau, 57 percent in American Samoa, 31 percent in CNMI, 27 percent in the Virgin Islands, and 13 percent in Guam. Appendixes I through V provide information on the economic development status of each insular area, federal assistance, and outlook for further development.

Federal Government Lacks Clear Goals and Objectives for Insular Areas

For many years, overall federal policy has been to support social and economic development of the insular areas. To this end, the United States has provided a variety of assistance, including support for local government operations, capital improvements, and a range of social programs, such as educational and health programs. According to Department of the Interior officials, the majority of assistance is provided for social programs rather than economic development.

In enacting the Compact of Free Association Act of 1985, Congress noted, among other things, that (1) the United States does not have a clearly defined policy for U.S. noncontiguous Pacific areas, (2) the federal government has often failed to consider the implications for and potential effects on noncontiguous Pacific areas in the formulation and conduct of foreign and domestic policy, and (3) the federal organizational arrangements for liaison with and providing assistance to the insular areas may not be adequate to coordinate the delivery of federal programs and adapt policy to the special requirements of each area. Congress required that the Secretary of the Interior, in consultation with the Secretary of State, submit to Congress and the President within 1 year of enactment of the law and each 5 years thereafter, a report on U.S. noncontiguous Pacific areas policy and recommendations as to how to accomplish the objectives of such policy.⁴ A of November 1993, policy for U.S. noncontiguous areas had not been clearly defined, and the required report had not been issued. According to an Interior official, the new administration is looking at relations with the insular areas, but has no plans to report in the near future.

Representatives of the insular areas have complained that federal laws and regulations do not routinely take into account the special situations of the islands. While congressional delegations from the insular areas have access to proposed legislation, and regulations are published for comments, there is no consistently applied process for reviewing the applicability to or impact of federal legislation or regulations on the insular areas. Bills have been introduced in Congress that contain proposals to establish a mechanism to ensure that the insular areas would be consulted before laws are enacted and regulations are adopted that might have negative consequences or be inappropriate to implement in the insular areas. However, no such mechanism has yet been established.

⁴P. L. 99-239 (99 Stat. 1770).

Federal Agencies Work Directly With Insular Area Governments

Although the Department of the Interior has administrative responsibility for insular area affairs, no one federal agency has the responsibility or authority for formally coordinating the activities of all federal programs or activities for the insular areas. Moreover, no comprehensive strategy has been articulated.

According to Department of the Interior officials, the federal government has not developed an economic development strategy for the insular areas because (1) development needs vary from island to island based on demographic characteristics, social needs, level of economic development, and other criteria and (2) enabling local island governments to identify their own priorities, rather than having the federal government dictate priorities, encourages self-reliance.

Nevertheless, without a comprehensive strategy, numerous agencies, each with its own priorities, could be pursuing different development activities according to their own priorities rather than approaching problems in a comprehensive and consistent manner to meet long-term objectives. For example, the Department of the Interior, the Department of Commerce's Economic Development Administration, and the Department of Housing and Urban Development's Community Block Grants provide funding for capital improvements, such as roads and sewers. Because each agency has its own priorities, the federal government cannot be assured that these capital improvements will be done in the manner that best addresses long-term goals.

In addition, there is no formal coordination among federal agencies involved in the insular areas. Coordination should include activities that meet common goals. According to Department of the Interior officials, interagency coordination takes place informally on an as-needed basis, and Department of the Interior field representatives are generally aware of projects and program activities in the small insular areas. In some cases, agencies have co-funded projects. However, due to a lack of coordination, Department of Commerce officials involved in trade promotional activities for the Pacific insular areas were unaware of videos promoting tourism and investment in these areas produced with Department of the Interior grant funds.

The lack of a central coordinating function also means that no federal agency consolidates data to develop a clear picture of the extent of federal funding for economic development going to the insular areas. There is no comprehensive listing of all federal program spending on economic

development in the insular areas. The U.S. Department of Commerce report previously noted showed that about 20 federal agencies, ranging from the Departments of the Interior, Agriculture, and Education to the National Endowment for the Arts, provided grants to the insular areas of American Samoa, Guam, CNMI, and the Virgin Islands in fiscal year 1992. However, this report did not identify what funding was used for economic development projects.

Bills pending in both houses of Congress recognize that coordination is an issue that needs attention.⁵ The Department of the Interior has drafted a proposal for an interagency insular affairs committee of the Domestic Policy Council that could be used as a basis for presidential action. The proposed committee would coordinate federal policy and activities and ensure close consultation with insular area leaders. Such a group, if endorsed by decisionmakers in the administration, could take the lead in reviewing what the goals for the United States in the insular areas should be. As of December 1993, the proposal was being discussed among interested congressional, executive branch, and insular area officials. The Department of the Interior could not estimate when executive action might be finalized.

Conclusions

Although federal funding supports actions designed to enhance economic development in the insular areas, the federal government has not articulated a clear policy about the goals it wants to achieve in the areas and does not always coordinate activities among agencies. We endorse the creation of an interagency committee charged with, among other things, (1) defining U.S. goals and objectives in the insular areas and developing an overall insular area strategy to guide federal activity toward achieving its goals, including supporting economic development and self-sufficiency and (2) establishing a mechanism to coordinate federal activity, including consolidating data on economic development expenditures in the insular areas.

Objective, Scope, and Methodology

The objective of this review was to review the extent to which the federal government has developed goals and strategies for its assistance to the

⁵S. 447, introduced in February 1993, would establish an Insular Areas Policy Council, chaired by the Secretary of the Interior. Comprised of the senior officials of federal agencies, the Council would coordinate the actions of the federal government with respect to the insular areas. H.R. 154, introduced in March 1993, would establish a formal federal insular policy and establish a Council on Insular Affairs to be chaired by the President's chief domestic and foreign policy advisers. The Council would include policy level officials from all federal agencies.

insular areas and has mechanisms to ensure coordination among the various federal agencies that provide assistance to the areas.

To gain an understanding of the economic development status of the insular areas, we reviewed various reports and documentation of current federal programs and private sector activities in American Samoa, CNMI, Guam, the Virgin Islands, and Palau. In performing our assessment, we used data provided by the Department of the Interior, other federal agencies and publications, and the island governments, but we did not independently verify the data. Our assessment of the potential impact of the North American Free Trade Agreement was limited to obtaining the perspectives of officials of the Department of the Interior and the governments of the insular areas. We did not attempt to validate their opinions.

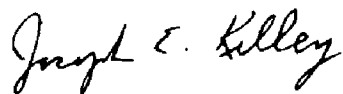
At the Department of the Interior, we interviewed officials responsible for coordinating federal policy to the islands, the Office of the Solicitor, and the Office of the Inspector General. We also interviewed officials with program and policy responsibilities at the Office of Management and Budget and the Departments of State, Defense, and Commerce. We interviewed current and former official representatives of American Samoa, CNMI, the Virgin Islands, and Palau, as well as economic development experts at the East-West Center, the Bank of Hawaii, and the Pacific Development Council in Hawaii. In addition, we requested information from the governors of the insular areas about their perceptions of their islands' development and obstacles to further development. We received responses from the governors of CNMI, Guam, and the Virgin Islands.

We conducted our review from June 1993 to November 1993 in accordance with generally accepted government auditing standards. We did not obtain formal agency comments on this report. However, we discussed our findings with officials at the Department of the Interior and have included their comments where appropriate.

We are sending copies of this report to the Secretaries of State, Commerce, and Defense; the governors of the insular areas; the Director of the Office of Management and Budget; and interested congressional committees. We will also make copies available to others on request.

Please contact me on (202) 512-4128 if you or your staff have any questions on the report. Major contributors to this report were Ronald A. Kushner and Margaret E. Gaddy.

Sincerely yours,

A handwritten signature in cursive script that reads "Joseph E. Kelley".

Joseph E. Kelley
Director-in-Charge
International Affairs Issues

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Abbreviations

CNMI Commonwealth of the Northern Mariana Islands

Profile of American Samoa

American Samoa is a group of seven islands in the Pacific Ocean, about 4,100 miles from the U.S. mainland and 2,300 miles southwest of Hawaii. It has a combined land area of 77 square miles. The population of American Samoa in 1990 was 46,638. American Samoans are nationals of the United States and may become naturalized citizens. American Samoa elects a nonvoting delegate to the U.S. House of Representatives.

Economic Conditions

The American Samoa economy is dependent on two primary sources: its tuna processing and canning industry and the American Samoan government. The canneries supply about half of the tuna consumed in the United States, and the two tuna canneries located on the islands represent almost all of American Samoa's exports. Of the 13,400 persons employed on American Samoa in 1991, about 4,000 (30 percent) worked in the tuna canneries and about 4,900 (37 percent) worked for the American Samoan government. Other sectors generally support these two primary sectors. Because most American Samoan residents prefer to work for the American Samoan government, most cannery workers are nonresidents from Western Samoa.

While many of the problems in attracting industry and capital to the islands are outside of its control, the American Samoan government has not been as efficient and effective as it could have been in supporting development. For example, the American Samoan government continues to have significant financial, budgetary, and internal control problems. The Department of the Interior's Inspector General estimated American Samoa's cash deficit for fiscal year 1992 at about \$30 million; the American Samoan government estimates the cash deficit at closer to \$20 million. These figures are estimates, however, because as of November 1993 the American Samoan government had not closed out its financial records for fiscal years 1992 or 1993. Our 1992 review indicated that a primary cause of the government's poor financial condition was its management practices.¹ Although the American Samoan government has developed an overall plan of action for addressing these problems, it has not yet addressed most of the problems with specific corrective actions.

Under the Samoan tradition, every member of a family contributes to the welfare of the group, a tradition very different from most developed economies, which emphasize individual effort and private ownership of resources. In keeping with its cultural traditions, about 90 percent of the

¹American Samoa: Inadequate Management and Oversight Contribute to Financial Problems (GAO/NSIAD-92-64, Apr. 7, 1992).

land is communally owned by family clans. Land tenure laws generally prohibit sale of land to any person who is less than one-half Samoan, although land may be leased to non-Samoans for up to 55 years.

Federal Assistance

Federal support for American Samoa, appropriated yearly through the Department of the Interior, has averaged over \$20 million per year for the past 5 years. For 1993, American Samoa received about \$22.7 million to support the operations of the local government, including the judiciary, health, and educational systems, and \$6.1 million for capital improvements. In addition, other federal agencies, including the Departments of Agriculture and Education, among others, provide grant assistance. Because poor financial management practices have been a primary cause of the territorial government's continuing financial difficulties, the Department of the Interior is working with the American Samoan government to improve financial management practices.

Development Outlook

American Samoa faces difficulties in attracting new investment and encouraging development, including its remote location, small and unskilled labor force, and limited infrastructure. In addition, limited access to capital, limited managerial skills, the need to import most goods and raw materials, and high labor costs compared to the rest of the region inhibit development of private sector businesses. High costs and the distance to markets restrict American Samoa's ability to export. Land ownership issues are considered by some experts as obstacles to attracting outside investment.

American Samoa is currently debating how to diversify the economy without harm to the local culture. Potential new sources of income for American Samoa include tourism, developing local substitutes for imported products, fisheries and aquaculture, and light industry. Although the tourism industry appears to offer the greatest potential for development in the near future, American Samoa's remote location and current lack of reliable air service makes the demand for large-scale tourism questionable. The American Samoa government is planning to diversify the islands' economy by supporting creation of a garment industry. According to an island representative, the government has recently recruited a textile expert to try to develop a small garment industry.

According to an island representative, the value of economic incentives that have kept the tuna canneries in American Samoa is being eroded; these include reduced tax rates, low labor costs relative to the U.S. mainland, the ability to unload foreign flag fishing vessels, and duty-free entry into U.S. markets. For example, although labor rates are lower on American Samoa than the U.S. mainland, U.S.-determined wage rates on American Samoa are higher than on other nearby islands.

According to a Department of the Interior analysis, the North American Free Trade Agreement may have a long-term negative impact on the tuna canneries upon which American Samoa's economy relies. Currently, Mexican tuna processing facilities do not meet the quality standards necessary to export their products to the United States. However, improvements in Mexican processing plants could lead to competition for American Samoa's tuna processing.

Profile of the Commonwealth of the Northern Mariana Islands

The Commonwealth of the Northern Mariana Islands (CNMI) is geographically a part of Micronesia; it consists of a chain of 12 groups of small volcanic islands in the Northern Pacific, about 6,000 miles away from the U.S. mainland. The CNMI combined land area is about 184 square miles. The population of the island has grown rapidly in recent years, due primarily to immigration, from 43,345 in 1990 to an estimated 1992 population of 52,404. A person born in CNMI is, as a general rule, a citizen of the United States. CNMI has a resident representative who serves as a liaison to the federal government, but it is not represented in Congress.

Economic Conditions

The CNMI economy grew about 400 percent between fiscal years 1982 and 1991, according to the CNMI government. Local revenues increased from \$14.2 million to \$147 million over the period, and commercial activity increased steadily. Employment increased by over 200 percent, according to CNMI government statistics; and, although development has not been evenly spread among the islands, some Pacific development experts said that CNMI, along with Guam, can be considered "developed."

Japanese investment and tourism drove the economic growth during the period. Tourism generated about 37 percent of the gross island product in 1991, according to the CNMI government. Tourism has also sparked increases in the construction industry. The garment industry is CNMI's only manufacturing activity. Garment manufacturers have located in CNMI to take advantage of CNMI's agreement with the United States that goods produced or substantially transformed in the territory may enter the U.S. markets duty- and quota-free under General Note 3(a)(iv) of the tariff schedule.

Development in CNMI, particularly in Saipan, has created jobs that far outnumber the available local labor pool. Foreign workers have been imported to fill the labor shortage. In 1990, the nonresident foreign workers made up 81.6 percent of the labor force, according to the CNMI government, and the number of foreign residents roughly matched the number of local residents. Employment in private sector entry level jobs, such as retail clerks and taxicab drivers, is reserved for CNMI residents, so foreign workers are employed primarily in the tourist, construction, garment, and domestic service industries. Of the local resident work force, the CNMI government is the single largest employer. About 50 percent of the local resident employment is in the CNMI and local governments.

The garment industry is dependent almost wholly upon foreign workers. The U.S. Department of Labor investigated unfair labor practices and violations of occupational safety and health laws by five of the garment firms. Under the terms of a settlement with the Department of Labor in 1992, the firms agreed to a payment of \$9 million in additional wages, and the CNMI government recently passed laws designed to improve treatment of workers. Questions have also arisen about the degree to which industry dependent on foreign labor contributes to the economy when foreign workers spend little of their incomes locally and place strain on the infrastructure. The Department of the Interior is now beginning a study of the costs and benefits of foreign workers on the islands.

Article XII of the CNMI Constitution restricts ownership of land to persons of CNMI descent. Land may be leased to non-island entities for up to 55 years.

Federal Assistance

The CNMI government reported that the multiyear funding appropriated by Congress pursuant to the commonwealth agreement¹ has assisted the island by providing funds for building up infrastructure, economic development, and support of government operations. In addition to assistance provided under the multiyear package, the United States has also provided funding for special infrastructure projects, such as \$10 million to renovate the Saipan port. The CNMI government also reported that federal grants from the Departments of Transportation, Education, Agriculture, and the Interior have been valuable in encouraging economic development, and the Federal Emergency Management Administration's assistance has helped the islands recover from damage from frequent typhoons.

Financial assistance to CNMI under the commonwealth agreement totaled \$192.5 million during the first 7 years (1978-85), and was used primarily to support government operations. During the second 7-year period (1986-92), the United States provided \$228 million in federal assistance, with more assistance dedicated to improved infrastructure and less to local government operations. For fiscal year 1993, CNMI received

¹A "Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States" was negotiated between the United States and the Northern Marianas. The Covenant was signed in 1975, the first constitutional local government took office in 1978, and the trusteeship under which the United States had administered CNMI was terminated as it applied to CNMI in 1986. Under the Covenant, the United States pledged to assist the CNMI government "in its efforts to achieve a progressively higher standard of living . . . and to develop the economic resources needed to meet the financial responsibilities of local self-government."

\$27.7 million in federal appropriations because another multiyear agreement had not been negotiated and approved.

Because CNMI still lacks the infrastructure to be self-sufficient, the United States and CNMI have agreed that the United States will provide \$120 million of federal funding during the 7 years beginning with fiscal year 1994. The agreement, signed in December 1992, has been presented to Congress for approval as part of the normal budgetary process. If approved, federal funds will be used for capital development and, over the 7-year period, will be matched by the CNMI government. The level of U.S. assistance over the 7 years will decline from \$22 million in fiscal year 1994 to \$9 million in fiscal year 2000, while the CNMI matching portion will increase over the period by the same amounts. Because the new agreement requires that no federal assistance be used for government operations and that CNMI match 100 percent of construction funding, CNMI may have to make changes to its local tax system to raise required local revenue. According to the Department of the Interior, the United States and CNMI both expect this to be the final period of guaranteed financial assistance.

The CNMI government has completed a report on tax reforms, including options to generate additional local revenue to support government operations and to match federal funding for construction. The principal option recommended was to implement graduated rebate rates on personal and corporate income taxes. However, the CNMI government did not indicate which proposals and options would be implemented. CNMI has implemented a tax on developers to alleviate the impact of development on key utilities, will soon implement a lottery, and is proposing using bond proceeds from previous financial assistance to raise local revenue.

In 1991, the Inspector General of the Department of the Interior notified CNMI that it intended to undertake an audit of the CNMI's income tax system to determine whether the system was capable of generating sufficient revenues to fund Commonwealth government operations and whether it effectively assessed and collected the income taxes imposed. CNMI challenged the authority of the Inspector General to audit revenue generated locally.² The CNMI government refused to cooperate with the audit, arguing that such an audit of locally generated revenue is an invasion of the sovereignty and principles of self-government. The 9th

²P. L. 97-357, 96 Stat. 1705 (1982), provided the Department of the Interior's Inspector General authority to audit revenues and expenditures of insular areas.

Circuit Court of Appeals has ruled that the Inspector General does have authority to perform the audit.³

Development Outlook

While CNMI has already experienced significant economic growth, the CNMI government has identified diversified private sector growth and increased economic opportunities for residents as its development goals. It has identified its geographic proximity to the Pacific Rim and its political status as a commonwealth of the United States as advantages to enhance development. However, CNMI faces substantial challenges to further development. Although CNMI has experienced significant growth in tourism and in its garment industries, further expansion in these sectors is uncertain due to several factors. First, an economic slump has made Japanese investors generally more cautious. Second, land alienation laws in CNMI are unresolved. Third, inadequate basic infrastructure and the small resident labor pool may hamper future development. However, CNMI continues to be a popular destination for Japanese tourists.

Restrictions on land ownership and leases by nonresidents may hamper further foreign investment in the islands. Because of non-alienation of land laws, long-term leases are the most common means for foreigners to acquire land for development. However, court decisions concerning the validity of land sales and leases have made investors less anxious to invest in these islands.

According to CNMI representatives, the islands' infrastructure is inadequate to support continued growth in tourism. The islands' topography and geography makes it difficult to provide an adequate water supply, and the water does not meet Environmental Protection Agency standards. The sewer system on Saipan, the most populated island, was designed to accommodate a population less than one-half the present population and is not adequate to meet present needs. The CNMI government estimated that almost \$1 billion in infrastructure improvements is needed.

Although the small island labor force has necessitated importing workers for industries, recent labor rights problems have led to changes in the CNMI minimum wage policy. The government of CNMI indicated to us that its policy objectives are to (1) protect the human rights of guest workers, (2) train local people to replace as many nonresident workers as possible to keep the number of guest workers to a minimum, (3) ensure

³U.S. ex. rel. Richards v. DeLeon Guerrero Nos. 92-15884, 92-16372, ___ F.3d ___ (9th Cir. (N. Mariana Islands) 1993).

enforcement of labor laws, (4) establish a fair minimum wage, (5) require that businesses employing nonresident workers generate enough tax and revenue so that local government can pay for added services and infrastructure, and (6) ensure that political power remains with residents by not allowing guest workers to gain citizenship.

According to the CNMI government, the North American Free Trade Agreement would negate the unique trade advantages provided to investors in the insular areas. The CNMI government believes that manufacturers will leave the islands for Mexico to take advantage of lower labor costs. Although a Department of the Interior analysis indicates that the threat of garment plant closures would not be immediate, there may be some long-term impact on the CNMI's garment industry. According to this analysis, the industry has grown primarily as a means for Asian garment manufacturers to ship in excess of their home country quotas by moving machinery and labor to Saipan. Moving operations to Mexico would not offer the same advantage under the agreement because of restrictions on the origin of yarn and cloth. However, in the longer run, as the Mexican economy develops, Asian manufacturers may find it cost effective to move to Mexico and change their operations to satisfy the rule of origin conditions.

Development experts and the CNMI government believe that CNMI should seek to diversify its economy. According to experts in island development, marine resources, including fisheries, marine minerals, and ocean thermal energy conversion, are areas that could be developed further.

The CNMI government identified several areas in which it perceives federal laws and regulations impede opportunities for development. For example, the CNMI government believes that federal control of the exclusive economic zones⁴ around the islands should be turned over to the local government and that land held by the Department of Defense should be available for development. Although asserting no precise estimate of the potential revenue, the CNMI government told us that minerals on the seabed and licensing of commercial fisheries could provide substantial revenue. The CNMI government is currently negotiating with the Department of Defense regarding the potential lease-back of Defense-held lands. In 1988, the Department of Defense indicated its willingness to arrange a lease-back agreement if the CNMI government agreed to use the property

⁴The U.S. federal government has claimed sovereignty over a 200-mile zone extending from the United States' coasts and surrounding Hawaii, Alaska's islands, and those of other states and insular areas. Federal sovereign rights include management, conservation, and development of whatever natural resources may exist in the seabed, subsoil, and water column of the zones.

**Appendix II
Profile of the Commonwealth of the
Northern Mariana Islands**

for purposes not incompatible with possible future military needs. The Department of Defense has not changed its views, but has waited for CNMI to propose an acceptable use for the property.

The CNMI government also noted that it would like to see (1) legislation to allow CNMI to accept assistance from other countries, (2) appropriation of funds to relieve the impact of Micronesian migration approved under the Compacts of Free Association with the Federated States of Micronesia and the Marshall Islands, (3) exemption from proposed legislation that would bar foreign ships from insular area ports, and (4) exemption from some environmental regulations.

Profile of Guam

Guam, a single island of approximately 212 square miles, is the largest island in the Northwestern Pacific and has long been considered of military importance to the United States. Guam is located about 3,700 miles west-southwest of Honolulu and about 6,000 miles from the U.S. mainland. The population of the already densely populated island is growing rapidly, with an estimated 135,000 persons living on Guam in 1992. Guam is the site of two U.S. military bases: Andersen Air Force Base and Naval Air Station Agana.¹ The people of Guam are citizens of the United States.

Economic Conditions

Since the mid-1980s, Guam's economy has increased in terms of employment, per capita income, and local government revenues. Private sector employment in Guam more than doubled between 1981 and 1991 to over 45,700 jobs. As a result, public sector employment, which reached 18,649 positions in 1992, declined as a percentage of all employment from about 42 percent in 1987 to about 27 percent in 1992. Unemployment decreased from 10.1 percent to 4.2 percent, according to the Guamanian government. Between 1980 and 1990, median household income increased from \$15,752 to \$30,755, and local government revenues have more than doubled since 1987 to about \$5.5 million in 1992.

Guam's economic growth has been fueled primarily by Japanese tourism and investment. Several factors made the island attractive to Japanese investment: (1) a stable government due to Guam's relationship with the United States; (2) location, within 1-1/2 hours by air; (3) tropical climate and the largest land area of the nearby islands; (4) better infrastructure than neighboring islands due to U.S.-supported construction; and (5) the ability for foreign entities to own land. In 1991, Guam fell behind only Hawaii, California, and New York in amount of Japanese investment in the United States. Investments totaled over \$1.5 billion during 1990 and 1991.

Guam's rapid development led to a significant rise in both total personal income and inflation as resource and labor markets were stretched. While median household income nearly doubled between 1980 and 1990, Guam's consumer price index increased 101 percent during the 1980s, almost twice the increase of the nation as a whole. The Guamanian government's decision in 1990 to give every government employee a salary increase of \$5,440 (about 20 percent) caused a sudden large increase in labor costs and was a primary cause of an increase in inflation of about 11.5 percent

¹Naval Air Station Agana is one of the bases to be closed in accordance with the 1993 report of the Base Closure Commission.

over the 8.5 percent reported for the previous year. As well as creating inflationary pressure on the economy, this action meant that revenues are not available to invest in the infrastructure needed to improve living conditions. In 1992, the inflation rate was about 7 percent.

According to the Department of the Interior, financial management practices have improved greatly since our 1988 review indicated significant financial problems and widespread internal control weaknesses. However, the Department of the Interior's Inspector General reported in 1992 that the government of Guam had problems in the assessment and collection of property taxes, administration of retirement funds, and planning and implementing road construction projects. The government of Guam has not always taken timely action to address audit findings and recommendations.

Federal Assistance

The government of Guam estimates that federal expenditures in 1992 totaled nearly \$715 million, inclusive of military expenditures,² federal grants, and payments to individuals. In all, according to the Department of Commerce,³ federal grant awards to Guam totaled an estimated \$178 million in fiscal year 1992. In addition to these amounts, the federal government allows Guam to keep the income taxes paid by mainland residents temporarily living on Guam and from Guamanians serving overseas in the military. This amounts to about \$48,500 for 1993. Guam does not receive additional grants for local government operations.

Increased local government revenue has enabled Guam to finance public works projects through the issuance of revenue bonds totaling \$875 million. Since 1989, Guam has requested congressional appropriations for only two public infrastructure projects: a \$3.2-million water project in fiscal year 1989 and a \$2.4-million hospital expansion in fiscal year 1991.

For fiscal year 1994, the government of Guam has requested assistance with socioeconomic problems associated with the impact of immigrating Micronesians. The Department of the Interior plans to address this request through technical assistance programs.

²The government of Guam noted that military expenditures, especially salaries, generally do not have multiplier effects on the island economy. Military families spend a major portion of their salaries on the base so spending does not enter the local economy.

³Consolidated Federal Funds Report for Fiscal Year 1992, Volume I: County Areas, U.S. Department of Commerce, DFFR/92-1.

Development Outlook

In responding to our questions about obstacles to economic development on Guam, the government of Guam identified its political status as the main obstacle to its goal of economic self-sufficiency. The government of Guam stated that the Jones Act,⁴ immigration rules, the exclusive economic zone, and other federal laws, are political issues because they represent federal standards that have been applied to Guam without giving the people of Guam an opportunity for approval or disapproval.

The government of Guam advocates congressional approval of the Guam Commonwealth Act to address its concerns about its political status and representation. The federal government, through an interagency task force, has not supported the enactment of the law as drafted. Key among the disagreements between the task force and the Guam government are the provisions of the bill that would

- give Guam the right to consent to or reject the application of federal laws and regulations in Guam,
- limit electoral rights on the question of political status to the indigenous Chamorro people and their descendants, and
- establish a trust for the benefit of the indigenous Chamorro people of Guam composed of certain lands returned by the United States to Guam.

The federal task force opposed the first provision because it believed that it would exempt Guam from the legislative authority of Congress and from the regulatory authority of the federal government. It objected to the second and third provisions because, among other reasons, they discriminate based on race.

While maintaining the necessity for a completely different political status, the government of Guam is seeking exemption from several regulations that it believes hamper further development. It believes that exemption from the Jones Act, which applies only to Guam among the Pacific insular areas, would reduce costs by fostering competition on the route between Guam and the United States. Guam also seeks exemptions from U.S. laws that prohibit foreign air traffic from flying from Guam to another U.S. point. Guam believes that opportunities for stop-over and through foreign carrier traffic from points in the United States and Asia could help Guam attract U.S. and foreign businesses.

⁴The Jones Act requires that U.S. flag vessels be used to transport passengers and cargo between two points in the United States (46 U.S.C. 13).

According to the government of Guam, Guam's economic development goal is economic self-sufficiency. To that end, the Guam government is seeking to diversify its economic base, including light manufacturing, commercial fishing, agriculture and aquaculture, financial services, high technology, and tourist-related industries. Guam is also examining the potential of developing local industries to replace imported goods and services.

The Japanese investment that supported rapid economic development in the 1980s slowed somewhat in 1992 and 1993 due to a recession in Japan. Guam has good air transportation links to Japan for tourism and access to Japanese markets, although tourism has slowed in recent months, according to a Department of the Interior official. Guam is attempting to diversify the countries from which visitors come to Guam. There is some concern, however, about the tourism industry's ability to recruit and satisfactorily train staff for visitor service.

Although the infrastructure on Guam is superior to that of neighboring islands, due primarily to U.S. investments, electric power is still a problem. The Guam government has approved a new bond issue to finance new generators. The government of Guam also believes that current holdings of land on Guam by the Department of Defense impede the island's economic development. The Department of Defense now controls about 18,000 acres of land on the island, and the government of Guam believes that this is not the "highest and best" use of the land. According to a Defense Department official, Defense intends to continue its presence on Guam for the foreseeable future. However, U.S. Air Force and Navy flight activities will be consolidated at Andersen Air Force Base over several years, and most facilities at the Naval Air Station Agana will be turned over to Guam for civil aviation activities.

The Department of Defense has declared excess about 3,000 acres that could be turned over to the government of Guam for agreed-upon public uses. However, the federal government and the government of Guam have not yet agreed on appropriate uses for the land. In its response to us, the government of Guam stated that uses of the land should be up to Guam and reiterated provisions in the Guam Commonwealth Act that call for the U.S. government to (1) justify the requirement for lands in Guam based on actual use; (2) transfer to Guam without cost or conditions those lands not necessary for direct and continuous operational, logistical, or security uses; and (3) reimburse the government of Guam for the lost revenues that result from the difference between military and civilian use.

**Appendix III
Profile of Guam**

Guam also seeks control over its exclusive economic zone. The government of Guam noted that numerous resources exist in its exclusive economic zone. The government of Guam believes that Guam has an inherent right to the zone.

Profile of U.S. Virgin Islands

The Virgin Islands are located about 1,000 miles southeast of Miami in the Caribbean Sea. Although more than 50 islands and cays totaling 132 square miles comprise this group, only St. Thomas, St. Croix, and St. John have populations of significant size. Most of the other islands are uninhabited or lack facilities necessary to make them habitable. The 1990 population was 101,809. Persons born in the Virgin Islands are U.S. citizens.

The United States purchased the islands from Denmark in 1917. A naval governor ruled the islands from 1917 until 1931. At that time, jurisdiction over the islands was transferred to the Department of the Interior, and a civilian governor was appointed by the President. Island residents were granted U.S. citizenship in 1927. In 1936, Congress passed an Organic Act, establishing a civil government, providing for universal suffrage, and extending most of the protections of the U.S. Bill of Rights to island residents. In 1954, the Revised Organic Act of the Virgin Islands was passed. The act stated formally that the islands are an unincorporated territory. The governor continued to be appointed by the President; the Secretary of the Interior was responsible for carrying out administrative functions for the islands. The act also required the U.S. Treasury to pay to the Virgin Islands federal taxes and duties collected on items produced in the Virgin Islands and shipped to the United States. The amount of the payment could not exceed the total local revenues collected by the Virgin Islands government for the fiscal year. In 1968, the Virgin Islands Elective Governor Act amended the 1954 law to provide for the popular election of the governor. The act eliminated some administrative functions of the Department of the Interior and the right of the President to veto local legislation. In 1972, Congress granted the Virgin Islands the right to elect a nonvoting delegate to the U.S. House of Representatives.

Economic Conditions

The Virgin Islands has the most diverse economy of the insular areas. The Virgin Islands government reported that over 1.9 million tourists visited the islands in 1992, and their expenditures were about \$791.5 million. Manufacturing also plays a large part in the Virgin Islands' economy, with heavy manufacturing (oil refining and alumina production) and light manufacturing (watch assembly, pharmaceutical, garments, sensitive instruments, and rum). Over 2,500 foreign sales corporations have been established in the Virgin Islands to take advantage of special tax incentives on worldwide exports, good infrastructure, modern communications, excellent transportation links, and U.S. currency and postage. There are no specific restrictions regarding land ownership in the U.S. Virgin Islands.

According to the Virgin Islands government, in 1992, the value of imports, exports, and corporate income taxes fell by 25 percent. The U.S. economy's recession and slow growth had a negative impact on the Virgin Islands, according to a Virgin Islands official.

According to the Virgin Islands government, the public sector is still the largest employer, with federal and territorial governments employing about 31 percent of Virgin Islands labor force. Of the private sector employment, wholesale and service industries make up 32 percent and 31 percent of employment, respectively.

The Virgin Islands government has experienced severe fiscal crises over the past several years. The government deficit for fiscal year 1992 was estimated at between \$35 million and \$45 million. In addition to declines in revenues due to the general U.S. recession, the Virgin Islands government did not manage its resources as effectively and efficiently as possible. The Department of the Interior's Inspector General has reported that funds were not always adequately accounted for, consultants were hired without contracts, and equipment and supplies were not always adequately controlled. In addition, lack of accurate and up-to-date financial information contributes to the government's management problems.

Federal Assistance

The Virgin Islands has become less dependent on U.S. funding than are most of the Pacific insular areas. The percentage of funding derived from federal grants has decreased from about 29 percent in 1988 to about 19 percent in 1992. In addition to between \$150 million and \$200 million in federal program grants, the Virgin Islands receive between \$26 million and \$30 million annually from rebates of U.S. excise taxes on Virgin Islands rum.

The Virgin Islands government indicated that programs administered by the Economic Development Administration, the Farmers Home Administration, and the technical assistance programs of the Departments of Housing and Urban Development and the Interior have encouraged economic development. In particular, the government noted that programs that have allowed the insular area flexibility to design programs to meet specific needs were most beneficial. The government identified needs for continued assistance in the areas of health services, law enforcement, drug enforcement, education, and provision of capital for private investments and public infrastructure improvements.

Development Outlook

The Virgin Islands' strategy for economic development is twofold: (1) enhance tourism by attracting more international visitors and (2) diversify the economy by attracting small- to medium-sized manufacturing or nonpolluting assembly industries and expanding the financial services sector. The government has recently developed a strategic plan to address perceived obstacles to development based on a survey undertaken by the Virgin Islands Department of Economic Development in 1990 and 1991. Businesses and community and business leaders surveyed perceived the greatest assets to be affiliation with the United States, climate, tax incentive programs, tourism, English language, and a strong economy. The greatest liabilities identified were lack of public/private partnership, inadequate education/training, inadequate infrastructure, lengthy and expensive permitting process, limited manpower availability, and cost of retraining.

The Virgin Islands government indicated that lack of entrepreneurial/technical knowledge and skills, inadequate shipping and cargo handling facilities within the region, insufficient capital for both private investment and infrastructure improvements, and lack of wind storm insurance are all significant obstacles to increasing private sector growth. The government identified several federal laws and regulations it believes have a negative impact on development. These include rules that govern implementation of textile agreements, lack of on-island U.S. Customs Service clearance for cargo being shipped to the United States, the need for Virgin Islands firms to receive certification from U.S. Customs to export duty-free to the United States, and the reduction in the percentage of federal excise taxes on rum turned over to the local government.¹

Because it has a larger manufacturing sector than other insular areas, the Virgin Islands economy may be more vulnerable to some negative impacts from increased competition under the North American Free Trade Agreement, according to federal and Virgin Islands officials. The rum distilling and watch assembly industries in the Virgin Islands are the primary industries that may be threatened by Mexican competition. The Virgin Islands government asserted that there is a strong likelihood that imports of Mexican rum will flood the U.S. market before the end of the 10-year phase-out of duties on Mexican rum and indicated a need for an import surge "side agreement." In addition to the potential loss of jobs in the rum industry, the Virgin Islands government also pointed out that the

¹Until a few years ago, the Virgin Islands received 100 percent of the federal excise tax of \$10.50 per proof gallon. The Virgin Islands still receives \$10.50 per proof gallon, although the excise tax has been raised to \$13.00 per proof gallon.

excise tax rebates on imported rum make up about 10 percent of the islands' local revenue, a payment of about \$30 million annually. In addition to the duty-free access that would be shared with Mexico and Canada under the agreement, however, rum industries in the Virgin Islands receive 90 percent income tax rebates and exemptions from other taxes under the local industrial incentive laws.

The Virgin Islands' watch assembly industry, like the rum industry, will still enjoy special benefits not limited to duty-free access, if the agreement is adopted. For example, watches imported from the U.S. insular areas are subject to special trade rules that permit them to ship to the U.S. mainland watches assembled from foreign components. Even after the 15-year phase-out of U.S. duties under the agreement, Canada and Mexico will not be allowed to ship watches assembled from foreign components duty free.

Profile of the Trust Territory of the Pacific Islands: The Republic of Palau

The Republic of Palau is located about 4,000 miles west-southwest of Honolulu and 530 miles from Manila in the Western Caroline Islands. The land area of Palau is 170 square miles, and the 1990 population was about 15,100. Palau is the only remaining entity of the United Nations' Trust Territory of the Pacific Islands.¹ The United States does not exercise sovereignty over Palau, and it is bound by the terms of the trusteeship agreement. Citizens of Palau are citizens of the Trust Territory of the Pacific Islands, not citizens or nationals of the United States.

Palau is currently governed under the Department of the Interior's Secretarial Order 3142 and the Constitution of Palau. The United States and the Republic of Palau have signed a Compact of Free Association,² which upon entry into force would terminate Palau's status as a trust territory. The citizens of Palau passed a referendum approving the Compact in 1993. The administrative steps necessary to terminate the trust territory status with respect to Palau can now be begun.

Economic Conditions

Palau's economy remains dependent upon the government sector but has shown slow but steady private sector growth. The government dominates the economy with funds available through various federal grant programs. Fishing and tourism are Palau's main private sector activities. Fisheries exports have grown significantly in recent years, primarily through exports to Japanese sashimi markets. The number of tourists visiting the islands rose to over 36,000 in 1992, an increase of about 12 percent, according to the Palau Visitors Authority.

Pursuant to its laws, Palau grants fishing rights, mainly for tuna, to companies and associations from Japan, Taiwan, the Philippines, and the United States. Subsistence farming dominates the agricultural sector. Also, the laws of Palau prohibit ownership of land in Palau by any non-Palauan citizens or firms, although sites can be leased from the government or private landowners.

According to the Department of the Interior, financial management practices have improved greatly since our 1988 review disclosed significant financial problems and widespread internal control

¹The United Nations created the Trust Territory of the Pacific Islands in 1947 and appointed the United States as trustee of the Trust Territory. Originally the Trust Territory included the Marshall, Caroline, and Northern Mariana Island groups.

²The Compact recognizes that Palau is a self-governing state, but gives full authority and responsibility for its defense to the United States for a period of 50 years. The Compact also guarantees continued U.S. economic assistance to Palau for 15 years.

weaknesses. However, problems remain. For example, in September 1992, the Department of the Interior's Inspector General reported that Palau did not effectively audit or collect gross revenue taxes.³ In 1992, Palau reported the first operational surplus in its history.

Federal Assistance

U.S. grant assistance provides the majority of Palauan national government revenues. In fiscal year 1992, the United States, through the Department of the Interior, provided almost \$24.5 million to support Palau's government operations, and development and capital improvement projects, in addition to about \$8.1 million in grants from other government agencies for education, health, safety, and economic development.

Unlike the U.S. insular areas, Palau may receive foreign assistance from other countries.⁴ Japan has provided about \$3 million per year since 1989. This assistance has been used to install electrical power lines and rural fishing infrastructure. Australia, New Zealand, and South Korea have also provided grants and technical assistance.

Development Outlook

According to federal officials, Palau's potential as a tourist destination is good because of its natural scuba diving attractions known worldwide and hotels that are comparable to those on the U.S. mainland. Several development experts expect Palau's economy to improve substantially after approval of the Compact of Free Association with the United States. Palau's objective, according to Interior officials, is to maximize the benefits of development without endangering the islands' culture and environment.

In addition to tourism, other opportunities for development include mariculture, fishing, and fish canning industries. However, because land ownership is restricted to Palauans and recent legislation enacted further requirements to increase participation of residents, Palau may have difficulty attracting foreign investment.

Upon acceptance of the proposed Compact of Free Association, the United States has pledged to provide annual financial assistance totaling about \$450 million over 15 years. However, according to the Compact

³Billings and Collections of the Republic of Palau's Gross Revenue Tax, Department of the Interior Office of Inspector General (Report No. 92-I-1368, Sept. 1992).

⁴The United States, as a donor nation, does not accept foreign aid. This prohibition covers U.S. states, the District of Columbia, and the insular areas.

Appendix V
Profile of the Trust Territory of the Pacific
Islands: The Republic of Palau

terms, no funds would be available until a national economic development plan is in place. The United States has funded the development of such a plan by a development firm selected by the United Nations Development Program. The plan is expected to be completed in 1994.

The Palau government will have to improve its ability to maintain and manage public sector services efficiently if it is to facilitate economic development. For example, the government faces severe debt problems due to its 1985 default on loans from commercial banks and may not be considered creditworthy. Resources will have to be used to repay debts that otherwise could be used for developing infrastructure.

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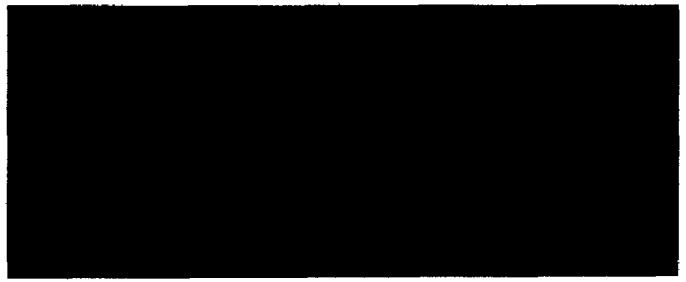
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