Commonwealth of the
Northern Marianas Islands

Facing the Challenge: *Addressing the CNMI's Fiscal Crisis*

March 31, 2020

This Commonwealth Fiscal Response Briefing Paper has been prepared by the Governor's designated Fiscal Response Task Force at the invitation of Hon. Governor Ralph DLG Torres. It is intended to serve as a technical input into a fiscal reform process that will be led by CNMI leadership.

Commonwealth of the
Northern Marianas Islands

Facing the Challenge:
Addressing the CNMI's Fiscal Crisis

About This Briefing Paper

This *Commonwealth Fiscal Response Briefing Paper* has been prepared by the Governor's designated Fiscal Response Task Force at the invitation of Hon. Governor Ralph DLG Torres. The Task Force is comprised of:

- Tracy Norita, Director Division of Revenue & Taxation
- Matthew Deleon Guerrero, Financial Analyst
- Ryan Camacho, Financial Services Manager, Department of Finance
- Vicky Villagomez, Special Assistant for Management and Budget
- Jason Aubuchon, PITI/VITI Senior Program Manager, Graduate School USA
- Debbie Milks, CPA, Financial Advisor, Graduate School USA
- Kevin O'Keefe, Economic Advisor, Graduate School USA

Technical support provided by the Graduate School USA team is made possible through funding support from the Department of the Interior's Office of Insular Affairs.

Introduction

It is apparent to all concerned parties that the CNMI is facing an unprecedented fiscal and economic crisis. The recently convened *Fiscal Response Task Force* has undertaken a comprehensive review of the historical and emerging fiscal and economic conditions of the CNMI with the following objectives:

Task 1: Assess the Size and Nature of the Crisis in two parts:

A. Assess the size of the structural fiscal deficit[1] that the CNMI has incurred annually and carried into FY2020, irrespective of any COVID-19 impacts; and

B. Assess the size of the cyclical fiscal deficit[2] projected to be caused by the COVID-19 pandemic—including an estimate of the impacts during the remaining half of FY2020, and all of FY2021 and FY2022.

Task 2: Identify a broad range of potential fiscal response policy options available to the government of the CNMI in the following areas:

- Expenditure Reductions
- Revenue Enhancements
- Re-Allocation of Public Funds
- Financing options, including potential federal support for fiscal adjustment

The work of the *Task Force* is presented below in detail and is built into the policy-modeling tools provided to support the policy decision-making process urgently required of the collective leadership of the Commonwealth.

[1] A fiscal deficit occurs when a government spends more that it receives. The deficit is deemed "structural" when it persists year-after-year, even when revenues are stable or growing.

[2] In contrast to a structural deficit, a cyclical deficit is usually temporary in nature and is commonly caused by a decline in government revenues due to a business cycle or a destructive event.

The analytical and facilitative work of the *Fiscal Response Task Force* does not extend to assigning blame or finding fault for the fiscal position of the Commonwealth; rather, the focus is forward-looking and aimed at identifying viable and timely solutions for consideration of the collective leadership of the Commonwealth.

The fiscal position of the Commonwealth entering the period of the COVID-19 pandemic

It is important to note that the CNMI entered this period of fiscal and economic crisis from a position of financial weakness. That weakness reflects a combination of

i. rapid growth in expenditures in the period since FY13;

ii. a dated tax and revenue system that relies heavily on relatively volatile tourism and gaming sources to support ever-growing government services to the people;

iii. judicially mandated pension obligations;

iv. expenditures persistently under budgeted, especially for medical referrals, overtime, utilities, and banking fees;

v. the prevalent practice of earmarking revenue sources—thereby adding binding rigidities to the fiscal operations of the Commonwealth; and,

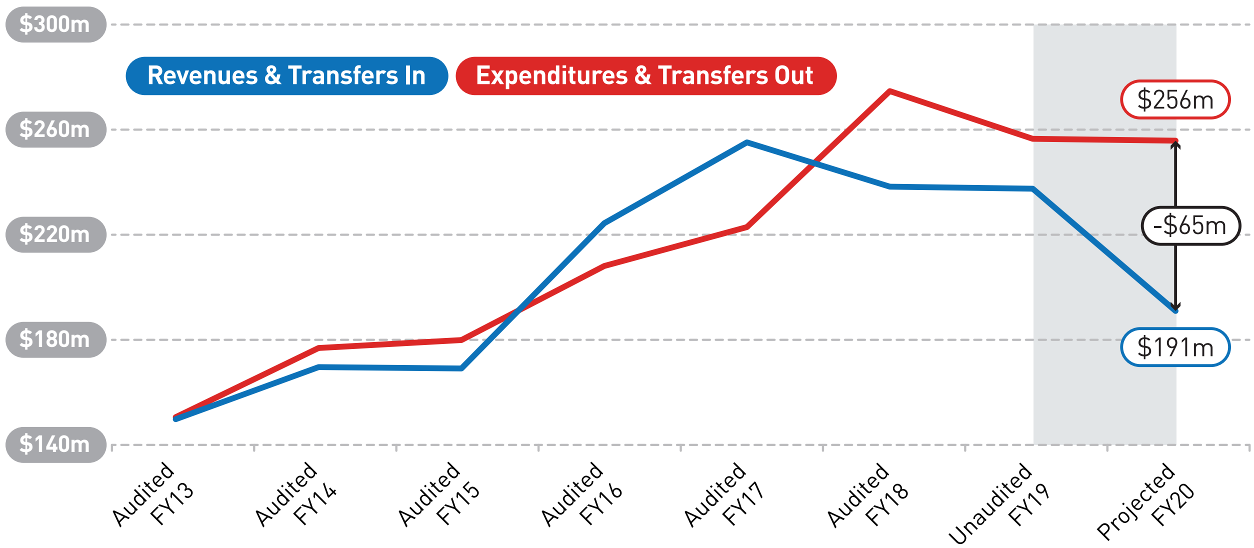
vi. moderately high outstanding liabilities relative to the size of the CNMI economy.

The *Task Force* briefly describes the fiscal and economic factors that will affect the decisions that Commonwealth leadership will need to make to bring the CNMI into near-term fiscal balance and to prepare the CNMI for economic recovery after the COVID-19 pandemic has relented.

Brief Fiscal and Economic Update

Figure 1 shows the pattern of "sources and uses" of the CNMI general fund from FY2013 through projections for FY2020. In CNMI budget terms, sources are equivalent to funds

Figure 1 *CNMI General Fund Total Sources & Uses FY13-FY20 projected*



Source: CNMI audited financial statements through FY2018 and CNMI Department of Finance and Task Force estimates

available for appropriation in the annual budget, while uses include both expenditures and other outlays appropriated in the annual budget. The general trend over the period is rapid growth in expenditures through FY18 followed by limited, but insufficient restraint on planned and actual spending. Revenues have lagged expenditures in all years but FY2016 and FY2017. Large annual deficits were experienced in FY18 and FY19 at $36.3 million and $19 million.

The FY2020 budget was, by definition, a balanced budget, except that it did not account for the persistent practice of over-expending in key areas discussed in detail below. The *Task Force* analysis describes this as a structural deficit accounted for by assuming/asserting that an additional $22.5 million would be spent absent specific, monitored and enforceable policies to control such over-expenditures. The related adjustment is shown in Figure 1 by increasing the "planned actual" spending identified in the budget from $233 million[3] to $255 million.

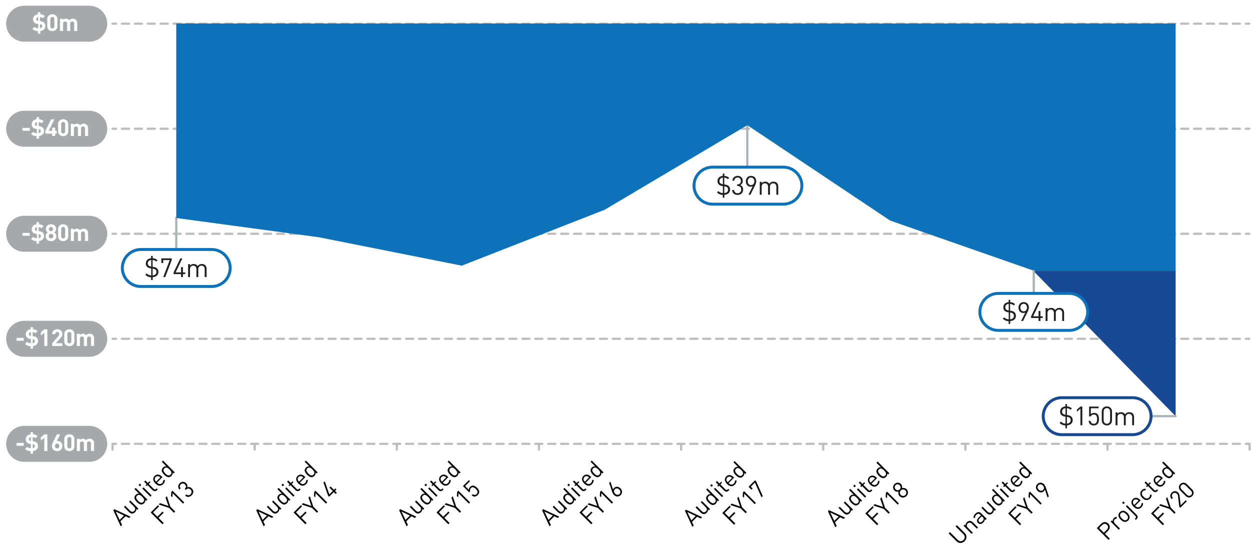
Similarly, the Task Force has adjusted revenues downward by the expected impact in revenues of the loss of Chinese and South Korean tourists for the remainder of FY2020 ($42.3 million). The projected deficit directly attributed to the coronavirus outbreak is thus $65 million. As described below, $65 million is the size of the fiscal challenge faced by the CNMI caused by this global pandemic to CNMI in FY 2020 in FY2020—with only half of the fiscal year remaining to make the adjustment. This estimate of the fiscal impact caused by the coronavirus is based on direct influences to government revenue, and will differ in size against a cumulative accounting of the CNMI's fiscal portrait.

Figure 2 shows the accumulated impact of the annual fiscal deficits described above. The

> *$65 million is the size of the fiscal challenge faced by the CNMI—with only half of the fiscal year remaining to make the adjustment.*

[3] The $233 million refers to the original budget as appropriated for FY2020; subsequent adjustments were presented to the legislature in January and March, ultimately reflecting a 48 percent reduction of the operating portion of the budget from $148.9 million to $77.2 million.

Figure 2 CNMI General Fund Accumulated Deficit



Does not include long term debt for the Settlement Fund, Bonds, or Landfill closure
Source: CNMI audited financial statements through FY2018 and CNMI Department of Finance and Task Force estimates

accumulated general fund debt was estimated at $94 million at the end of FY2019, awaiting confirmation in the audit. If the CNMI were to run a deficit of $65 million through FY2020, that accumulated debt would grow to nearly $150 million. However, the CNMI government has no access to fast-disbursing financing that would enable it to grow the general fund debt to such a level. Failure to meet payroll obligations would result in forced financing at the expense of employees, institutions such as social security and health and life insurers, and the creditors to whom employees have made allotments. Such a drastic projected general fund deficit for FY2020 must be avoided through the implementation of a sufficiently-sized fiscal response.

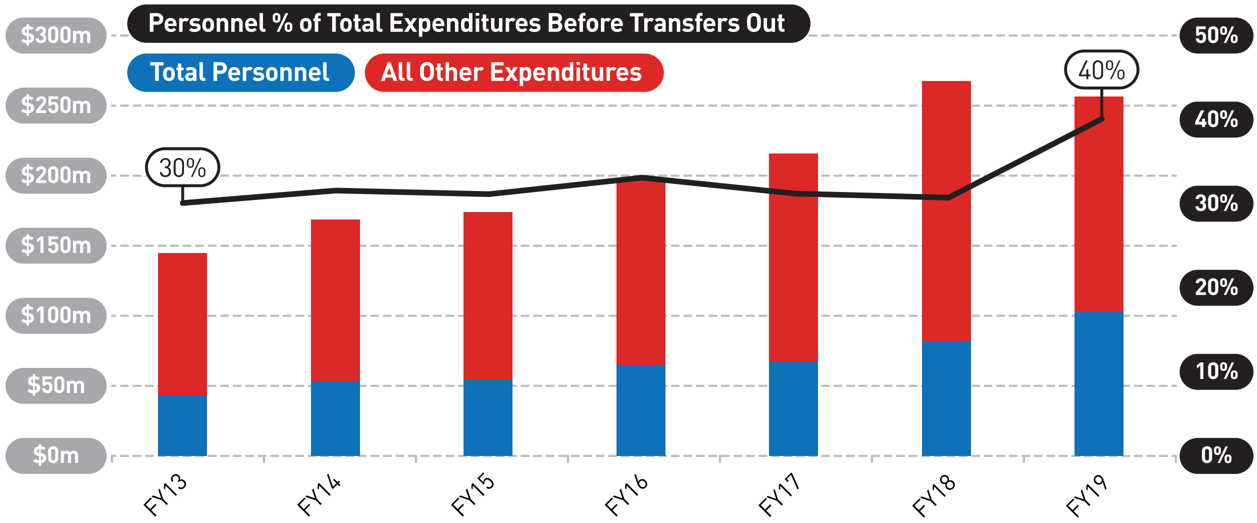
Figure 3 shows the rapid growth in CNMI expenditures from less than $144 million in FY2013 to over $255 million in FY2019. Notably, there is an even more rapid rise in personnel expenditures, having grown from $43 million to $102 million over the same period. Importantly, the share of total government outlays on personnel also increased from 30 percent to 40 percent. Such a large change in the composition of expenditures is often associated with personnel being employed in jobs for which the availability of goods, services, equipment and consumables is insufficient to complete the desired work of the department or agency. **Figure 4** makes a similar point, highlighting personnel growth of 136 percent while all other expenditure categories grew by just 52 percent from FY2013 to FY2019.

Figure 5 is the *Task Force's* attempt to present the unique, perhaps even intractable, challenges facing the CNMI executive and legislative branches in providing for the operations of government, given the complicated array of earmarks and adjudicated commitments applied to available resources. The infographic provides detailed information on the CNMI's fiscal operations for FY2020 as initially planned through the budget process and as modified to reflect both the structural deficit and the impact of the COVID-19 pandemic. Three points are worth highlighting:

i. the CNMI faces an extraordinary level of rigidities resulting from earmarks and fixed commitments;

ii. the share of available funds for truly discretionary purposes—to run the government outside of PSS was just 47 percent of the total originally planned for FY2020; and

Figure 3 *CNMI General Fund Expenditure Growth FY13 - FY19*

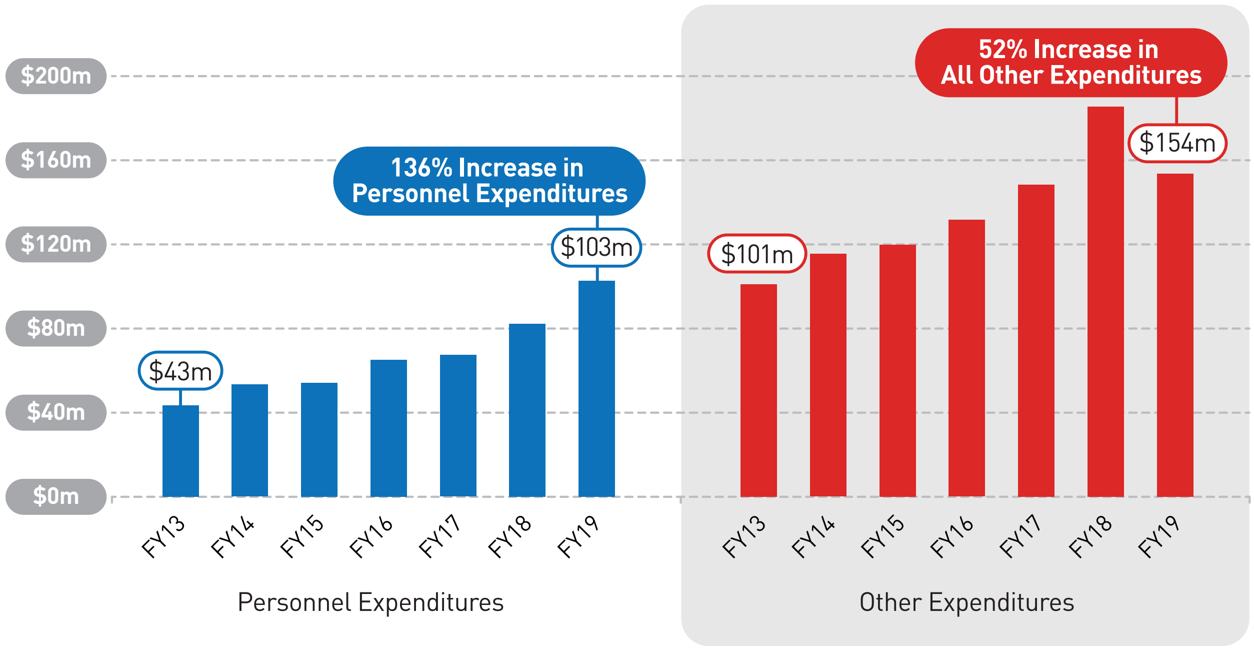


Source: CNMI audited financial statements through FY2018 and CNMI Department of Finance and Task Force estimates

iii. once modifications for structural and cyclical deficits are factored in, the share of funding available for discretionary purposes is just 40 percent of the reduced total available.

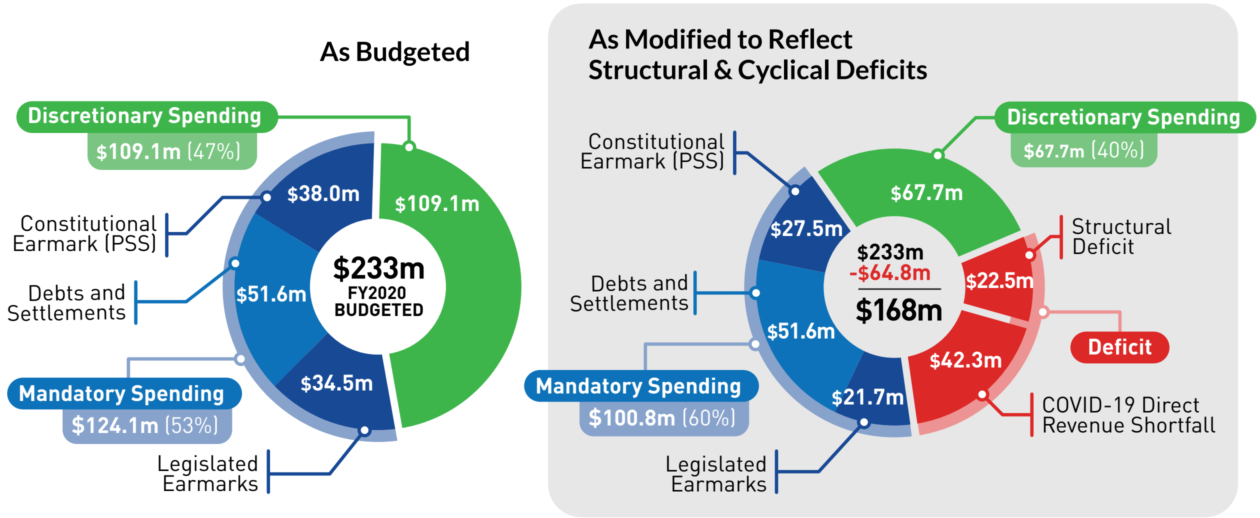
Clearly, such rigidities will make a comprehensive fiscal response more complicated and, perhaps, more painful for those parts of the government not favored by earmarks. In the long-run, an improved fiscal policy for the CNMI would necessarily address—and reduce—the role of earmarks.

Figure 4 *CNMI General Fund Personnel Growth FY13-FY19*



Source: CNMI audited financial statements through FY2018 and CNMI Department of Finance and Task Force estimates

Figure 5 *CNMI FY2020 Fiscal Operations*

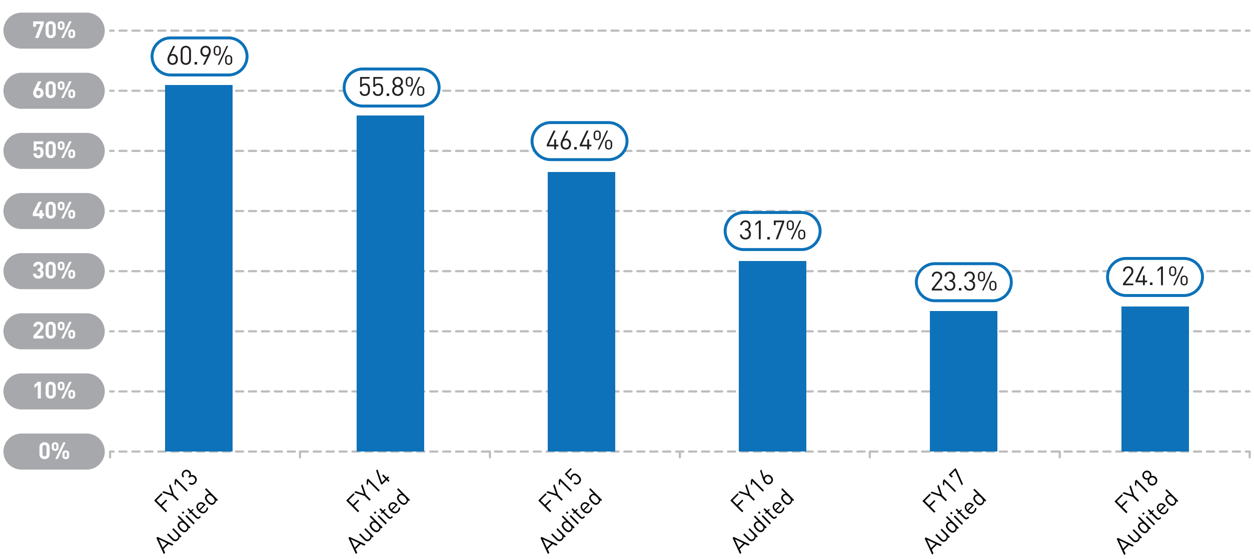


PSS reduction from $38.0 million to $27.5 million is based on the assumption that the original budget reflected the 25 percent requirement; this modified figure reflects a revenue base reduced by $42.3 million (plus expected Compact Impact funds of $0.2 million). Legislated Earmarks reduced from $34.5m to $21.7m to reflect reductions in gross revenue estimates from which the specific earmarks are derived and recent suspensions of certain earmarks.

Source: FY2020 CNMI Budget and subsequent Governor's communications to the Legislature

Looking at economy-wide factors, **Figure 6** shows that the official debt for which the CNMI is responsible for paying has come down from dangerously high levels—anything above a 30 percent debt to GDP ratio is considered to place the government in "debt-distress" position. Notably, the CNMI has come down from high levels of debt to a sustainable level of debt. If the core operations of the CNMI government were not structurally imbalanced prior to the COVID-19 pandemic, and if the pandemic's impact was small and limited in time, one could argue that the CNMI would have been eligible to make an orderly and measured return to the

Figure 6 *CNMI Total Liabilities as Share of GDP*



Source: CNMI audited financial statements and US Bureau of Economic Analysis bond markets with institutional quality issues and moderate borrowing costs. Such a return to those markets is out of the question at this time. Neither should a return to borrowing be the primary response of the CNMI even after the worst of the current fiscal crisis is in the rear-view mirror.

Figure 7 shows the population of the CNMI as reported by the US Census Bureau. A striking feature is the rapid decline in population from FY2004-2009 followed by more gradual annual declines through the present. The economy last faced a sustained and deep decline in the five consecutive years from 2005 through 2009. It is hoped that the decline being caused at this moment by the COVID-19 pandemic will be short enough in time to not cause a renewed and sustained period of population decline.

Finally, with respect to this brief summary of fiscal and economic factors that will affect the decisions that Commonwealth leaders will need to make to bring the CNMI into near-term fiscal balance and to prepare the CNMI for economic recovery after the COVID-19 pandemic has relented, the *Task Force* shares Figure 8. Clearly the CNMI is a tourism (and gaming) driven economy. With volatility in value-added as measured by the US Bureau of Economic Analysis for the gaming sector, the ratios fluctuate significantly; however, the total amount of employee compensation attributed to the sector presents a smooth and increasing trend.

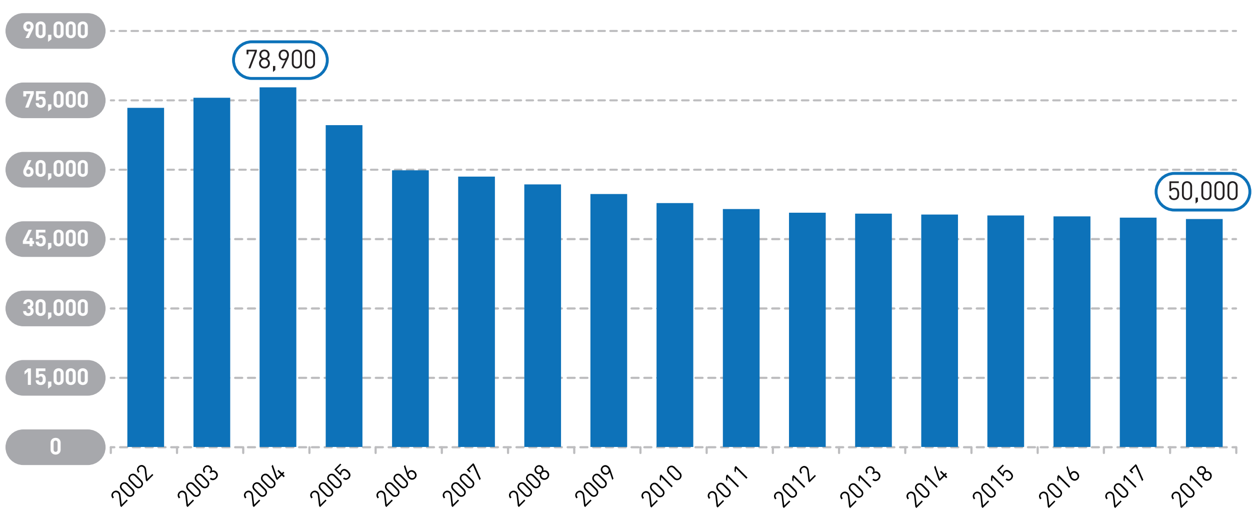
> *...it is estimated that the impact through FY2021 will be a 25-30 percent decline in GDP...*

With over a third of the economy based on direct accommodation and gaming businesses, the CNMI needs to be prepared for an extraordinary impact from the COVID-19 pandemic on the economy—and thus on its fiscal operations. The *Task Force* does not have a fully-specified macroeconomic model to project the full impact; however, it is estimated that the impact through FY2021 will be a 25-30 percent decline in GDP on top of the 18 percent decline measured by the US Bureau of Economic Analysis for FY2018 (the last year for which GDP is reported).

The intended use of the analytical/facilitative support of the Fiscal Response Task Force

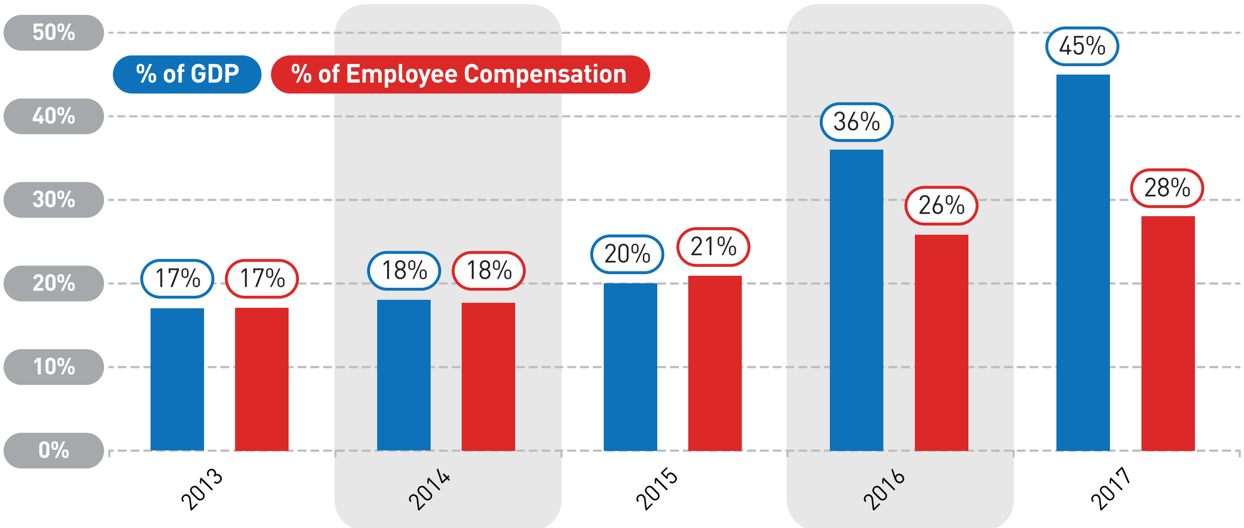
The work presented in this briefing paper—together with the policy-modeling tools

Figure 7*   *CNMI Population



Source: US Census Bureau

Figure 8 *CNMI Accommodations & Amusement Sector*



Source: US Bureau of Economic Analysis

developed by the Task Force—would best be used to support a broad-based, participatory Leadership Summit. Such a Summit would allow for representatives of all stakeholders in the Commonwealth to (i) fully comprehend and deeply understand the size and nature of the current crisis; (ii) have all of their questions and concerns answered with respect to the underlying fiscal and economic assumptions and findings; and then, (iii) work collectively and collaboratively to choose among the presented policy options to create and endorse a Fiscal Response Policy Package sufficient to address the size and urgency of the current crisis.

The Fiscal Response Policy Package that would be expected to emerge from the Summit process outlined above would have two simultaneous benefits of great importance to the Commonwealth. Firstly, the process would allow for a consensus process that brings all parties to an internally designed and endorsed "way forward" that could be implemented in a spirit of cooperation. Secondly, the domestic consensus—and the implementation of painful but necessary fiscal measures—would bolster the credibility of the CNMI when seeking assistance from its potential partners (especially the federal government), other financing sources, and perhaps even the federal court if financing relief is sought as a part of a policy package.

Sensible and necessary COVID-19 precautions preclude the convening of a Summit

Unfortunately, the nature of the crisis that has caused the cyclical component of the current fiscal crisis eliminates the possibility of convening a broad-based, participatory Leadership Summit as originally envisioned and endorsed. The health-related risks to the CNMI posed by such a gathering are simply too great. The analytical and facilitative support of the Fiscal Response Task Force will need to be utilized in another—less than ideal—manner.

Plan B: A smaller, physically dispersed process utilizing Remote Conferencing Technology

The alternative to hosting a Commonwealth-wide public summit would involve the creation of a targeted group of public and private sector leaders gathered under the auspices of an officially chartered Fiscal Response Commission. The creation and makeup of this Commission may be guided by Legislative Resolution submitted to the Governor in an effort to ensure objectivity and shared ownership of the Commission and its mandates. Care should be given in the formulation of this group toward adhering to local, national and international health guidance which recommends limiting the size of gatherings. Ideally, the total size of the Commission would not exceed twenty (20) individuals.

This Commission will be supported by the *Fiscal Response Task Force* and will be expected to provide an avenue for a broad cross-section of individuals throughout the community to assess the current crisis and begin the iterative process described for the full summit exercise. The Fiscal Response Commission will work toward the development of an Implementation Plan of agreed upon fiscal policy actions.

The Fiscal Response Commission will work toward the development of an Implementation Plan of agreed upon fiscal policy actions.

The Implementation Plan will be created following the consensus decisions of the Fiscal Response Commission and will be made public with clear delineations of entities responsible for carrying out the action, the timeline for implementation, and the intended result of each action.

To ensure the safety of the assembled members of the Fiscal Response Commission, a large meeting area will be reserved that will allow the recommended physical distancing between individuals. Further, the Commission will be divided into two smaller subgroups that will work through the process with a goal of agreeing on selected policy options.

While not providing the broadest level of participation of stakeholders that a full summit would have achieved, this Commission approach—deemed a necessity for public health—provides (i) a necessary baseline of information of this crisis; (ii) allows for collaboration across sectors toward possible solutions; and (iii) creates the opportunity for a plan that is endorsed by representatives of the primary stakeholders within the Commonwealth.

Analytical Findings of the Fiscal Response Task Force

TASK 1A: The Structural Deficit

To assess the structural deficit, the Task Force reviewed audited financial statements through FY2018, an unaudited general fund revenues and expenditures report for FY2019, and a financial system report for FY2020 through 29 February (5 months). The Task Force also used visitor arrival data for China to estimate the permanent downturn in Chinese visitors (as distinct from the COVID-19 related temporary losses). Our estimates are that approximately 30 percent of the China visitors will not be recovered even after the COVID-19 pandemic is no longer an issue. The CNMI experienced a decline in the impact of Chinese visitors beginning in the last quarter of CY2019—prior to any COVID-19 impact—due to, decreased demand for travel among Chinese tourists to U.S. destinations, rapid devaluation of the Yuan, and the widespread economic consequences as a result of the ongoing trade dispute between the United States and China.

The components of the structural deficit are detailed (as best current estimates) in Table 1. The impact is partial (from the reduction in Chinese visitors) for FY2020 and of the same size for FY2020-FY2022 for all other components. The Task Force used multi-year data for four categories of consistent over-expenditure to estimate the size of the structural deficit at $22.5 million annually. Those categories are: medical referrals, overtime, utilities and banking fees.

Solutions to a structural deficit typically require permanent fiscal response policies. A policy adopted mid-year in FY2020, if kept in place, will have a larger impact in the full fiscal years following.

Table 1: Best Estimate of the Size and Components of the CNMI Structural Fiscal Deficit, FY2020-FY2022

		FY2020	FY2021	FY2022
CNMI Structural Deficit (est. @ FY20 start)		(22.5)	(22.5)	(22.5)
China Tourism Loss COVID-19 Structural Deficit	30%	(6.1)	(9.1)	(9.1)
Structural Deficit sub-total		(28.6)	(31.6)	(31.6)

Solutions to a structural deficit typically require permanent fiscal response policies.

Task 1B: The Cyclical Deficit

To assess the cyclical deficit, the Task Force used actual visitor numbers for prior fiscal years and data available through 27 February. The subsequent loss of the slowly recovering Japanese market has not been taken into account as of yet—the recovery in Japan visitors was not anticipated in the FY2020 budget process. The components of the cyclical deficit are detailed (as best current estimates) in **Table 2**. The assumptions used for the length of this crisis differ for the origin of visitors:

- The Task Force assumes travelers from South Korea will begin to return to the CNMI starting in April 2021 and gradually grow through the remainder of FY2021. By the outset of FY2022 it is assumed the numbers of visitors from South Korea will be fully recovered.
- For China, the Task Force assumes the recovery will begin three months later and the 70 percent of previous visitor numbers will be fully attained by the end of December 2021. The cyclical impact resulting from China visitor reductions is thus projected to spill over into the first quarter of FY2022.

Solutions to a cyclical deficit typically require only temporary fiscal response policies. A policy adopted mid-year in FY2020, may be reduced or even eliminated when the cause of the cyclical fiscal shock has been resolved and revenues have recovered.

Task 1: The Combined Deficit

The Task Force planned to support the Summit participants to address the full deficit—both structural and cyclical—through the development of an appropriately "sized" fiscal response package. Given public health realities, the Task Force will now direct their support to the smaller, but still representative and participatory Commission described above. **Table 3** shows the combined total of the deficit. This $64.8 million is the TARGET size of the needed fiscal response package for the remainder of FY2020. This target assumes the full FY2020 budget and does not account for impact of the budget reduction directives issued by the Governor in February and March. Part of

Table 2: Best Estimate of the Size and Components of the CNMI Cyclical Fiscal Deficit, FY2020-FY2022

		FY2020	FY2021	FY2022
China Tourism Loss, COVID-19 Cyclical Deficit	70%	(14.2)	(21.3)	(5.3)
Korean Tourism Loss, COVID-19 Cyclical Deficit	100%	(22.0)	(32.3)	(0)
Cyclical Deficit sub-total		(36.2)	(53.6)	(5.3)

Table 3: Best Estimate of the Size of the Full CNMI Cyclical Fiscal Deficit, FY2020-FY2022

	FY2020	FY2021	FY2022
CNMI DEFICIT TOTAL	(64.8)	(85.2)	(36.9)
CNMI Fiscal Stabilization Contribution Target, est.	-	-	20

Solutions to a cyclical deficit typically require only temporary fiscal response policies.

the work of the task force will be to ensure that core governmental functions can continue while less critical programs are paused until this crisis has passed.

Note that Table 3 includes a "proposed" surplus for FY2022. While this is a notional estimate and entirely subject to the will of CNMI's decision-makers, it is put forward as a "best effort" goal for fiscal policy in the CNMI. Assuming a return to normalcy in the tourism market, the level of fiscal adjustment that the CNMI might have implemented during the final six months of FY2020 and all of FY2021 would be more than enough to run a surplus budget in FY2022. Such a surplus budget could be the beginning of a fiscal responsibility regime that would be well-suited to the concentrated, tourism-reliant economy of the Commonwealth. The goal of a Commonwealth fiscal responsibility regime would be to be able to support itself without massive fiscal disruptions and without reliance upon external support through the fiscal shocks that can be conservatively modeled—and therefore expected—in terms of size and frequency.

Task 2: Identifying Potential Fiscal Response Policy Options

The Fiscal Response Task Force reviewed the entire fiscal operations of the CNMI government, including all branches and all agencies. The range of fiscal response policy options is meant to be comprehensive, constrained only by the likely viability of each potential option. The overriding assumption is that the CNMI will consider all options—and seek all relief—that will enable it to continue operations without failing to meet its obligations and without forcing financing onto the private sector or other institutions through any failure to fully meet its bi-weekly payroll including all allotments therein.

Task 2A: Expenditure Reductions

1. Reduction in hours worked (e.g. from 80 to 64 hours per pay period, already implemented and estimated to save approximately $3.8 million in the last half of FY2020)
2. Reduction in Personnel
    a. Transition of personnel to federal grant coverage (by fractional FTEs)
    b. Reduction of jobs resulting from mergers or consolidation of units
    c. Temporary reduction of jobs (furlough period to be estimated)
    d. Permanent reduction of jobs
3. Reduction in Overtime
4. Reduction in Travel
5. Reduction in Professional Services
6. Reduction in All others
7. Cancel/Postpone Additional 25% Pension Payments
8. Reduction in Medical Referral costs

Task 2B: Revenue Enhancements

1. Reform of the BGRT
2. Reform of the Earnings Tax

3. Reform of the Rebate of Territorial Income Tax
4. Increase of Selective Fees

Task 2C: Re-Allocation of Public Funds

1. Reform Medical Referral (funded MOU with CHC)
2. Collect GF-expended Payroll Expenses from FEMA
3. Collect GF-expended Procurement Expenses from FEMA
4. Seek Pledge from Commonwealth Casino Commission
5. Seek Temporary Reallocation from Casino License Fee (with Advance)
6. Seek removal/relief from various earmarks to broaden participation in fiscal response.

Task 2D: Financing options including potential federal support for fiscal adjustment

1. Seek Financing Relief from Full Payment of Pension Liabilities (Extend Settlement Period)
2. Seek Federal Assistance through relief from FEMA matching requirement
3. Seek temporary allowance for section 702 CIP use to support fiscal response
4. Seek Federal Assistance through COVID-19 stimulus program(s), including CNMI share under the CARE Act ($38 million for use from March 1 – December 31, 2020
5. Seek community disaster loan program from FEMA ($5 million)

Using the Fiscal Response Policy Modeling Tool

The above-outlined policy response options are will be each fully "costed" to show what level of contribution each area—in specified levels of adjustment—would contribute to solving the overall size of the fiscal deficit in each fiscal year. If the exercise is undertaken by a participatory and representative group or groups, the Task Force will provide:

- A keynote presentation of the size and nature of the fiscal challenge and an overview of the content of this briefing paper;
- The policy model itself, specified for each of the above policy options;
- Technical support to each group in the form of "operators" of the policy model so that as each of the policy response options is considered, a rolling, cumulative impact on the final solution will be calculated and visible to all parties;
- Informational support in the form of background material to support consideration of each of the policy response options; and
- On-demand analytical support in the event the groups using the tools have new policy options to consider or if additional, detailed calculations that had not been anticipated need to be made.

In conclusion, the Task Force stands ready to support the CNMI leadership in general and the Fiscal Response Commission specifically to achieve consensus on a fiscal response package that hits the target of $65 million for FY2020 and $85 million for FY2021. As noted above this will require the Commission members to work collectively and collaboratively to choose among the presented policy options to create and endorse a Fiscal Response Policy Package sufficient to address the size and urgency of the current crisis.

...the Task Force stands ready to support the CNMI leadership in general and the Fiscal Response Commission specifically.

This *Commonwealth Fiscal Response Briefing Paper* was prepared by the *CNMI Fiscal Response Task Force* at the invitation of Hon. Governor Ralph DLG Torres. It is intended to serve as a technical input into a fiscal reform process that will be led by CNMI leadership. Composition of the *CNMI Fiscal Response Task Force* includes representatives from the CNMI government, with analytical and technical support provided by the Graduate School USA's Pacific & Virgin Islands Training Initiatives (PITI-VITI). PITI-VITI is funded through technical assistance from the Department of the Interior's Office of Insular Affairs; additional program information is available online at http://www.pitiviti.org.