RMI Policy Note

Adopting a two phased approach to Tax Reform in the RMI

Background

Since the original tax reform policy note prepared by the Graduate School[1], the RMI government has indicated its interest to adopt the reforms. However, given the time to implement the program, usually in the order of two years, the government has indicated its desire to provide some tax relief immediately to the lower and disadvantaged income groups for recent cost of living increases. This is sensible as the first stage reforms are quite easily done, while the delay of the second stage would allow sufficient time for legislation and technical preparation for implementation of the full reform program in a managed and efficient manner within the subsequent two years. A two-part or phased approach is thus proposed with the following timetable: the first on October 1, 2024, and the second phase following two years later.

The goal of this note is to add to the prior tax reform proposal and should be read in conjunction with it. The note focuses on the design of the two-staged approach and its economic and fiscal impact. It concludes with an explanation of the interplay between the structure of the wage tax system and fiscal impact.

Design of the Proposed Reforms

In the first stage, an initial tax relief is implemented by overhauling the current tax on wages and salaries. Wage earners earning an annual income of $8,320 (equivalent to the new minimum wage of $4 an hour) or less will be exempt from taxation. Earners with a yearly income between $8,320 and $15,600 ($250 a week) will have all income taxed at 8 percent. Wage earners earning between $15,600 and $26,000 ($500 a week) will have the first $15,600 subject to the 8 percent tax while the excess of their income will be subject to 12 percent. Wage earners earning above $26,000 will pay the same as the prior group plus 16 percent above that level. Table 1 summarizes the proposed annual income bands and their respective tax rates.

1 *Tax Reform Options for the RMI and the Estimation of the Fiscal and Economic Impact*, Graduate Schol USA, May 2024.

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Table 1: Income Brackets and Tax Rates at the Initial Relief

Annual Income Brackets	Tax Rate
$0-$8,320	Nil
$8,321-$15,600	8%
$15,601-$26,000	12%
above $26,000	16%

The tax boundary distortion is not removed during phase 1. As discussed in the original tax reform policy note, the current tax regime suffers from a distortion at the $5,200 boundary. Since wage earners above this level pay 8 percent of all income, somebody earning between $5,200 and $5,650 will receive less take home pay than someone earning $5,200. It is not proposed to remove this "distortion" during phase 1, but it is intended to be fully corrected and removed during phase 2 when the full package will be implemented. The reasons for this approach are explained below.

A comprehensive tax reform package is pursued in the second stage. Following the initial tax relief in phase 1, the full package consisting of further income tax reforms, the introduction of the Marshall Islands Consumption Tax, excise taxes, and the business profits tax will be introduced. In the second stage the tax bands and rates are left unaltered. However, unlike the initial relief, the tax band distortion is now removed. This means that all wage earners will now receive the first $8,320 of their annual income tax-free.

Economic and Fiscal Impact

a. Initial Tax Relief

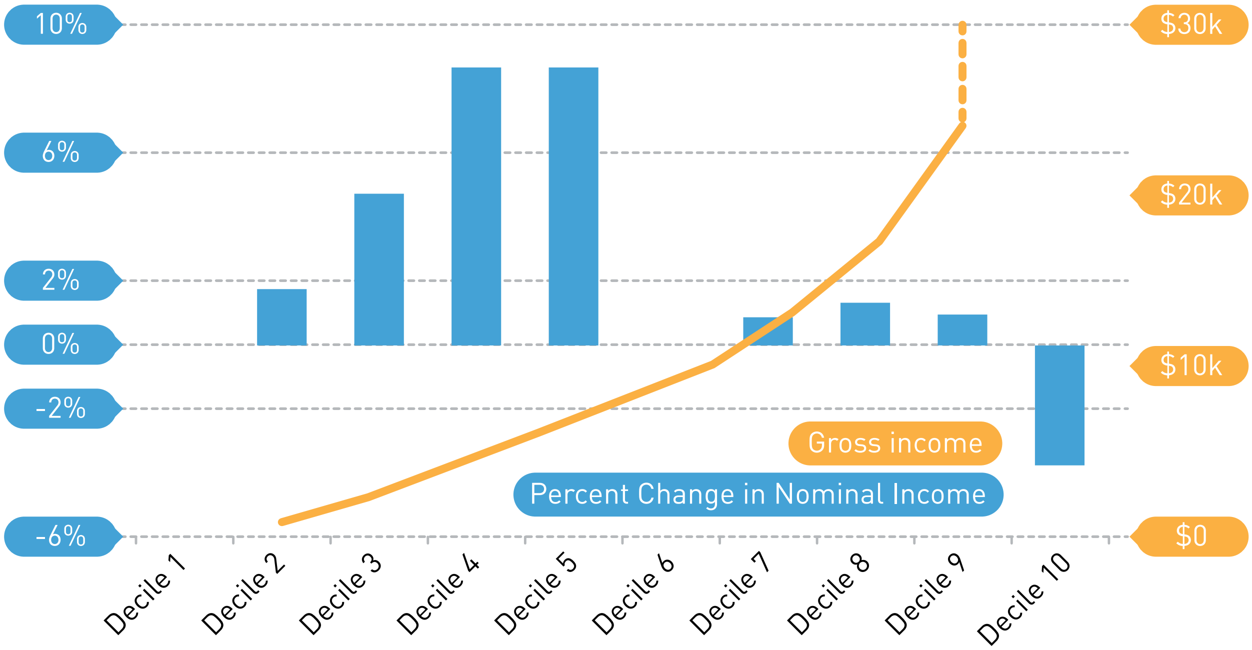
The impact of the initial tax relief is concentrated on lower-income households. Figure 1 shows the percentage increase in nominal incomes by decile group after implementing the first stage of the reforms. On average, the after-tax nominal incomes of RMI wage earners are expected to increase by 2.4 percent. More importantly, the figure also shows that the lower 50 percent of wage earners distribution in the economy or those earning lower than $7,500 in a year will significantly benefit from the relief. Additionally, the impact on the first decile remains nil as these are workers who earn below $1,560 annually and are exempt from taxation in the current system .

Wage earners in the top decile are taxed at a higher rate than present and experience a loss in real income. While the seventh to the ninth decile will benefit from some relief in the first stage, wage earners belonging to the highest income group experience a relative decline in after-tax incomes given changes in the tax rates compared to the current system.[2]

The initial tax relief benefits to wage earners in the Marshall Islands given amounts to $1.8 million. This is also a direct loss in revenues to the national government. The estimated value of the tax relief benefits represents 11.0 percent of the total wages and salaries tax collection of RMI authorities in FY22.

2 The fact that some wage earners appear to be paid below the minimum reflects that these workers are employed for less than full-time or only a part of the entire year.

Figure 1: Impact of the Initial Tax Relief on Nominal Incomes by Decile



Source: EconMAP calculations.

b. Second-Stage Wage Tax Reform

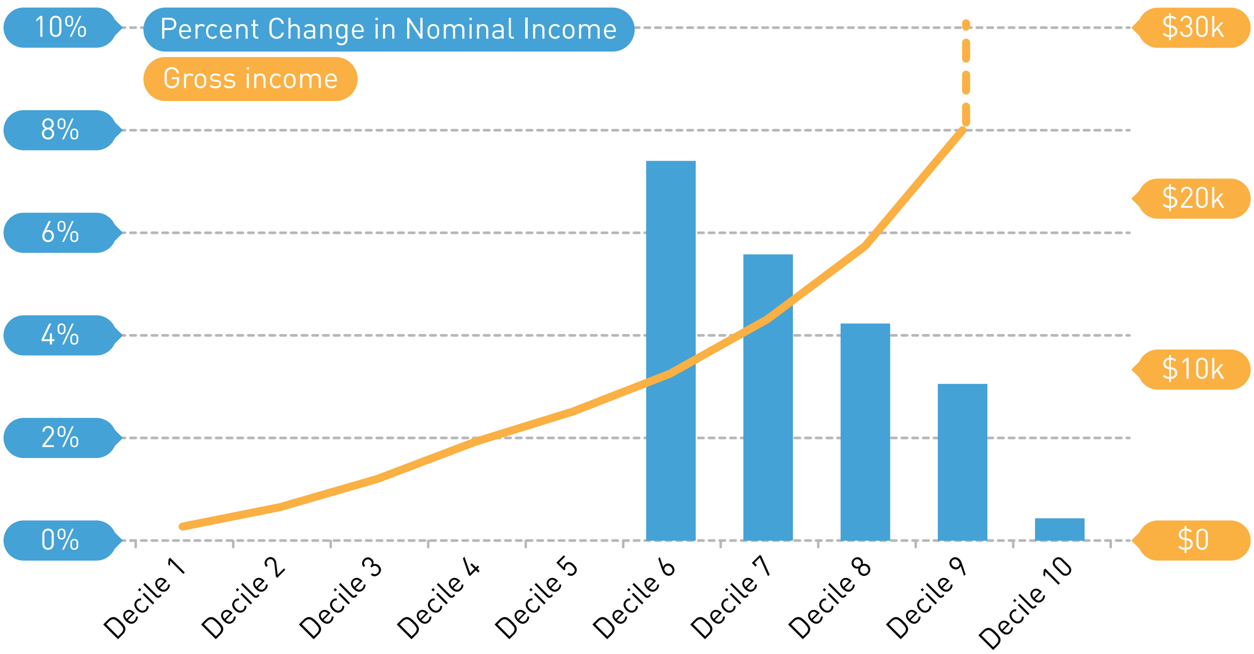
Higher-income taxpayers will reap nominal after-tax income benefits in the second stage. As the tax-free threshold is extended to higher-income taxpayers, in the second round of tax reforms, the upper deciles will enjoy higher after-tax incomes. Further, the benefits are higher for taxpayers who are in the upper middle part of the distribution (sixth and seventh deciles) relative to the eighth, ninth, and tenth deciles (**Figure 2**). Given that the lower decile wage earners have been eligible for the tax-free thresholds in the first round and the same benefit is enjoyed in the second round, there is no addition in nominal after-tax incomes for wage earners in these groups.

c. Overall impact of the Wage Tax Reforms on Household Incomes

Taking into account inflation, the overall effect of the tax reforms on household incomes remains positive. After the introduction of the Marshall Islands Consumption Tax (MICT), the repeal of the BGRT, food taxes, general import taxes, and local government sales taxes, the reforms will induce a change in the price of goods and services in the economy[3] and real incomes (earnings after inflation). **Figure 3** demonstrates that the overall impact of the reform remains positive for all taxpayers except for those belonging to the highest income group. In particular, on average, the real income of Marshallese wage earners is estimated to increase by 4.9 percent.

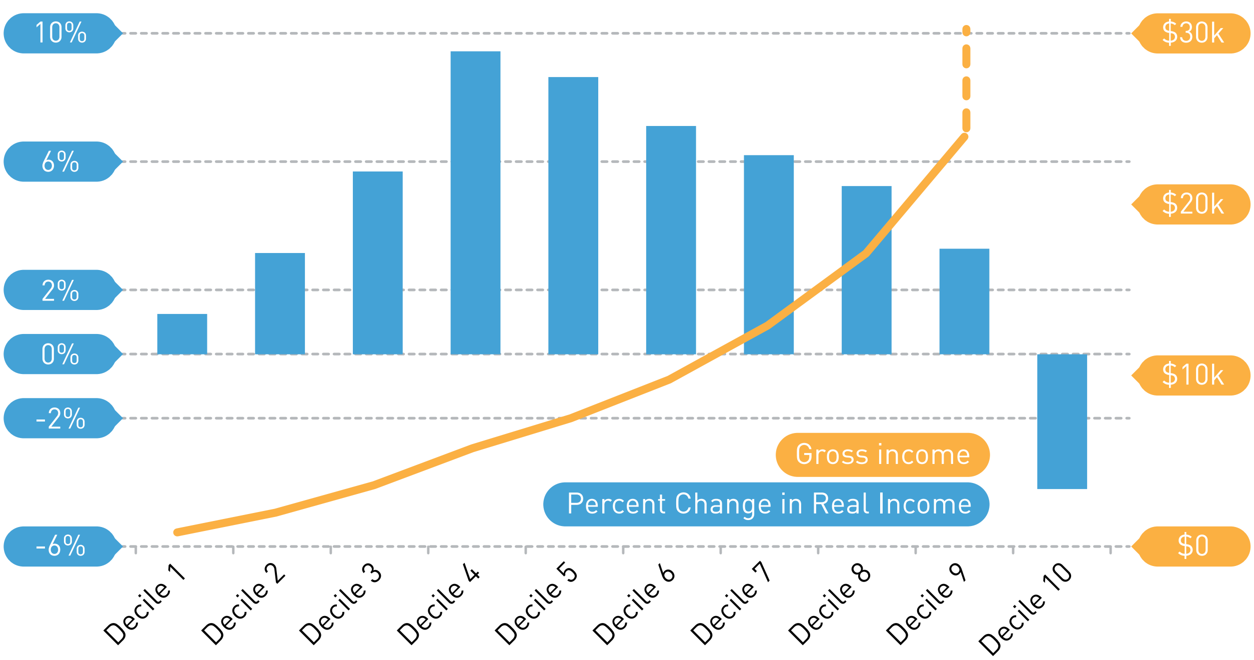
3 The impact of prices of the comprehensive tax reform is outlined in the Graduate School USA's paper on Tax Reform Options for the RMI and the Estimation of the Fiscal and Economic Impact.

Figure 2: Impact of the Second-round Income Tax Reforms on Nominal Incomes by Decile



Source: EconMAP calculations.

Figure 3: Impact of Overall Tax Reforms on Real Incomes



Source: EconMAP calculations.

Fiscal Implications of the Phasing of the Reforms

The reforms introduced in phase 1 to the wages tax do not immediately eliminate the boundary distortion; this is removed in stage 2 when further benefits are provided to wage earners. The design of the two-phase approach and the provision of tax relief in the early stages to low-income earners was chosen to avoid a large immediate negative fiscal impact. An alternative approach might have been to reform the wage tax regime and eliminate the boundary "distortion" in phase 1. However, with the tax rates and tax bands chosen, this would have led to an estimated $3.5 million loss in revenue, which was considered too great a burden for the RMI to absorb. Further, this policy would have eliminated measures to offset the changes in taxes resulting from the introduction of the MICT in stage 2. The removal of the boundary distortion thus occurs in the second phase which at the same time offsets the increased cost of living arising from introduction of the MICT.

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