

# **GET-RICH OR KEEP TRYING: Reimagining Tax Reform in the Federated States of Micronesia**

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## **ABSTRACT**

Since 2005, the Federated States of Micronesia (FSM), nervous over the uncertain future of the Compact of Free Association and seeking to improve its fiscal self-sufficiency, has wasted time and resources on a pie-in-the-sky tax reform proposal with too many moving parts and too many stakeholders to satisfy. A more practical path to tax reform must be found—and as the authors argue, Hawaii’s unique tax system should be used as a map forward.

The FSM and Hawaii each have broad-based consumption taxes—the gross revenues tax and the general excise tax, respectively. Although these two taxes appear similar at first glance, Hawaii’s tax has developed sophisticated characteristics over the past eighty-five years. Instead of attempting yet again to discard its gross revenues tax, the FSM should transform it. Replicating and accelerating Hawaii’s eighty-five-year tax evolution could offer the FSM a much more practicable—and less politically daunting—shortcut to a modernized, efficient, and lucrative tax system.

## **ABOUT THE AUTHORS**

The authors are both attorneys employed by the Hawaii Department of Taxation and proud alumni of the University of Hawaii’s William S. Richardson School of Law. The views expressed in this Article are the authors’ own and do not reflect the views of the Hawaii Department of Taxation. The authors would like to acknowledge Allison Leffen for her research assistance and guidance, as well as T. Lam Dang for his generous agreement to be interviewed for this Article.

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## INTRODUCTION

In early 2005, as the United States (U.S.) Congress put the finishing touches on what would become the Tax Increase Prevention and Reconciliation Act of 2005,<sup>1</sup> the Federated States of Micronesia (Micronesia) formally began a nationwide tax reform initiative.<sup>2</sup> Micronesia, an island nation in the western Pacific Ocean comprised of more than 600 islands, was in its 26<sup>th</sup> year of self-rule, and trying to navigate a common reality for postcolonial nations.<sup>3</sup> The ratification of a constitution in 1979 marked the end of Micronesia's supervision under the United Nations International Trustee System, but a close relationship with a major power was still important to the new nation.<sup>4</sup> Years before, in 1969, negotiations had begun on a Compact of Free Association (COFA) between Micronesia and the U.S.<sup>5</sup> Concluded in 1986, the COFA<sup>6</sup> mandates that the United States provide Micronesia with economic, social, and defense assistance; in return, Micronesia must grant the United States with operating rights—and exclusive rights of denial of access to other nations—in

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1. Tax Increase Prevention and Reconciliation Act of 2005, 26 U.S.C.A. § 4965 (West 2006).

2. See, e.g., U.S. Dep't of Interior, First Five-Year Review of the Compact of Free Association, As Amended, Between the Government of the United States and the Federated States of Micronesia: Report to the Congress of the United States of America 32 (2013), <https://www.doi.gov/sites/doi.gov/files/uploads/First-5-Year-Review-of-Compact-for-the-FSM.pdf> [<https://perma.cc/U5HZ-TD8D>] (describing the creation of the Tax Reform Task Force).

3. Under Micronesia's federalist system, there is a national government operating in parallel with four state governments (Chuuk, Kosrae, Pohnpei, and Yap). See Government of the Federated States of Micronesia at <https://gov.fm> [<https://perma.cc/U8AJ-KSDX>] (official government website).

4. See, e.g., Thomas R. Matelski, *America's Micronesia Problem*, DIPLOMAT (Feb. 19, 2016), <https://thediplomat.com/2016/02/americas-micronesia-problem> [<https://perma.cc/77RE-K9G8>].

5. Arthur John Armstrong & Howard Loomis Hills, *The Negotiations for the Future Political Status of Micronesia (1980–1984)*, 78 AM. J. INT'L L. 484, 485 (1984).

6. 48 U.S.C. § 1681 (1986).

Micronesian territory.<sup>7</sup> The COFA was amended in 2003.<sup>8</sup> The amendments made significant changes to the economic provisions of the COFA and provided for continued economic assistance until 2023.<sup>9</sup>

In 2005, after adoption of the amended COFA, fears of a post-COFA funding shortfall sparked the Micronesian government's desire to increase domestic tax revenue.<sup>10</sup> Proponents hoped to improve the overall tax regime, but especially to improve the amount of tax revenue collected.<sup>11</sup>

Unfortunately, this ambitious tax reform initiative came up short and died a slow death: suffocation by legislative inertia.<sup>12</sup> There were numerous reasons for its failure, but the chief culprit was the archipelagic nation's complicated system of political logistics.<sup>13</sup> Micronesia's Consti-

7. Howard Loomis Hills, *Compact of Free Association for Micronesia: Constitutional and International Issues*, 18 INT'L LAW. 583, 584 (1984). See also Univ. of Haw. Library Research Guides, *Micronesians in Hawai'i: Compacts of Free Association (COFA)*, U. HAW. MANOA LIBR. (Oct. 11, 2020), <https://guides.library.manoa.hawaii.edu/c.php?g=105631&p=686651> [<https://perma.cc/EB79-PNJP>]; Ku'uwehi Hiraishi, *Future of Health Care in the Pacific Uncertain As End to Compact Funding Nears*, HAW. PUB. RADIO (Sep 10, 2018), <https://www.hawaiipublicradio.org/post/future-health-care-pacific-uncertain-end-compact-funding-nears> [<https://perma.cc/X94S-GJTV>].

8. Joint Resolution to approve the Compact of Free Association, as amended, between the Government of the United States of America and the Government of the Federated States of Micronesia, and the Compact of Free Association, as amended, between the Government of the United States of America and the Government of the Republic of the Marshall Islands, and to appropriate funds to carry out the amended Compacts, Pub. L. No. 108-188, 117 Stat. 2720 (2003), <http://www.fsmlaw.org/compact> [<https://perma.cc/8X5C-6Y9H>].

9. See *id.* §§ 211–255.

10. See U.S. DEP'T OF INTERIOR, *supra* note 2, at 75.

11. Skype Interview with T. Lam Dang, FSM Congress Legislative Counsel and former Customs and Tax Advisor, Department of Finance and Administration (June 26, 2020); see also FEDERATED ST. OF MICR., STRATEGIC DEVELOPMENT PLAN (2004–2023): THE NEXT 20 YEARS: ACHIEVING ECONOMIC GROWTH & SELF RELIANCE 62 (2004).

12. Bill Jaynes, *FSM Tax Reform: Epic Fail!*, KASELEHLIE PRESS (June 16, 2014), <http://www.micronesiaforum.org/index.php?p=/discussion/12271/fsm-tax-reform-epic-fail> [<https://perma.cc/C4UM-XQZW>]; see also Clement Yow Mulalap, *Micronesia in Review: Issues and Events, 1 July 2013 to 30 June 2014*, 27 CONTEMP. PACIFIC 211, 217 (2015) (Special Issue, “Decolonization, Language, and Identity: The Francophone Islands of the Pacific” discussing generally the breakdown of the tax reform initiative).

13. Skype Interview with T. Lam Dang, *supra* note 11 (discussing that Chuuk and Kosrae enacted their parts of the tax reform, but Yap and Pohnpei did not. Yap did not due to Yap State Constitutional concerns, and Pohnpei did not due to opposition from powerful business interests); see generally F.S.M. Pub. L. No. 17-50, § 87 (2012) (providing a sunset date that automatically repeals the establishment of the Unified Revenue Authority and the other changes to the tax laws if all four states have not enacted VAT legislation by a certain date, demonstrating the complex nature of the multigovernment initiative); F.S.M. Cong. Stand. Comm. Rep. No. 17-125 (March 2012), <http://www.c fsm.gov.fm/iframe/17th%20Congress/Standing%20Committee%20Reports/SCR%20No.%2017-125.pdf> (discussing the complexity of the effort and justifying Congress's inclusion of the sunset date in the RAA enacting legislation); IMF, *Federated States of Micronesia: Selected Issues and Statistical Appendix*, IMF Country

tution required all four state governments *and* the national government to unanimously enact coordinated legislation to adopt the full tax reform package for it to become law.<sup>14</sup> The national government's taxing power is limited to income and import taxes, so including a nationwide value added tax (VAT) made adoption of the package impossible to enact solely at the national level.<sup>15</sup>

Despite the failure of the tax reform initiative—and good reasons for that failure<sup>16</sup>—authorities *still* continue to press for the adoption of a Micronesian VAT.<sup>17</sup> This Article urges a different approach. We propose that Micronesia give up on its current Sisyphean tax reform initiative and seek a less daunting, simpler alternative. Given the global strife and economic uncertainty caused by the ongoing COVID-19 pandemic, particularly in the United States, guaranteeing some sort of stable, predictable revenue for Micronesia is more critical than ever.<sup>18</sup>

Micronesia can achieve some of its main tax reform goals by gradually transforming its current gross revenues tax (GRT) to resemble Hawaii's contemporary general excise tax (GET). In the following pages, this Article will describe how Micronesia could use Hawaii's GET as a roadmap, or jumping-off point, to evolve its GRT into a modern, functional, and internationally competitive tax, and why it would be especially appropriate for Micronesia to do so.

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Report No. 05/103, 24–25, 28 (Mar. 2005) (describing the state responsibility for consumption taxes in the FSM and the difficulty of acquiring full state commitment).

14. F.S.M. CONST. art. VII, § 1 (national system of government), *id.* art. VIII, § 2 (powers not expressly delegated to national government reserved for the states), *id.* art. IX, § 2(d)–(e) (limiting the national governments power of taxation to taxes, duties, and tariffs based on imports and taxes on income).

15. F.S.M. CONST. art. VIII, § 2; *id.* art. IX, § 2(d)–(e). As will be explained *infra*, the tax reform package included a value added tax, which is not a tax on income. See U.S. Chamber of Commerce, An Introduction to the Value Added Tax (VAT) 8 (Apr. 25, 2010), [https://www.uschamber.com/sites/default/files/legacy/issues/econtax/files/vat\\_paper\\_4\\_25\\_2010.pdf](https://www.uschamber.com/sites/default/files/legacy/issues/econtax/files/vat_paper_4_25_2010.pdf) [<https://perma.cc/V3WU-T26A>]. Given Micronesia's constitutional system, adopting this full tax reform package became an impossibility at the national level.

16. See Skype Interview with T. Lam Dang, *supra* note 11; Jaynes, *supra* note 12; Mulalap, *supra* note 12.

17. See IMF, *Federated States of Micronesia 2019 Article IV Consultation—Press Release; Staff Report; Statement by the Executive Director for the Federated States of Micronesia*, I.M.F. COUNTRY REPORT NO. 19/288 (Sep. 2019) (recommending adoption of a VAT in Micronesia as recently as 2019); see also F.S.M. Cong. Bills Nos. 21-81 and 21-82 (2020) (reintroduction of the two bills in the FSM national congress required to adopt the tax reform at the national level).

18. See, e.g., World Health Organization, *COVID-19 response in the Pacific Islands*, WHO (Feb. 21, 2021), <https://www.who.int/westernpacific/emergencies/covid-19/covid-19-in-the-pacific> [<https://perma.cc/K2FP-WTZL>]; U.S. DEP'T OF STATE, U.S. EMBASSY IN THE FEDERATED STATES OF MICRONESIA (2021), <https://fm.usembassy.gov/covid-19-information/> [<https://perma.cc/59FV-25N2>].

## I. TAXES IN THE FEDERATED STATES OF MICRONESIA

Micronesia's current tax structure includes a tax called the Gross Revenues Tax, or GRT. Micronesia's GRT predates Micronesia itself, at least in its current political form. The GRT has been a part of the Micronesian tax system since it was a postwar Trust Territory<sup>19</sup> under the United Nations International Trustee System.<sup>20</sup> The GRT is imposed at the rate of 3 percent on a business's gross revenues that exceed \$10,000 per year.<sup>21</sup> The GRT also imposes a flat fee of \$80 per year on gross revenues not exceeding \$10,000 and fully exempts businesses that earn gross revenues of \$2,000 or less per year.<sup>22</sup> "Gross revenues" is defined broadly and includes all receipts from trade, business, commerce, sales of tangible personal property or services, rents, interest, royalties, fees, or other emoluments, however designated.<sup>23</sup> Deductions are limited and include refunds and rebates, money held in a fiduciary capacity, wage and salary income, receipts from sale or rental of commercial aircraft, cash discounts, and receipts from exported goods.<sup>24</sup>

In addition to the GRT, Micronesia has a quasi-income tax called the Wages and Salaries tax (WST).<sup>25</sup> The WST is imposed only on individuals' wages and salaries, excluding the value of dividends, rents, and interest.<sup>26</sup> As a result, the current tax system in Micronesia captures the value of consumption through the GRT and the value of certain income through the WST, but does not capture the value of business income.<sup>27</sup> For example, Micronesia lacks any mechanism to tax business profits, either at the business level or as passed to owners through dividends.

The national government imposes a basic import tax at varying rates.<sup>28</sup> In addition, each of the four FSM states has its own sales tax and other minor excises and miscellaneous taxes.<sup>29</sup> The state sales taxes are not uniform and are each unique in their own way. For example, the sales tax imposed by Pohnpei State is imposed on the seller rather than

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19. Glenn B. Martineau, *Micronesia's Simplified Income Tax System*, 62 A.B.A. J. 1176, 1177 (1976).

20. See United Nations, *History: International Trusteeship System*, U.N. (2021), <https://www.un.org/dppa/decolonization/en/history/international-trusteeship-system-and-trust-territories> [<https://perma.cc/B38G-8UYT>].

21. 54 F.S.M. Code § 141(2).

22. *Id.* § 141(1)–(3).

23. *Id.* § 112(5).

24. *Id.*

25. *Id.* § 121.

26. See generally *id.* §§ 111–903 ("Taxation and Customs").

27. Christopher Faulkner-MacDonagh & Bing Xu, *Federated States of Micronesia: Selected Issues and Statistical Appendix*, INT'L MONETARY FUND (2007).

28. 54 F.S.M. Code §§ 211–270.

29. See generally Taxpayer Services, Micr. Division of Customs and Tax Admin. & Dept of Fin. and Admin., FEDERATED STATES OF MICRONESIA TAX INFORMATION (2016).

on the purchaser, as opposed to the more traditional sales tax imposed by Chuuk, which is imposed on the purchaser.<sup>30</sup>

Overall, Micronesia's tax system captures approximately 12 percent of its gross domestic product (GDP), which is low compared to other Pacific Island nations.<sup>31</sup> The International Monetary Fund (IMF) estimates that, on average, Pacific countries' tax systems capture close to 20 percent of GDP.<sup>32</sup> For example, the Cook Islands, an island nation of approximately 9,000<sup>33</sup> people which is in an associated state relationship with New Zealand,<sup>34</sup> is estimated to have a tax-to-GDP ratio of roughly 25 percent.<sup>35</sup> Significantly, the two other nations in free association with the United States,<sup>36</sup> the Republic of the Marshall Islands and the Republic of Palau, both exceed Micronesia in terms of tax revenue as a share of GDP.<sup>37</sup>

As recently as July 2019, the IMF recommended that Micronesia add taxation worth about "4–5%" of its GDP and adopt "growth-friendly" tax measures.<sup>38</sup> The same IMF report describes the recent overperformance of Micronesia's domestic tax system as the result of largescale tax windfalls from its corporate tax scheme.<sup>39</sup> Nonetheless, with COFA's

30. See Skype Interview with T. Lam Dang, *supra* note 11.

31. IMF, *Federated States of Micronesia 2019 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for the Federated States of Micronesia*, I.M.F. COUNTRY REPORT NO. 15/128 (May 2015).

32. *Id.*

33. Central Intelligence Agency, *Country Comparison: Population*, THE WORLD FACTBOOK, at <https://www.cia.gov/the-world-factbook/field/population/country-comparison> (last visited Oct. 11, 2020).

34. New Zealand Foreign Affairs & Trade, *Countries & Regions: Cook Islands*, <https://www.mfat.govt.nz/en/countries-and-regions/pacific/cook-islands> (last visited Oct. 11, 2020) [<https://perma.cc/C28P-M9JN>].

35. Organisation for Economic Co-operation and Development, *Revenue Statistics in Asian and Pacific Economies 2020* Chapter 3, <https://www.oecd.org/tax/tax-policy/revenue-statistics-in-asian-and-pacific-economies-26179180.htm> (last visited Oct. 11, 2020) [<https://perma.cc/P8QN-RHTW>].

36. Univ. of Haw. Library Research Guides, *supra* note 7 ("The Compacts of Free Association are a series of treaties between the United States, the Federated States of Micronesia (FSM), the Republic of Palau, and the Republic of the Marshall Islands (RMI). These treaties were partially established as compensation for the loss of life, health, land, and resources due to the numerous nuclear weapons tests on the Marshall Islands and Bikini and Eniwetok Atolls issued by the United States from 1946 to 1958. The Compacts allow citizens of Micronesia to live and legally work in the U.S. without a visa, as well as have access to social and health services. In return, the United States has sole access and substantial amount of military and veto power over these islands that are considered of strategic value.").

37. See IMF, *supra* note 17, at 9.

38. *Id.* at 5 ("Implement a fiscal adjustment of 4–5 percent of GDP through 2023 to cope with the fiscal cliff. This can be achieved by gradually introducing growth-friendly tax measures and rationalizing nonessential expenditures, while protecting spending on education, healthcare, and infrastructure.").

39. *Id.* at 8. (The report describes the large payments as windfalls because they originate from occasional sales of foreign assets, therefore, they cannot be counted on to be consistent in the long term.).

future clouded by political uncertainty and its financial provisions due to expire,<sup>40</sup> the current level of public funding in Micronesia is widely believed to be inadequate.<sup>41</sup>

## II. MICRONESIA'S PROPOSED TAX REFORM AND WHY IT FAILED

Micronesia's tax reform proposal was ambitious, to say the least. It would have affected nearly every type of Micronesian tax and would have transformed the nation's tax structure both in substance and administration.<sup>42</sup> The proposal imposed a credit-invoice method *value added tax* (VAT)<sup>43</sup> as a replacement for the GRT and the states' sales taxes, as well as a business income tax to capture the business profits missed by the WST.<sup>44</sup> The proposal also adjusted the WST to provide relief to low-income earners due to higher prices expected to result under a brand-new VAT.<sup>45</sup>

If this reform had been successful, the Tax Reform Task Force estimated Micronesia would have captured an additional \$11.24M.<sup>46</sup> That impressive figure includes the value of dividends, rents, interest, and other business income that, as of this writing, remains tax-free when earned by businesses and stays tax-free when distributed.<sup>47</sup>

The primary objective of reform was to increase tax revenues, but reformers also sought to modernize Micronesia's tax system and bring it in line with best practices from elsewhere.<sup>48</sup> The architects of the tax reform's legislative package were also sensitive to the negative consequences of tax cascading;<sup>49</sup> adoption of the VAT aimed to minimize its

40. *Id.* at 7–8.

41. *Id.* (Describing the expiration of the COFA grants leading to a 4.5 percent deficit in FY2024). *See also*, IMF, *Mission Concluding Statement, Federated States of Micronesia (FSM)-2012 Article IV Consultation Concluding Statement of the IMF Mission* (2012), archived at <https://perma.cc/UK8E-DAR3>; IMF, *Press Release: IMF Executive Board Concludes 2015 Article IV Consultation with the Federated States of Micronesia* (2015) archived at <https://perma.cc/A47C-TA8W>; Asian Development Bank, *Draft FSM 2023 Action Plan* (2014), <https://www.adb.org/sites/default/files/linked-documents/cobp-fsm-2016-2018-ld-02.pdf>.

42. F.S.M. Presidential Communication No. 16–184, March 24, 2010 (on file with author).

43. *See infra* notes 97–101 and 164–167.

44. Strategic Development Plan (2004–2023), *supra* note 11, at 64–65.

45. *Id.*

46. *Report of the Tax Reform Task Force, Appendix 1: "Impact of the Proposed Tax Plan"* (2005) (On file with author).

47. The proposed Business Profits Tax would not have taxed dividends directly, but would have taxed the business profits, at the business level, that eventually become dividends in the hands of shareholders.

48. *See* U.S. DEP'T OF INTERIOR, *supra* note 2 (citing to recommendations for tax reform to increase government revenue and to encourage domestic and foreign private investment).

49. *See* Skype Interview with T. Lam Dang, *supra* note 11. "Cascading," as used by the Tax Reform Task Force, referred to the cumulative effect of different types applied to the same products. The issue was demonstrated to the authors as an import tax of 4 percent combining with a 5 percent state sales tax on the same product,

deleterious effects.<sup>50</sup> However, gross receipts taxes like the GET and GRT have another drawback—a tendency to *pyramid*, meaning they increase the overall price of goods with each stage of economic transaction.<sup>51</sup> Gross receipts taxes generally apply to “intermediate” or business-to-business sales—not just to “final” sales from a retailer to a consumer—and thus the addition of the tax amount at each new level of sale leads to a cumulative increase in final price that far exceeds the nominally stated tax rate.<sup>52</sup> Under the Tax Reform Task Force, cascading is rate multiplication across multiple tax types, on the contrary, tax pyramiding concerns the effect produced by a single tax.<sup>53</sup>

The VAT appealed to the drafters of the tax reform package because it would largely eliminate the cascading between the GRT and the state sales taxes.<sup>54</sup> But it would also reduce the pyramiding of the GRT upon itself.<sup>55</sup> The IMF officially still recommends a VAT for Micronesia,<sup>56</sup> claiming it would be more efficient and less distortive than an increase to the existing gross revenues tax.<sup>57</sup>

Whatever good intentions there might have been, Micronesia’s tax reform effort failed.<sup>58</sup> As mentioned, reform primarily failed due to the complex logistics of Micronesia’s quasi-federalist archipelagic governing system.<sup>59</sup> Other reasons included the national government’s refusal to fully embrace its leading role in adopting the tax reform package,<sup>60</sup> state legal and constitutional concerns,<sup>61</sup> and the influence of powerful stakeholders with lobbying power.<sup>62</sup> The rest of this Article will focus on another way for Micronesia to achieve some of its goals, using its nearby neighbor to the northeast as a model.<sup>63</sup>

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equaling a total tax rate of 9 percent, nearly as much as the proposed VAT.

50. *Id.*

51. Arthur D. Little, *Hawaii’s General Excise Tax: Prospects, Problems, and Prescriptions*, REP. TO STATE OF HAW. DEPT. OF TAX 47. (Nov. 1968).

52. *Id.* See also William F. Fox, *Defining the General Excise Tax Base: Exemptions and Pyramiding*, TAX REV. COMM’N WORKING PAPERS AND CONSULTANT STUD. 72 (Sept. 1, 1989); Fred W. Bennion, *Broad Coverage of Services—Hawaii’s Experience Under the General Excise Tax Law*, 62 PROC. OF THE ANN. CON. ON TAX’N UNDER THE AUSPICES OF THE NAT’L TAX ASS’N 147, 158 (1969).

53. Little, *supra* note 51.

54. See Skype Interview with T. Lam Dang, *supra* note 11.

55. Donald J. Rousslang, *Tax Expenditures in Paradise*, 68 STATE TAX NOTES 549 (2013) (providing a comprehensive list of exemptions and provisions to reduce pyramiding); see also Fox, *supra* note 52, at 72.

56. IMF, *supra* note 17, at 8.

57. *Id.* at 8–9.

58. Jaynes, *supra* note 12.

59. See *supra* notes 13–15 and accompanying text.

60. F.S.M. Cong. Stand. Comm. Rep. No. 17-125 (March 2012), <http://www.c fsm.gov.fm/iframe/17th%20Congress/Standing%20Committee%20Reports/SCR%20No.%2017-125.pdf>.

61. Mulalap, *supra* note 12, at 217 (stating that it was actually the Yap state legislature that raised the issue of constitutionality).

62. See Skype interview with T. Lam Dang, *supra* note 11.

63. For more on the historic relationship between Hawaii and Micronesia, see, for

### III. HAWAII'S TAX REFORM AND WHY IT SUCCEEDED

Before the Great Depression sucked governmental coffers dry around the world, Hawaii's Territorial Legislature was not primarily concerned with tax collection.<sup>64</sup> Given American control dating back to the illegal overthrow of the Hawaiian Kingdom in 1893 and nonconsensual congressional annexation by the United States in 1898, Hawaii's government was, until statehood in 1959, effectively controlled by the United States government and run for the purpose of catering to American business and military interests.<sup>65</sup>

The market crash of 1929 and the depression that followed prompted state and local governments across the United States to enact sales taxes, hastily attempting to raise needed revenue.<sup>66</sup> Hawaii's Territorial Legislature, following mainland trends, passed the Business Excise Tax (BET) in 1932.<sup>67</sup> The BET was a rudimentary version of a VAT,<sup>68</sup> with a base consisting of businesses' operating costs and income, minus any losses.<sup>69</sup> The tax base did not include any costs of inventory or inputs.<sup>70</sup> By design, the BET's tax burden fell upon the business community, which would make it unsurprisingly unpopular with Hawaii's business elites.<sup>71</sup> Ultimately, the BET alone was not enough and was repealed and replaced by the GET: the *General Excise Tax*, as part of the Territory's more urgent response to the Great Depression.<sup>72</sup>

The GET was enacted as part of a comprehensive tax reform initiative to respond to the Great Depression.<sup>73</sup> The initiative's goal was straightforward: to raise money.<sup>74</sup> By the time the Territorial Legislature had convened in 1935, the Territory was facing a \$1,000,000 deficit, the Territory's employees had all received a 10 percent salary cut, all

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example, Adam Keawe Manalo-Camp, *There Are Many Ties Between Hawaiians and Micronesians*, CIVIL BEAT (Sept. 28, 2018), <https://www.civilbeat.org/2018/09/there-are-many-ties-between-hawaiians-and-micronesians> [https://perma.cc/8ALA-YC9Y].

64. See Ronald Williams Jr., *Race, Power, and the Dilemma of Democracy: Hawaii's First Territorial Legislature, 1901*, 49 HAW'N J. HIST. 1 (2015).

65. See, e.g., *Historical Essays: Exclusion and Empire, 1898–1941*, U.S. H.R., <https://history.house.gov/Exhibitions-and-Publications/APA/Historical-Essays/Exclusion-and-Empire/Hawaii> [https://perma.cc/J4EK-6S7Z] (last visited Oct. 11, 2020).

66. RICHARD D. POMP, *State and Local Taxation* §§ 6–4 (7th ed. 2011).

67. ROBERT M. KAMINS & Y.S. LEONG, HAW. LEGIS. REF. BUREAU, HAWAII'S GENERAL EXCISE TAX 5–6 (1963).

68. *Id.* at 5.

69. *Id.*

70. *Id.*

71. *Id.* at 5, 8; see also TAX REV. COMM'N, *Origins of Hawaii General Excise Tax*, REP. OF THE TAX REV. COMM'N, App'x C, p. 85 (1989).

72. KAMINS & LEONG, *supra* note 67, at 6; see also WILLIAM BORTHWICK, HAWAII'S GROSS INCOME TAX: ITS ADOPTION, SCOPE OF THE LAW, ACCOMPLISHMENTS, REACTION OF TAXING OFFICIALS (1940).

73. KAMINS & LEONG, *supra* note 67, at 6.

74. BORTHWICK, *supra* note 72, at 3. Borthwick writes that an estimated \$3,000,000 was needed for the 1935–1937 biennium.

departments had been curtailed, and its government was not functioning properly.<sup>75</sup> It was estimated that \$3,000,000 would need to be raised during the 1935–1937 biennium to keep the Territory on solid financial footing.<sup>76</sup> During 1934, Governor Joseph B. Poindexter, an appointee of President Franklin Roosevelt, sponsored an extensive study of Hawaii’s existing tax system and appointed an advisory committee on taxation to push the Territory toward reform.<sup>77</sup> To stress the Territory’s financial deficits and the critical need for additional revenue that tax reform would hopefully provide, Poindexter used his opening address to the 1935 Legislature to urge lawmakers to quickly pass the reform proposal, including the GET, during that session.<sup>78</sup>

The legislature responded and promptly passed the proposed tax reform, which was enacted shortly thereafter.<sup>79</sup> The replacement of the BET with the new GET was the centerpiece.<sup>80</sup> The reform also extended the income tax to dividends.<sup>81</sup> New revenue from the GET quickly poured into government coffers,<sup>82</sup> with the GET generating 25 percent more revenue than originally projected during its first two years.<sup>83</sup>

In some ways, Micronesia’s 2005 reform initiative was similar to Hawaii’s 1935 tax reform. Both proposed to impose a broad-based consumption tax.<sup>84</sup> In Hawaii, this tax was the GET; in Micronesia it would have been a new VAT. Both proposals aimed to tax the same type of previously untaxed income: business income, particularly income that passed to owners through dividends.<sup>85</sup> Incorporating a new type of tax to complement and augment the existing tax structure, as Hawaii did with the GET and Micronesia sought to do with its business income tax,<sup>86</sup> could increase revenue while expanding and stabilizing the tax base.

75. *Id.* at 1.

76. *Id.* at 1.

77. *Id.* at 1.

78. *Id.* at 2.

79. Act 141, 1935 Haw. Sess. Laws 74.

80. DEBRA M.K. OYADOMORI, *Origins of Hawaii’s General Excise Tax*, in TAX REV. COMM’N WORKING PAPERS AND CONSULT. STUDIES 86 (1989).

81. *Id.* at Appendix C. The tax reform initiative also included the repeal of the bank excise tax law, but this is not relevant to this Article.

82. BORTHWICK, *supra* note 72, at 10.

83. *Id.*

84. JEFFREY STUPAK & DONALD MARPLES, CONG. RSCH SERV., R44342, CONSUMPTION TAXES: AN OVERVIEW (2016), <https://fas.org/sgp/crs/misc/R44342.pdf> [<https://perma.cc/9774-6M7Y>] (“With a consumption tax, however, an individual’s tax liability would be determined by total expenditures on goods and services. Income not spent on goods or services, or “savings,” would not be taxed. Consumption taxes can take many different forms—which differ in when the tax is collected, how the tax is calculated, and who is responsible for remitting the tax—but they all share the common tax base of consumption. Common consumption tax designs include a value added tax (VAT), a national sales tax (NST), and a consumed-income tax”).

85. Strategic Development Plan (2004–2023), *supra* note 11, at 93. *See also* Report of the Tax Reform Task Force, *supra* note 46.

86. Strategic Development Plan (2004–2023), *supra* note 11, at 64–65.

Unlike the taxes many states enacted to respond to the Great Depression, the GET was neither a true sales tax<sup>87</sup> nor a value added tax.<sup>88</sup> Around the time of its enactment, William Borthwick, the Territory's Tax Commissioner, described the GET as a broad-based and cumulative tax using gross income as its measure.<sup>89</sup> What made and kept the GET lucrative was its cumulative application to transactions at *every* level of the economy.<sup>90</sup> A sales tax—the GET's cousin, for which it is so often mistaken—is critically different: it only applies to the *final retail sale*.<sup>91</sup>

To demonstrate the difference, consider the GET treatment of coffee grown, roasted, distributed, and sold in Hawaii.<sup>92</sup> The GET applies at *each* of these four steps. GET is owed on the income that the grower, the roaster, and distributor, and the final seller each earn. If the rate of tax is set at a flat 1 percent, then a 1 percent tax would be levied at each level for an ultimate imposition of 4 percent on the coffee. However, the businessperson at each level would likely seek to recover their 1 percent cost,<sup>93</sup> necessitating a potential 1 percent increase in the price charged, and subsequently leading to a potential cumulative imposition of more than 4 percent on the coffee. In contrast, with a typical retail sales tax, only the final seller would be subject to tax on the sale of the coffee, meaning only the final price is affected by the tax rate.

The GET replaced the BET, and they differed in important ways.<sup>94</sup> A value added tax like the BET provides relief for the taxpayer's purchase of inputs and other costs of doing business.<sup>95</sup> The GET applies to gross income and makes no adjustment for business inputs or the costs of doing business.<sup>96</sup> Under the previous example, the coffee grower would be subject to 1 percent tax on its income from growing. The roaster would be subject to 1 percent tax on its income from roasting, but instead

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87. BORTHWICK, *supra* note 72, at 3.

88. *Id.*

89. *Id.*

90. ROBERT M. KAMINS, UNIVERSITY OF HAWAII SMALL BUSINESS MANAGEMENT INSTITUTE, HAWAII'S REVISED TAX SYSTEM 9, (Univ. of Haw. Small Bus. Mgmt. Inst. ed., 1957).

91. WALTER HELLERSTEIN ET. AL., STATE AND LOCAL TAXATION, CASES AND MATERIALS 649 (10th ed. 2014).

92. The use of the coffee industry as an example when discussing Hawaii's GET is a time-honored tradition that the authors would like to acknowledge and continue. *See, e.g.*, KAMINS, *supra* note 90 at 10; R.M. KAMINS, ET AL., SOME EFFECTS OF HAWAII'S 1957 TAX LAW 28 (1959), [https://lrb.hawaii.gov/wp-content/uploads/1959\\_SomeEffectsOfHawaii1957TaxLaw.pdf](https://lrb.hawaii.gov/wp-content/uploads/1959_SomeEffectsOfHawaii1957TaxLaw.pdf) [<https://perma.cc/8LPX-L5YR>]; Bennion, *supra* note 52 at 158.

93. The GET allows for but does not require an explicit pass on of the tax to the consumer. This is credited with spreading the burden of funding the territory among more of the population and across more of the economy. An explicit requirement that the amount of the tax be stated to the consumer was proposed and considered, but ultimately defeated. *See* KAMINS & LEONG, *supra* note 67, at 6, 8.

94. *Id.* at 5–6 (describing the BET as a version of a VAT).

95. *See* U.S. Chamber of Commerce, *supra* note 15, at 4.

96. KAMINS & LEONG, *supra* note 67, at 6.

of subjecting the *entire* income of the roaster to tax, the value added tax would allow the roaster to subtract from the roaster's total income the amount that the roaster spent on *input purchases*: beans, pots, a new stove, and the like.<sup>97</sup> The distinction between the two tax mechanisms—particularly with respect to potential collectible revenue—makes it easy to see why the GET was so lucrative and rapidly solved the Territory's financial problems.<sup>98</sup>

The originally-enacted GET was a competent source of revenue thanks to its simple, broad base and relatively low rate, but it quickly faced significant pressure to evolve.<sup>99</sup> When the GET was adopted in the 1930s, Hawaii's economy was based mostly on production and export—in tax terminology, the *production100* and *manufacture101*—of sugar and pineapple, without much emphasis on retail activities.<sup>102</sup> Most of the value ultimately deriving from “producing” and “manufacturing” sugar and pineapple was exported outside the territory, meaning the ultimate retail value would have escaped taxation if Hawaii had adopted a typical sales tax.<sup>103</sup> The GET changed the game by capturing that value before it left the territory, targeting gross business income instead of retail sales transactions.<sup>104</sup> Hawaii's earlier experiment with a VAT, though probably not impacting the “bottom line” for the large plantation owners any more than the GET did, was far less effective at raising revenue in the Territory.<sup>105</sup> The GET was developed to take advantage of the economy that Hawaii had at the time, and the fact that substantial revenue was generated by Hawaii's export-focused agricultural oligopoly would have helped to “soften the blow” of the new broad-based consumption tax for most average consumers.<sup>106</sup>

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97. See U.S. Chamber of Commerce, *supra* note 15, at 5. This example describes the mechanism of a subtraction-method VAT. The other major version of a VAT, the credit-invoice method, offers similar input relief but through a tax credit rather than through a deduction (subtraction) for input purchases.

98. KAMINS & LEONG, *supra* note 67, at 6.

99. Lowell Kalapa, *Sales Tax or Not? General Excise Tax, That is a Beautiful Beast*, HAW. FREE PRESS (Sep. 25, 2011), <http://www.hawaiiifreepress.com/Articles-Main/tabid/56/ID/5130/Kalapa-History-of-the-Hawaii-GE-Tax.aspx> [https://perma.cc/63DE-WX5S].

100. The General Excise Tax of 1935 defines “producer” generally as farmers; more specifically, a producer includes any person or organization that raises or sells agricultural, animal, or poultry products, or is engaged in the business of fishing, for resale or incorporation into a finished manufactured product or construction contract. Act 141, § 1, 1935 Haw. Sess. Laws 76.

101. The original GET law did not directly define “manufacture,” but the imposition language of the tax on manufacturers lists eight categories: “compounding, canning, preserving, packing, milling, processing, refining or preparing.” *Id.* at 77.

102. Kalapa, *supra* note 99.

103. *Id.*

104. *Id.*

105. *Id.*

106. See, e.g., Lynn Danninger, *Isle Institutions Economic Impact Endures: 3 Members Turn to Real Estate and Retail Ventures after Ownership Changes and the Decline*

The world has changed since 1935, and Hawaii is no exception. Hawaii attained Statehood in 1959,<sup>107</sup> leading to increased decisionmaking autonomy, and Hawaii also developed tourism as the major, if often pyrrhic, driver of its economy.<sup>108</sup> Hawaii's GET has responded, evolving from a strict gross receipts tax into a nuanced and sophisticated taxing mechanism worthy of evaluation and consideration.

#### IV. EVOLUTION OF THE GET AND THE IMPORTANCE OF AVOIDING PYRAMIDING

The GET was not a perpetual silver bullet for Hawaii's fiscal well-being. Like most ambitious legislative or policy overhaul efforts, ongoing tweaks and modifications were necessary for the tax to achieve optimal performance.

The GET originally had a general "retail" rate of just 1.25 percent.<sup>109</sup> But that figure is deceptively simple, as the GET included a variety of special rates: a special rate of 0.25 percent for manufacturers other than sugar refiners and canneries,<sup>110</sup> a special rate of 1 percent on gross income from printing and publishing,<sup>111</sup> and a special rate of 0.5 percent on taxpayers belonging to "professions,"<sup>112</sup> a nebulous term that was not further defined in the law.<sup>113</sup>

Importantly, the original version of the GET also contained a 0.25 percent wholesale rate<sup>114</sup> for wholesalers<sup>115</sup> and producers.<sup>116</sup> The wholesale rate only applied to production and wholesale sales of tangi-

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*of Local Sugar and Pineapple*, HONOLULU STAR BULLETIN (Sep. 29, 2002), archives.starbulletin.com/2002/09/29/special/story3.html[https://perma.cc/2HCM-5ZUP].

107. Jennifer Latson, *How Statehood Changed Hawaii's Economy*, TIME (Aug. 21, 2015), <https://time.com/3994194/hawaii-statehood-economic-effects> [https://perma.cc/3HRG-PNJZ]

108. Allison Schaefer, *Lack of Clear Plan to Replace Tourism Leaves Hawaii's Economic Future in Doubt*, STAR ADVERTISER (May 11, 2020), <https://www.staradvertiser.com/2020/05/11/hawaii-news/lack-of-clear-plan-to-replace-tourism-leaves-hawaiis-economic-future-in-doubt> [https://perma.cc/F28U-UX4J].

109. Act 141, § 2, 1935 Haw. Sess. Laws 79. Unusually, the original GET law allowed the treasurer to increase or decrease the general rate of 1.25 percent if the expected proceeds were expected to be short or in surplus of the expected need—though the increase still could not exceed an additional .25 percent.

110. *Id.* at 77.

111. *Id.* at 80.

112. *Id.* at 81.

113. Black's Law Dictionary defines the term as "vocations or occupations requiring advanced education and skill predominantly involving mental or intellectual, rather than physical, exertion." *Profession*, BLACK'S LAW DICTIONARY (11th ed. 2019).

114. Act 141, § 2, 1935 Haw. Sess. Laws 79.

115. Act 141, § 1 defines "wholesaler" as a person or organization that sells to retailers "in wholesale quantities and at wholesale rates." *Id.* at 75–76.

116. Act 141, § 1 defines "producer" generally as farmers; more specifically, a producer includes any person or organization that raises or sells agricultural, animal, or poultry products, or is engaged in the business of fishing, for resale or incorporation into a finished manufactured product or construction contract. *Id.* at 76.

ble personal property<sup>117</sup> and did *not* apply to service businesses at all.<sup>118</sup> That said, the original version of the GET *did* include a deduction for subcontractors.<sup>119</sup> Though the new GET was born of economic desperation,<sup>120</sup> it still managed to contain the special wholesaling rate and the subcontractor deduction, both of which are the basis for the anti-pyramiding structure of the GET that eventually materialized in Hawaii.<sup>121</sup> We believe this wholesale rate is the key tax principle that Micronesia should emulate.

How does introducing a wholesale rate help to mitigate “pyramiding” within the GET?<sup>122</sup> Consider again the example of the coffee industry. As stated previously, in Hawaii, the GET would apply at each of the following four steps: growing, roasting, distributing, and selling the coffee. In our example, there would be an imposition of 1 percent at each of these levels. As the businessperson at each level would recover as much of the 1 percent as it could, an overall price increase to the consumer of more than 1 percent would result. However, if we apply a wholesale rate of 0.25 percent to each level before the final retail level, the overall increase in price to the consumer will be substantially less, and closer to the nominal rate of 1 percent.<sup>123</sup>

Hawaii’s effort to address pyramiding began in 1951 with Act 165,<sup>124</sup> which added two new limited quasi-wholesale provisions for the taxation of *services*.<sup>125</sup> The first new provision was limited to a “tire recapper, photo-printer, auto paint shop or the like”—meaning services affecting tangible personal property.<sup>126</sup> The second new provision was limited to services to manufacturing.<sup>127</sup> The rates for both of these “not-quite-wholesale” intermediate service activities remained 1 percent.<sup>128</sup>

1957 saw a major tax reform enacted in Hawaii, which included more anti-pyramiding efforts.<sup>129</sup> 1957’s Act 1 reduced the wholesale rate, still only applicable to sales of tangible personal property, from 1 percent

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117. Act 141, § 2, 1935 Haw. Sess. Laws 79, 81. (showing the allowance of the wholesale rate in a separate imposition section than the imposition of the tax on service businesses); *see also* TERRITORY OF HAWAII, TAX PRIMER OF THE GROSS INCOME TAX (July 1935) (discussing the gross income tax in general and providing discussion and examples of the application of the wholesale rate and of the tax on service providers).

118. Act 141, § 2, 1935 Haw. Sess. Laws 79, 81.

119. *Id.* at 80.

120. *See* KAMINS & LEONG, *supra* note 67; Borthwick, *supra* note 72.

121. *See, e.g.*, Rousslang, *supra* note 55.

122. COMM. OF WHOLE REPORT I ON S.B. 2, S. JOURNAL 29, 1957 Spec. Sess., at 26 (Haw. 1957).

123. Donald J. Rousslang & Jonathan W. White, *Is Hawaii’s GET a Good Solution to State Budget Shortfalls?*, 83 ST. TAX NOTES 1127, 1130–31 (Mar. 27, 2017).

124. Act 165, 1951 Haw. Sess. Laws 292.

125. *Id.* at 294–95.

126. *Id.*

127. *Id.*; *see also* H. STANDING COMM. REP. NO. 369 (Haw. 1951).

128. Act 111, § 9, 1947 Haw. Sess. Laws 199.

129. KAMINS, *supra* note 90; *see also* COMM. OF WHOLE REPORT I ON S.B. 2, *supra* note 122.

to 0.75 percent and raised the general rate from 2.5 percent to 3.5 percent.<sup>130</sup> The relevant Senate Committee report, the “Committee of the Whole Report,” specifically mentions avoiding *tax pyramiding* as justification for reducing the GET’s wholesale rate.<sup>131</sup> Act 1 also enacted a new section with impositions on certain types of retailing activities, setting the stage for a more explicit “retail vs. wholesale” distinction to come.<sup>132</sup> Finally, Act 1 lowered the rate on all manufacturing other than sugar and pineapple from 1.5 percent to 1 percent.<sup>133</sup>

The wholesale and intermediary services rates were changed in 1960, the year following Hawaii’s statehood.<sup>134</sup> The wholesale rate was reduced to 0.5 percent, which is the current wholesale rate for all wholesalers in Hawaii as of 2021.<sup>135</sup> The recently-created intermediate services rate was likewise reduced to 0.5 percent.<sup>136</sup> These rate changes were accompanied by precise reductions in the tax rates that applied to sugar processing and pineapple canning, which were treated as special manufacturers at the time, lowering both rates from 2.5 percent to 2.0 percent.<sup>137</sup> Act 4 also reduced the general manufacturing rate from 1 percent to .5 percent.<sup>138</sup> The House Standing Committee Report No. 203 specifically mentions the “pyramiding of the general excise tax” as a justification for the lower rates on sugar processing and pineapple canning, Hawaii’s two preeminent export industries.<sup>139</sup> This report and the “Committee of the Whole Report” discussed above show that the Hawaii State Legislature was determined to resolve the issue of GET pyramiding, even if it meant an immediate revenue loss of approximately \$456,000.<sup>140</sup>

In 1962, Act 27 gradually reduced the rates applied to sugar processing and pineapple manufacturing from 2.0 percent down to 1.4 percent as of July 1, 1962, 1.0 percent as of July 1, 1963, and to the general

130. Act 1, §§ 3(g), (v)–(w), 1957 Haw. Sess. Laws 34–35, 38.

131. COMM. OF WHOLE REPORT I ON S.B. 2, *supra* note 122.

132. Act 1, § 3(u), 1957 Haw. Sess. Laws 37 (“section 117–14.6 as an imposition section on certain retailing”).

133. Act 1, § 3(e), 1957 Haw. Sess. Laws 33. The Act left the 2.5 percent rates on sugar and pineapple manufacturers unchanged.

134. Act 4, 1960 Haw. Sess. Laws 6. These rate changes were accompanied by reductions in the rates applied to sugar processing and pineapple canning. Senate Standing Committee Report No. 105 discusses the effects of the lower rates on sugar and pineapple but does not mention the other nascent wholesale rates at all. House Standing Committee Report No. 203 does discuss the wholesaling rate change and specifically mentions tax pyramiding. Also, during consideration of this bill, an exemption for food was considered and defeated. *Budget Session*, HAW. HOUSE JOURNAL 195–196 (1960).

135. Act 4, §§ 4, 6, 1960 Haw. Sess. Laws 6, 7.

136. *Id.*; see also HAW. H. JOURNAL 341 (1960) (Budget session table chart).

137. Act 4, § 2, 1960 Haw. Sess. Laws 6.

138. *Id.*

139. HAW. H. STANDING COMM. REP. NO. 203 (1960).

140. HAW. H. JOURNAL 341 (1960).

manufacturing rate of 0.5 percent as of July 1, 1964.<sup>141</sup> In 1965, Act 155 raised the general retail rate to from 3.5 percent to 4.0 percent.<sup>142</sup>

In 1970, Act 180 made major changes to eligibility for the GET's wholesale rate.<sup>143</sup> This Act amended Hawaii Revised Statutes (HRS) section 237-13(6) to allow a wholesale rate to service providers<sup>144</sup> and to include "service providers" in the definition of wholesalers.<sup>145</sup> This expansion was explicitly in response to pyramiding concerns from the industries that were excluded from 1960s rate changes.<sup>146</sup>

In 1999, the modern GET sprouted into fruition with the transition to full wholesale rate treatment for all wholesalers, not just service providers or those taxpayers involved with pineapple and sugar.<sup>147</sup> Act 71, passed by the Hawaii State Legislature that year, established rules for wholesale services in the context of property-to-service, service-to-service, service-to-property, service-to-contracting, and service-to-transient accommodations transactions.<sup>148</sup> Act 71 also gradually reduced the rates applicable to these transactions from 3.5 percent in 2000 to 0.5 percent in 2006.<sup>149</sup> Guidance issued by the Hawaii Department of Taxation on Act 71 specifically cited anti-pyramiding relief as justifying the expansion of the wholesale rate base.<sup>150</sup> The Act also broadened the definition of "wholesaler" in section 237-4, HRS.<sup>151</sup>

In general, the broad 0.5 percent "wholesale rate" of GET applies to items that are subsequently resold<sup>152</sup>—generally, most inputs—<sup>153</sup> whereas the 4 percent "retail rate" of GET applies to products at final sale.<sup>154</sup> The wholesale rate is much lower than the retail rate, which results in inputs

141. Act 27, § 1, 1962 Haw. Sess. Laws 34.

142. Act 155, § 14, 1965 Haw. Sess. Laws 203.

143. Act 180, §§ 9, 10, 1970 Haw. Sess. Laws 358-66; *see also* Act 180, § 11, 1970 Haw. Sess. Laws 366 (1980) (repealing the old wholesale services language in HAW. REV. STAT. § 237-18(c)). During consideration of this bill, an exemption for food was once again considered defeated. HAW. H. JOURNAL 314 (1970).

144. Act 180, § 10, 1970 Haw. Sess. Laws 365.

145. *Id.* § 9.

146. HAW. H. STANDING COMM. REP. NO. 108-70 (1970); CONF. COMM. REP. NO. 21 (1970).

147. Act 71, § 1, 1999 Haw. Sess. Laws 107.

148. Ray K. Kamikawa, *Department of Taxation Announcement No. 99-18* (July 16, 1999), [https://files.hawaii.gov/tax/news/announce/1990\\_2003/99ann18.htm](https://files.hawaii.gov/tax/news/announce/1990_2003/99ann18.htm) [<https://perma.cc/869X-9H2D>].

149. Act 71, § 1, 1999 Haw. Sess. Laws at 107.

150. Kamikawa, *supra* note 148.

151. Act 71, § 4, 1999 Haw. Sess. Laws at 107-110.

152. *See* HAW. REV. STAT. §§ 237-4(a)(1), (8), (10) (2012) (requiring the tangible personal property or services to be resold and disallowing the wholesale rate if the tangible personal property of services is not an "identifiable element" of the final product sold, if the benefit of the service does not pass to the consumer, or if the tangible personal property or service is overhead).

153. ALAN M.L. LEE, ET. AL, TAXES OF HAWAII 2018: A COMPREHENSIVE GUIDE FOR TAXPAYERS AND TAX PROFESSIONALS 263 (2018).

154. *Id.*

mostly escaping taxation.<sup>155</sup> The introduction of the broadly applied wholesale rate transformed Hawaii's GET from a simple gross receipts tax into a modern and sophisticated gross receipts tax.<sup>156</sup>

In addition to a near-universal wholesale rate, the GET has also developed other exemptions for business-to-business transactions for the purpose of reducing tax pyramiding.<sup>157</sup> One noteworthy example is the related-entities exemption.<sup>158</sup> The related-entities exemption is an exemption for the value of support services provided across commonly owned groups of entities. A common example would be the value of a centralized payroll and accounting division that is servicing many different locations of a commonly owned business organized as separate entities. This value is not taxable gross income for GET purposes under the related-entities exemption.<sup>159</sup>

Indeed, these evolutions have created a GET that resembles a VAT—specifically a *subtraction-method* VAT—more than it resembles an ordinary gross receipts tax like Micronesia's GRT.<sup>160</sup> Let us consider three hypothetical scenarios that assume a \$100 input and \$150 final price; a 4 percent tax rate; and a 0.5 percent tax rate on wholesale sales, if any.

In the first scenario, consider a standard subtraction-method VAT; this is our control scenario. Under a subtraction-method VAT there would be no tax on the sale of the \$100 input, and only a 4 percent tax on the sale of the \$150 final product.

Next, consider a tax like Micronesia's GRT. Under this tax type there is only one rate of tax that applies to all sales of all goods and services—in this hypothetical, 4 percent. Therefore, the total tax imposition on the sale of the \$100 input and the \$150 final product is \$10. That \$10 consists of 4 percent of \$100, which is \$4, plus 4 percent of \$150, which is \$6. This demonstrates the revenue-generating power of pyramiding of a gross receipts tax as discussed above.<sup>161</sup>

Finally, consider a tax like Hawaii's current GET, which is a tax with a 0.5 percent wholesale rate. In this scenario, the intermediate sale is subject to a tax rate of only 0.5 percent instead of 4 percent. The final sale is still subject to the general rate of 4 percent. Thus, the total tax imposition on both the sale of the \$100 input and the \$150 final product is only \$6.50. The results can be reviewed in the table below:

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155. Rousslang & White, *supra* note 123 at 1131.

156. *Id.* at 1130–31.

157. See Rousslang, *supra* note 55, at 550.

158. HAW. REV. STAT. § 237–23.5 (2012).

159. *Id.* Such services do not qualify as “wholesale” services because they would be considered overhead, or, something that is “consumed” by the recipient entity rather than resold.

160. Rousslang & White, *supra* note 123, at 1130–31.

161. See generally *supra* notes 47–55.

		This Article recommends:	
Tax Type	GET w/ no wholesale rate (gross receipts tax)	GET w/ wholesale rate	Subtraction-method VAT
Input level	$100 \times 4\% = 4.00$	$100 \times 0.5\% = .50$	$100 \times 4\% = 4$
Final consumer level	$150 \times 4\% = 6.00$	$150 \times 4\% = 6.00$	$(150 \times 4\%) \text{ less } (100 \times 4\%) = 2$
Total	10.00	6.50	6.00

The table shows the dramatic effect the wholesale rate has on the way the GET operates on the economy. The overall tax burden is similar to the burden resulting from a subtraction-method VAT, whereas the burden of the GET with no wholesale rate, such as Micronesia's GRT, is much higher. This represents the reduction in tax pyramiding often associated with gross receipts taxes.<sup>162</sup> The consequences of tax pyramiding were major drivers in the effort to reform Micronesia's tax system by introducing a VAT.<sup>163</sup>

## V. SHORTCUT TO A MODERNIZED TAX STRUCTURE FOR THE FEDERATED STATES OF MICRONESIA

Despite the failure of the tax reform initiative, the adoption of a VAT in Micronesia has been re-recommended by outside advisors as recently as 2019<sup>164</sup> and the entire proposal was reintroduced in the FSM Congress in November of 2019.<sup>165</sup> Given the many difficulties of tax reform discussed above,<sup>166</sup> particularly the difficulty of instituting a national VAT, it is time for a rethink. We propose abandoning the idea of a national VAT and adopting a less ambitious approach toward modernizing Micronesia's tax system.

By tracking and mimicking the evolution of the GET, Micronesia's taxpayers can enjoy the modernization and anti-pyramiding benefits of a VAT while keeping the familiar elements of the GRT. Most crucially, under the Micronesian Constitution, this approach would only require action from the national government while leaving the four discrete state-level systems untouched. We propose retaining the current GRT, but evolving it to mimic how the modern GET operates in Hawaii.

At first glance, Micronesia's GRT appears similar to Hawaii's GET.<sup>167</sup> However, this is not the case. Instead of resembling the modern GET, the GRT is much more like Hawaii's pre-reform GET, which offered little to no anti-pyramiding relief.<sup>168</sup> As discussed and demonstrated

162. *Id.*

163. FEDERATED ST. OF MICR., STRATEGIC DEVELOPMENT PLAN, *supra* note 11, at 93.

164. *See* IMF, *supra* note 17; *see also* F.S.M. Cong. for the 2019 Article IV Consultation, press release (recommending adoption of a VAT in Micronesia as recently as 2019); *see* F.S.M. Cong. Bills, *supra* note 17.

165. *See* F.S.M. Cong. Bills, *supra* note 17 at 21–79 to –83.

166. *See, e.g.*, Jaynes, *supra* note 12.

167. *See* Taxation and Customs, 54 F.S.M. CODE § 111–57 (2014).

168. FEDERATED ST. OF MICR., STRATEGIC DEVELOPMENT PLAN, *supra* note 11, at 93.

above, Hawaii has gone to great lengths to minimize pyramiding in its GET.<sup>169</sup> The special wholesale rate is the GET's primary weapon against pyramiding.<sup>170</sup> In current GET law, the wholesale rate generally applies to tangibles that are purchased to be resold as inputs to production<sup>171</sup> and to services that are neither consumed nor constitute overhead of the purchaser.<sup>172</sup> This definition of wholesale and the wholesale rate prevents some but not all of the multilayered addition of the tax to the price of goods—unlike Micronesia's current, relatively “unevolved,” GRT.

The introduction of a wholesale rate is the most critical step forward for the potential evolution of the GRT. Our first recommendation is that Micronesia introduce a wholesale rate of tax into its GRT. A wholesale rate, with wholesale transactions defined as they currently are in the GET, would greatly reduce the effect of pyramiding in the GRT.<sup>173</sup> The wholesale rate could be implemented either immediately or gradually, through annual reductions to the wholesale rate to an eventual target rate as Hawaii did for wholesale services between 2000 and 2006.<sup>174</sup> This will lessen revenue in the immediate term, necessitating tax increases elsewhere if a short-term revenue loss is not acceptable. However, the longterm benefit of upgrading to a modern tax system, with pyramiding relief as a primary focus, should outweigh the burden generated by a short-term rate increase.

We also recommend that Micronesia go further than Hawaii has gone in its efforts to combat pyramiding. There are several ways to do this. The simplest and narrowest in scope would be to reduce the wholesale rate to 0 percent.<sup>175</sup> However wholesale transactions are defined, this change would further reduce the tax on business-to-business transactions as well as any subsequent pyramiding.

Another option would be for Micronesia to expand the definition of transactions at wholesale to include those involving items that are consumed by their purchasers, and not just items that are bought and subsequently resold as inputs.<sup>176</sup> Under Hawaii's GET, only items that are resold are eligible for the wholesale rate; items consumed by their purchasers are not eligible.<sup>177</sup> Expanding the eligibility for the wholesale rate will further isolate the tax imposition on the final sale while reducing pyramiding.<sup>178</sup> One way to do this, which has been proposed for Hawaii's

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169. See generally *supra* notes 47–55.

170. Rousslang & White, *supra* note 123, at 1130.

171. HAW. REV. STAT. § 237–4 (2012). (Hawaii's wholesale rate does not apply to all business purchases. Hawaii's wholesale rate does not apply to items that are consumed by the purchasing business, for example, overhead expenses.

172. HAW. REV. STAT. § 237–4(a)(10) (2012).

173. Rousslang & White, *supra* note 123, at 1130.

174. See Act 71, 1999 Haw. Sess. Laws 107, 107; see also Kamikawa, *supra* note 148.

175. Rousslang & White, *supra* note 123.

176. Rousslang, *supra* note 55.

177. See HAW. REV. STAT. §§ 237–4(a)(1), (8), (10) (2012).

178. Rousslang & White, *supra* note 123, at 1131.

GET in the past, is the direct use rule.<sup>179</sup> Under this liberal rule any product that is purchased by a business for direct use would be eligible for the wholesale rate.<sup>180</sup> When proposed for Hawaii in the 1960s, the direct use rule was estimated to reduce the tax burden on business by one half.<sup>181</sup> Thus, such an expansion of the definition of wholesale transactions could significantly further reduce pyramiding in Micronesia's GRT.

Yet another option is the use of targeted exemptions of certain business-to-business transactions.<sup>182</sup> Examples of such exemptions in the GET are the subcontractor deduction,<sup>183</sup> the related entities exemption,<sup>184</sup> and the capital goods excise tax credit.<sup>185</sup> Adoption of these exemptions or their equivalent would effectively reduce pyramiding for the transactions affected.<sup>186</sup>

Ultimately, we recommend that Micronesia expand the definition of wholesale transactions and reduce the wholesale rate to 0 percent or as close to 0 percent as possible. We also recommend against the introduction of a targeted set of exemptions.<sup>187</sup> The introduction of many individual exemptions to cover business-to-business transactions will be immediately subject to interference by special interests promoting or opposing certain industries and transaction types. For example, the subcontractor deduction in Hawaii's GET allows a contractor to deduct amounts that have been previously taxed to another contractor.<sup>188</sup> This allowance means that for the contracting industry, inputs are not taxed and the wholesale rate is effectively 0 percent.<sup>189</sup> However, because "con-

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179. Little, *supra* note 55, at 118.

180. *Id.*

181. *Id.* (This recommendation was made in 1968 and was therefore estimated to reduce the business to business tax burden from the relatively high burden of that time compared to the relatively low burden currently after the final expansion of wholesale sales and reduction of the wholesale rate).

182. Rousslang & White, *supra* note 123, at 1130; *see also* Rousslang, *supra* note 55 (providing a comprehensive list of exemptions and provisions to reduce pyramiding).

183. HAW. REV. STAT. § 237-13(3)(B) (2012).

184. HAW. REV. STAT. § 237-23.5 (2012).

185. HAW. REV. STAT. § 235-110.7 (2017) (The capital goods excise tax credit is an income tax credit available at 4 percent of the cost of eligible depreciable property. The purpose of the credit is to offset the effect of the GET on capital investments.).

186. Rousslang & White, *supra* note 123, at 1130-31.

187. Note that Hawaii is guilty of this. For example, there are exemptions for gross receipts from scientific contracts under HAW. REV. STAT. § 237-26, for certain shipbuilding and repair services under HAW. REV. STAT. § 237-28.1, and for aircraft service and maintenance facilities under HAW. REV. STAT. § 237-24.9. So please—do as we say, not as we do.

188. HAW. REV. STAT. § 237-13(3)(B) (2012); *see also* Rousslang & White, *supra* note 123, at 1130.

189. Although the subcontractor (the would-be wholesaler) is taxed at 4 percent rather than 0.5 percent, there is effectively only one layer of tax, and thus a 0 percent wholesale rate, for everything the contractor performs. This is because the prime contractor can deduct its entire payment to the subcontractor. *See* Hawaii Administrative Rules § 18-237-13-03(c) for examples of the qualification for the subcontractor

tracting” is narrowly defined, the deduction and its effective 0 percent rate are limited in application.<sup>190</sup> Allowing limited instances of pyramiding relief with a series of exemptions will lead to an industry by industry patchwork of exemptions and incomplete and unequal pyramiding relief. By contrast, the wholesale rate, if properly defined, would apply to all sales between businesses, across all industries.<sup>191</sup> With no industry left out, there would be little incentive to lobby for an exemption or against a competitor’s receipt of one. The wholesale rate’s general application removes questions of political influence or self-dealing. A broad definition of wholesale transactions, with a dedicated 0 percent tax rate, has the best chance of reducing pyramiding in the GRT.

## VI. GETTING TAX REFORM DONE: AVOIDING MAJOR PITFALLS

Aside from the efficacy of our proposal, we believe our proposal has a fighting chance of actual passage and acceptance by Micronesia’s leaders and its people for several reasons.

First is the simplicity of the proposal. Any tax imposed by Micronesia’s national government must be either an income tax or an import tax. Sections 2(d) and (e) of Article IX of the Constitution of the Federated States of Micronesia expressly delegate to the Congress of the Federated States of Micronesia (FSM Congress) the power to impose “taxes on income” and “taxes, duties, and tariffs based on imports.” These delegations constitute the extent of the FSM Congress’s power to impose taxes, but they also provide all authorization necessary for our tax proposal to be enacted. Whereas the original FSM tax reform proposal would have required the states to repeal their current sales taxes and replace them with the proposed VAT,<sup>192</sup> the strategy that this Article proposes would require action only by Micronesia’s national government and no action by any of Micronesia’s four states. This proposal is simple, pragmatic, and politically expedient, especially given the complex political dynamic between Micronesia’s national government and its states.<sup>193</sup>

Next is the proposal’s practicality. The modified GRT proposed by this Article would be less radical and more politically palatable than the proposed VAT. Because our proposal is only an evolution of the current GRT, the government’s primary revenue-raiser would remain in a familiar form, thus continuing to bear little resemblance to the sales and excise

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deduction.

190. HAW. REV. STAT. § 237-6 (2012) (Defines “contractor” as any person or entity engaged in the business of improving real property, or in a related activity such as architecture, professional engineering, surveying, and landscape architecture, and also includes the business of pest control and fumigation.).

191. See HAW. REV. STAT. §§ 237-4(a)(1), (8), (10) (2012) (in Hawaii, there are actually three separate definitions: one for sales of tangible personal property, one for sales of tangible personal property to service providers, and one for sales of services to other service providers).

192. FEDERATED ST. OF MICR., STRATEGIC DEVELOPMENT PLAN, *supra* note 11, at 64.

193. See *supra* notes 11, 12.

taxes imposed by each of Micronesia's four states. This helps avoid complicating the administration of those taxes in the way that a substantively distinct credit-invoice VAT might. The previous tax reform proposal failed partly due to the complex coordination required to actually institute a VAT in Micronesia, so avoiding the states' taxing "territory" as much as possible is key.<sup>194</sup> Moreover, the modified GRT, like the current GRT, would *not* be passed on to the consumer at the register as a separate line item. The proposed credit-invoice VAT would have been separately passed on at the register. Thus, the modified GRT, unlike the proposed VAT, would not "look" like a new tax being imposed on every citizen at the grocery store. Because political expediency is clearly an issue, appearance matters as well as substance. In addition, the Micronesian people have historically kept a tight rein on their Congress's taxing authority,<sup>195</sup> and thus will likely be extremely suspicious of any tax that appears to have VAT characteristics.

Finally, the proposal's constitutionality is clear. In addition to best effectuating the FSM Congress' policy goals, our proposal would also pass muster with Micronesia's judiciary. The current GRT has been deemed a tax on income and thus constitutional under the FSM Constitution. In *Ponape Federation of Coop. Ass'ns vs. FSM*, 2 FSM Intrm. 124 (Pon. 1985) the FSM Supreme Court was asked to determine whether the GRT was a tax on income authorized by section 2(e) of the Constitution.<sup>196</sup> The FSM Supreme Court held that "taxes on income" includes gross receipts taxes like the GRT.<sup>197</sup> The Court included no qualifiers in the opinion regarding the uniformity of the tax rate. Therefore, under current FSM Supreme Court jurisprudence, the introduction of a wholesale rate to the GRT would likely not disqualify the GRT from being considered a tax

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194. See generally F.S.M. Pub. L. No. 17-50, §§ 87, 88 (2012) (providing a sunset date that automatically repeals the establishment of the Unified Revenue Authority and the other changes to the tax laws if all four states have not enacted VAT legislation); see also F.S.M. Cong. Stand. Comm. Rep., *supra* note 60 (discussing the complexity of the effort and justifying Congress's inclusion of the sunset date in the RAA enacting legislation).

195. Rosalinda Yatilman, *FSM Constitutional Amendment of Dual Citizenship*, THE FOURTH BRANCH (Apr. 30, 2012), [www.tfbmicronesia.com/articles/2012/4/30/fsm-constitutional-amendment-of-dual-citizenship-by-rosalind.html](http://www.tfbmicronesia.com/articles/2012/4/30/fsm-constitutional-amendment-of-dual-citizenship-by-rosalind.html) [ <https://perma.cc/HZC7-4VLG>]; see also John Haglegam, *A Close Look at the Proposed Amendments to the FSM Constitution*, MICR. SEMINAR (Apr. 2002), <https://micronesianseminar.org/micronesian-counselo/a-close-look-at-the-proposed-amendments-to-the-fsm-constitution> [ <https://perma.cc/X76L-3ZRN>]. In November 2001, the third FSM Constitutional Convention was convened in Palikir. The Convention produced 14 proposed amendments, including No. 01-13 which would add the power to impose a value-added tax to the FSM Congress's taxing powers. To become part of the Constitution, each proposed amendment needed to be approved by at least 75 percent of the votes cast on the proposed amendment in 3 of the 4 FSM States. The proposal failed, denying the FSM Congress the authority to levy a VAT.

196. See *Afituk v. Federated States of Micr.*, 2 F.S.M. Intrm. 260 (Truk 1986).

197. *Ponape Fed'n of Coop. Ass'ns v. Federated States of Micr.*, 2 F.S.M. Intrm. 124, 126 (Pon. 1985).

on income. Moreover, the FSM Supreme Court has previously differentiated between the GRT and a typical sales tax. The GRT is imposed on the business itself and taxes its overall income rather than individually transacted sales.<sup>198</sup> These fundamental characteristics would not change by evolving the GRT to resemble Hawaii's GET.

Ultimately, the introduction of a wholesale rate would not fundamentally change the GRT or distinguish it from a tax on gross revenues, which has been deemed to fit squarely into the taxing authority of the FSM Congress. Even with the wholesale rate, the tax base of any entity subject to the tax would consist of its gross revenues.

### CONCLUSION

Although Micronesia's attempt at a major tax reform failed, the country could make progress by pursuing a less ambitious tax transformation of its Gross Receipts Tax. Hawaii's General Excise Tax, and its transformation from a pure gross receipts tax—like Micronesia's current GRT—into a modern gross receipts tax with sophisticated anti-pyramiding relief, can be used as a blueprint for modernizing Micronesia's consumption tax structure without upsetting the delicate appletart that is the archipelagic nation's domestic politics.

Micronesia should introduce a low wholesale rate and a broad definition of "wholesale transactions" into its GRT. Wholesale transactions should include as close to all business-to-business transactions as possible. The wholesale rate should be as near to 0 percent as possible. This will modernize Micronesia's GRT and reduce its pyramiding effects, helping to ease the burden on individual taxpayers while still contributing to an increase in overall revenue. Time is of the essence for Micronesia to plan its next steps, given COFA's financial provisions' uncertain future and forthcoming expiration within the next three years—a daunting prospect even before the onset of the worldwide COVID-19 pandemic. The move to a more modern and efficient tax structure will remove one obstacle in Micronesia's path to longterm growth and economic self-reliance.

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198. *Id.* at 127.

