



TECHNICAL ASSISTANCE REPORT

REPUBLIC OF THE MARSHALL ISLANDS

Consumption and Income Tax Reform

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Prepared By

Alexander Klemm, Vincent de Paul Koukpaizan, John McAlister, and Ross Warwick

Authoring Department

Fiscal Affairs Department

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Abbreviations and Acronyms

ADB	Asian Development Bank
ASYCUDA	Automated System for Customs Data
ATO	Australian Taxation Office
ATR	Average Tax rate
CBCR	Country by Country Reporting
CFC	Closed Foreign Company
CoFA	Compact of Free Association
COTS	Commercial of the Shelf
CPI	Consumer Price Index
DCTRT	Division Customs, Treasury, Revenue and Taxation
DFAT	Department of Foreign Affairs and Trade (Australia)
EIN	Employer Identification Number
FAD	Fiscal Affairs Department
FMIS	Financial Management Information System
GRT	Gross Revenue Tax
IMF	International Monetary Fund
IIR	Income Inclusion Rule
IT	Information Technology
ITAS	Integrated Tax Administration System
KAJUR	Kwajalein Atoll Joint Utility Resource Inc.
KPI	Key Performance Indicator
LTO	Large Taxpayer Office
LTX	Long Term Expert
MEC	Marshalls Energy Company
MICT	Marshall Islands Consumption Tax
MISSA	Marshall Islands Social Security Administration
MTR	Marginal Tax Rate
NDC	Nationally Determined Contribution
PACER	Pacific Agreement on Closer Economic Relations
PFTAC	Pacific Financial Technical Assistance Centre
PICTA	Pacific Island Countries Trade Agreement
PMO	Project Management Office
RMI	Republic of the Marshall Islands

ROW	Rest of the World
RST	Retail Sales Tax
RTU	Revenue and Taxation Unit
SIDS	Small Island Developing States
SOP	Standard Operating Procedure
SSN	Social Security Number
TA	Technical Assistance
TPS	Taxpayer Services
UBI	Universal Basic Income
UN	United Nations
UTPR	Undertaxed Profit Rule
VAT	Value Added Tax
VITARA	Virtual Training to Advance Revenue Administration
WoRLD	World Revenue Longitudinal Database
WHO	World Health Organization
WTO	World Trade Organization

Preface

In response to a request from the Marshallese authorities, a capacity development mission of the Fiscal Affairs Department (FAD) of the IMF visited Majuro, during the period December 4-13, 2024, to provide advice on tax policy and administration reforms to modernize and improve the income and consumption tax system. The mission comprised Messrs. Alexander Klemm (mission chief), Vincent de Paul Koukpaizan, Ross Warwick (all FAD), and John McAlister (PFTAC).

The mission met with Minister David Paul and many leading staff of the Ministry of Finance. It also met with Mr. Frederick De Brum, Director of the Economic Policy Planning and Statistical Office, Mr. Bryan Edejer, CEO of the Marshall Islands Social Security Administration, and Ms. Ryana Kumar, Chief Financial Controller of the Majuro Atoll Local Government. The mission also held meetings with Mr. Randel Silvester, head of the Tax Reform and Modernization Commission, and other commission members. Finally, the mission met with representatives from the donor community (Graduate School USA, Asian Development Bank, and Embassy of Japan) and the private sector (Marshall Islands Chamber of Commerce, Pacific International Inc.).

The mission wishes to express its sincere appreciation for the excellent support and cooperation that it received from Mr. Niuatui Niuatui, Resident Economist, in the Ministry of Finance.

Executive Summary

This report assesses consumption and income tax reforms in the context of an ongoing reform program. The first phase, covering revisions to personal income tax rates and thresholds, was legislated in October 2024 and may still be amended. The more involved second stage, which includes introduction of a value-added tax (VAT) and profit tax, is foreseen for October 2026.

The tax system of the Marshall Islands is relatively simple, but inefficient, being based on turnover taxes, import duties, and a personal income tax. Revenues are largely driven by grants, while tax revenues are only the third largest source of fiscal income at around 15 percent of GDP.

The depth of these important reforms will require significant preparatory work on the policy, legislative, and administrative sides, which should be supported by extensive capacity development. Ideally all reform proposals should be introduced as a package, but if prioritization becomes necessary, introducing a VAT and profit tax are the most urgent. Those two can be well combined, as both require similar bookkeeping and administrative changes. Strengthening administrative capacity through the recruitment and training of new staff is a priority. The IMF is preparing further significant support, which should be complemented by other donors, notably the ADB, with which the IMF (including PFTAC) teams are in close contact.

Indirect Taxes

The current system of general and specific import duties, local sales taxes, and a turnover tax, is inefficient. Import duties distort trade, and those specific duties addressing externalities do not cover local products. Local sales taxes that differ across municipalities create complexity. The cascading turnover tax does not fulfil the role of a consumption tax (or a profit tax, see below).

Many problems can be addressed by introducing a modern VAT at rate of 10 percent with a registration threshold of \$100,000. VAT would not cascade or distort trade and would treat different types of consumption more equally. It should be designed to be broad, with only a few exemptions (e.g., residential rents, margin-based financial services, property resales). The suggested rate ensures overall revenue-neutrality when combined with the other policy recommendations below, while the threshold balances revenue gains and administrative and compliance costs. A higher VAT rate is required if other revenue-raising measures are not implemented.

Specific import duties should be replaced by excises, many of which have scope for increases. Notably fossil fuels, tobacco, and alcohol are undertaxed in relation to their negative externalities. Indexing specific excises to inflation would maintain their value in real terms over time.

The foremost challenge for the tax administration is ensuring business continuity while preparing for the introduction of new taxes. Currently, a team of only seven staff members operates in a manual environment and lacks the resources needed for the successful implementation of new taxes. Key areas of focus should include reform project management, organizational structure, taxpayer registration, operating procedures and manuals, staffing and training, taxpayer education and publicity, information technology (IT) systems, taxpayer compliance, and post-implementation monitoring. Accomplishing these

tasks in a relatively short timeframe is a daunting challenge, even for larger tax administrations. The current capacity constraints are significant obstacles that need to be addressed promptly. Otherwise, the reform is at risk of encountering serious difficulties.

Development of an effective campaign to prepare the public and the business community will require significant effort. Past attempts to introduce tax reform appear to have been unsuccessful in large part due to a lack of understanding regarding the implications and benefits of the reforms.

Income Taxes

The sudden withdrawal of the tax-free allowance creates a notch, implying an exceedingly high marginal tax rate. Taxpayers earning near the notch are discouraged from working more or from complying. The reform legislated in October 2024 strengthens progressivity but exacerbates the notch.

To avoid this threshold effect, the tax-free allowance should be granted to every taxpayer, financed by higher tax rates. The mission prepared corresponding reform proposals, with the preferred option raising the top rate from the currently legislated 16 to 20 percent while being revenue neutral. The missions' proposals make the tax system more progressive (the regressive removal of the new 16 percent rate should be avoided). To maintain the system in real terms, thresholds should be indexed to inflation.

To broaden the labor tax base, the housing allowance should be abolished, and more generally, the treatment of in-kind benefits reviewed. A tax-exempt housing allowances of up to \$9,000 per year creates incentive to avoid taxes by changing the form of remuneration. Abolishing the housing allowance could finance an increase in the general tax-free allowance, which accrues to everyone. Other in-kind benefits, especially company cars, should be brought into the tax net.

Capital income should be included in the tax base. The wealthiest households receive significant shares of their incomes in the form of dividends, rents, capital gains, and interest, of which only land rents are taxed (at the low rate of 3 percent). Taxing interest income is particularly important, because this will be deductible under the profit tax. Initially, a simple solution with flat capital income tax rates would work well. Dividends paid by firms out of taxed earnings can be exempt (or subject to a lower rate).

The turnover tax (Gross Revenue Tax, GRT) favors successful and established firms, increases risks of bankruptcies, distorts sectoral composition, and discourages specialization. The fixed rate on turnover does not reflect differences in margins and tax cascading discourages production chains involving various firms. Moreover, international creditability of the GRT is not assured.

The new VAT should be complemented by a profit tax, which would address most of the disadvantages of the GRT. It is neutral with respect to profit margins because costs are deductible (so loss-making firms will not pay tax), and it does not cascade. It is creditable against other countries' profit taxes. For small enterprises, the GRT remains a more practicable option, but voluntary adoption of the profit tax (and VAT) would allow firms that are disadvantaged by the GRT to avoid its drawbacks.

Considering both revenue and international considerations, as well as interactions with the personal income tax, a tax rate of 20 percent would be a good starting point. This aligns with the mission's proposed top personal income tax rate and is above the new international minimum effective tax rate of 15 percent, while remaining among the lowest in the region.

The tax holiday and some of the exemptions can be abolished while pressure to introduce new tax incentives should be resisted. The 5-year tax holiday might have played a role to facilitate new business formation under a turnover tax, but is not needed under profit tax, which automatically exempts any firms that are not yet profitable. Instead of granting tax incentives, which favor one sector over others, a better strategy is to maintain a broad base and low rate. This would also be easier to administer.

The income tax reform will introduce changes with administrative implications. While the reformed taxation of labor income should not pose significant challenges to their administration, replacing the GRT with profit tax for large taxpayers will introduce new obligations for taxpayers and challenges for the tax administration. The underlying rules and principles of the profit tax are more complex than those of the GRT. The implementation of the profit tax will likely trigger an obligation to file financial statements with the tax administration, which in turn requires that accounting standards are aligned and followed.

Extensive education programs will be needed for business tax taxpayers. The requirements for self-assessing and paying profit tax liabilities are more complex than those of the GRT.

The tax administration needs to lift the level of tax compliance. While most large taxpayers have a high compliance rate (98.6 percent), small and medium-size businesses lag behind (56 and 89 percent respectively).

Cross Cutting Tax Administration Issues

The Revenue and Taxation Unit (RTU) (in the Division of Customs, Treasury, Revenue and Taxation) needs improvements to its organizational structure and staffing to effectively deliver its mandate. The current structure composed of only Compliance and Audit sections does not support modern tax administration. Essential functions, such as taxpayer services and assistance, or reform project management are missing. With only seven employees, the tax administration is understaffed, requiring the recruitment of additional staff.

The RTU should manage the tax registration database. A modern, risk-based tax administration requires knowing who must contribute through taxes, duties, and other lawful impositions. Recognizing who is and who should be in the tax system is crucial. Maintaining a high-integrity registration database by the tax administration enhances revenue system effectiveness. Without accurate data, voluntary compliance and confidence in the tax system may decline.

Efficient filing management is crucial for a tax administration to ensure that taxpayers can file their returns with ease and in a timely manner. Making it easy for taxpayers to pay is essential for a tax administration to ensure timely and accurate payments. Leveraging technology, such as online payment systems and electronic signatures, automates the process and reduces errors.

Efficient processing of tax refunds is crucial for maintaining taxpayer trust and compliance. Refund processing will be particularly important under the VAT to prevent unwanted cascading.

Verifications (including auditing) to ensure compliance with tax laws and regulations is a critical function of tax administration. Utilizing a risk-based approach to select audit cases improves efficiency by focusing on high-risk taxpayers or industries. Integrating third-party data sources, such as customs import data, aids in detecting non-compliance.

Recommendations¹

Tax Policy Aspects of Consumption Taxes		
No.	Description	Revenue Impact (Percent of GDP)
3.1	Remove import duties and local sales taxes, plus the GRT for businesses that register for VAT.	-6.86
3.2	Introduce a broad-based VAT using the destination-based, credit-invoice design for commencement in October 2026, with a standard rate of 10 percent and compulsory registration for businesses with turnover of \$100,000 or above (aligned with the profit tax).	+4.35
3.3	Make VAT registration voluntary for all other businesses with turnover of at least \$10,000, an established place of business, and sufficient bookkeeping. Maintain the GRT for businesses that opt to not enter the VAT system.	-
3.4	Introduce automatic indexing of all specific duty rates, with annual adjustments at the start of each fiscal year to alter specific duty rates in line with the change in the CPI in the preceding year.	0. Compared to baseline of no indexation: +0.04 (1-year) +0.17 (5- year)
3.5	Introduce fuel excise tax rates of \$0.50 per gallon for gasoline, \$0.31 per gallon for diesel and jet fuel, and \$0.12 per pound for LPG. In the medium-term, raise rates for diesel and jet fuel to be at least in line with gasoline.	+0.17
3.6	Abolish exemptions for fuel imports by energy utilities (or start by reducing them).	+0.32 (apply current fuel duty rates) +1.54 (apply fuel duty rates in 3.5)
3.7	Introduce a tobacco excise tax of \$2 per pack of 20 cigarettes and \$5 per 1.2oz pack of tobacco, maintaining the 151 percent rate on cigars.	+0.11

¹ All policy recommendations are for implementation from October 2026 (Phase 2), except the proposed changes to personal income tax thresholds and rates, which should apply from April 2025. The time frames for the administration recommendations are indicated in the Table.

3.8	Introduce alcohol excise taxes of \$0.375 per 12oz can of beer, \$13 per gallon of wine, and \$40 per gallon of spirits. In the medium-term, seek to apply a fixed rate per unit of alcohol of \$100 per gallon, adjusted for inflation.	+0.24
3.9	Consider national harmonization of tobacco and alcohol taxation in collaboration with the governments of Majuro and Kwajalein, including through revenue-sharing agreements.	-
3.10	Consider lowering purchase taxes on vehicles and increasing ownership fees or taxes, with differentiation by size and fuel efficiency.	0
Tax Administration of Consumption Taxes		Time Frame
4.1	Seek external technical assistance support, including the appointment of a long-term advisor or temporary supplementation to help with the development and implementation of the VAT project	Short-term
4.2	Strengthen project management by establishing a dedicated Tax Reform Project section comprising RTU and customs unit staff within the DCTRT to oversee the VAT reform efforts. This section should develop a comprehensive project document outlining critical outcomes, resource availability, and project management methodologies.	urgent
4.3	Enhance administrative capacity to address the current staffing limitations by recruiting additional staff and providing extensive training on VAT administration. This includes initial training for new recruits and ongoing training for existing staff. Include communications experts in the Tax Reform Project section.	Short-term
4.4	Improve taxpayer registration by launching a robust taxpayer registration campaign well in advance of the VAT implementation. Ensure that only registered VAT taxpayers can issue VAT invoices, claim refunds, and implement controls to prevent the registration of bogus businesses.	6-12 months prior to the launch of the VAT
4.5	Conduct publicity campaigns and engage with the business community and the public to inform and educate them about the VAT. Address concerns, provide necessary information, and highlight the benefits of the VAT reform.	6-12 months prior to the launch of the VAT
4.6	Develop effective compliance programs supported by IT systems and risk management techniques. This includes designing simple VAT return forms, providing support to taxpayers to them comply,	2-6 months prior to the launch of the VAT

	developing audit programs, and facilitating information exchanges with Customs.	
4.7	Progress with the ITAS acquisition project to leverage IT to support the VAT administration. If ITAS is not operational, consider manual administration for a limited period while ensuring the system development is aligned with policy.	Short to medium term
Tax Policy Aspects of Income Taxes		Revenue Impact (Percent of GDP)
6.1	Abolish the withdrawal of the tax-free allowance, financed by an increase in tax rates to 12, 16, and 20 percent and a reduction in the tax-free allowance by \$1000.	0
6.2	Abolish the tax exemption for the housing allowance and use the revenue gain to increase the tax-free threshold.	0
6.3	Review employer-provided in-kind benefits for inclusion in the tax base, starting with the private use of company vehicles.	+
6.4	Introduce a 10 percent flat capital income tax covering interest, rents, and capital gains, exempting dividends.	+
6.5	Automatically adjust annually all thresholds for inflation.	0
6.6	Replace the GRT by a profit tax at a rate of 20 percent for firms with turnover exceeding the VAT threshold from October 2026.	GRT included above. profit tax: + 1
6.7	Allow voluntary adoption of the profit tax in line with VAT, for firms that have the necessary accounting in place. Do not allow switching back to the GRT for at least five years.	-
6.8	Allow loss carry forward, either unlimited or for up to 5 years.	-
6.9	Abolish the tax holiday for new firms, grandfathering existing beneficiaries if they remain in the GRT. Refrain from adopting tax incentives other than accelerated depreciation. Review exemptions for potential removal, starting with the exemption for air transportation.	+
Tax Administration of Income Taxes		Time Frame
7.1	Plan for careful implementation including development of a detailed plan for tax reforms, including staff training and a timeline for rollout.	Short-term
7.2	Establish and enforce mandatory accounting standards aligned with Compact of Free Association (CoFA) requirements, for	First year of Profit tax implementation

	businesses to ensure the maintenance of accurate financial records.	
7.3	Digitally transform the tax administration and implement ITAS, moving from a paper-based system to a digital platform and ensure timely implementation of the ITAS to manage profit tax complexities and improve efficiency. If ITAS is not operational, consider manual administration for a limited period while ensuring the system development is aligned with policy.	Short to medium term
7.4	Implement taxpayer education and provide extensive support and training programs to help taxpayers understand new tax obligations and processes.	6-12 months prior to the launch of the Profit tax
7.5	Enhance compliance monitoring including strengthening compliance risk management using data analytics to risk assess and address non-compliance effectively.	Medium – term
Cross Cutting Tax Administration Issues		Time Frame
8.1	Enhance RTU organizational structure by adding dedicated sections for taxpayer services and assistance, as well as for managing ongoing reform projects.	Short-term
8.2	Recruit three or four additional personnel with project management and taxpayer service expertise to ensure effective cross-functional development and implementation of compliance strategies.	Short – term
8.3	Implement e-filing systems, electronic signatures, online payment systems, and automated refund processing to streamline processes, reduce errors, and improve compliance.	Medium - term
8.4	Develop key performance indicators (KPIs) to measure success along with regular reviews mechanisms to track progress and make necessary adjustments	Short - term

I. Introduction

1. This report assesses consumption and income tax reforms in the context of an ongoing reform program. Having planned a tax reform in the early 2010s, which was never implemented, authorities have shown renewed reform interest and are now planning a phased reform process. The first phase, covering revisions to personal income tax rates and thresholds, was legislated in October 2024; the more involved second stage is foreseen for October 2026.

2. The first phase of reform, even though already legislated, may still be amended, while many details of the second phase still needs to be defined. The changes to schedules and rates in the first phase cause no administrative issues, as no fundamental aspect of the system changes. As it will apply from May 2025, there is still time to amend changes, though. Authorities are considering removal of the legislated new top income tax rate, but the mission developed an alternative proposal removing a notch in the tax rate schedule and introducing a slightly higher top rate. Phase two will be more involved and cover replacing a turnover tax, local sales taxes, and various import duties, by a more modern system of value-added tax (VAT), profit tax, and excises. This second phase represents far more fundamental changes and require major administrative adjustments. This is a highly ambitious agenda, but feasible given significant previous work and the availability of donor support.

3. This report is structured as follows. The remainder of this introduction provides a brief background of the Marshalllese tax system, and the revenues it generates, followed by a summary of past technical assistance. Section II describes in more detail the current indirect tax system, followed by an assessment from a policy (Section III) and administration (Section IV) perspective. Section V turns to a description of the income tax system, again followed by a policy (Section VI) and administration (Section VII) assessment. Then Section VIII provides information on cross cutting tax administration issues.

A. The Marshalllese Tax System in Context

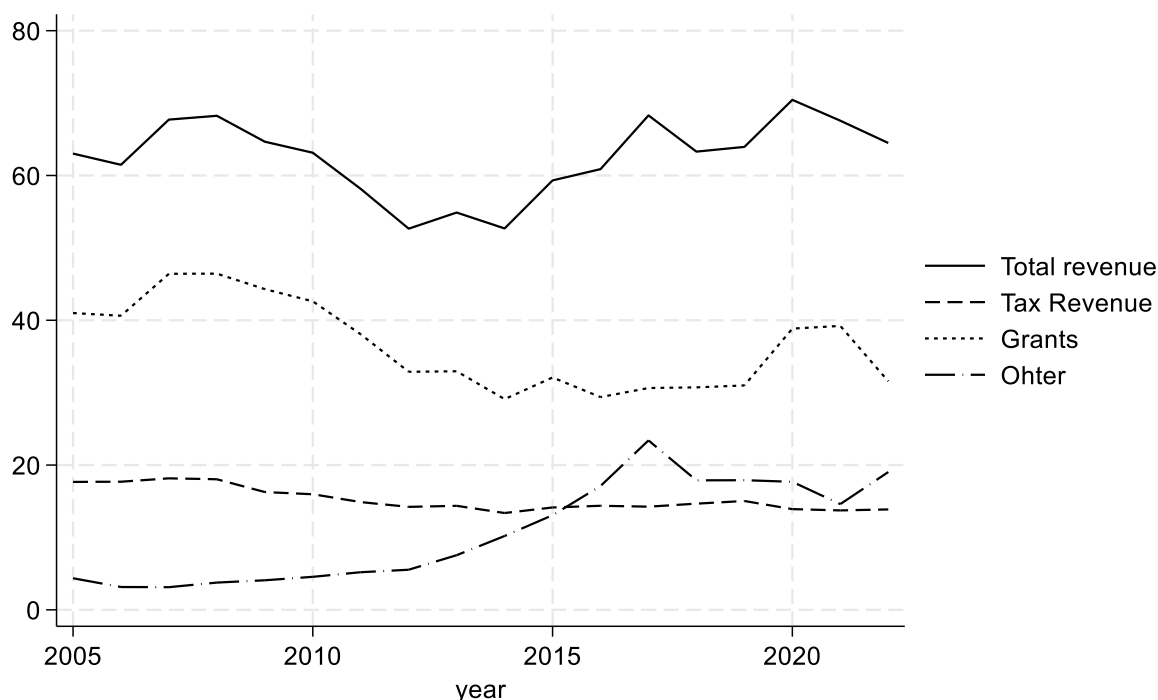
4. The tax system of the Marshall Islands is relatively simple being based on turnover taxes, import duties, and a personal income tax. This simple system has its origins in Trust Territory days. The most sophisticated part of the system is the personal income tax, which has a graduated rate structure, though it applies to labor income only. Further taxes include local sales taxes (in Kwajalein and Majuro), as well as property taxes. Most taxes are administered by the Division of Customs, Treasury, Revenue and Taxation (DCTRT) at the Ministry of Finance. The sales and property taxes are levied and administered at the level of local authorities.

5. The Marshall Islands have a very high fiscal revenue ratio, exceeding 60 percent of GDP in most years (Figure 1.1). During the pandemic year of 2020, the ratio even exceeded 70 percent of GDP.

6. The revenues are largely driven by grants, while tax revenues are only the third largest source of fiscal income. Grant revenue stands at over 30 percent of GDP (and almost reached 40 percent in the pandemic year of 2020). Other revenue—which represents mostly nontax revenue such as fishing licenses—is also important having risen over the last two decades toward 20 percent of GDP. Tax

revenues, however, raise only around 13-15 percent of GDP and have slightly declined over the last 2 decades.

Figure 1.1. Fiscal Revenues in the Marshall Islands, 2005-2022



Source: WoRLD.

7. The revenue structure is unusual, including in comparison to other small island states (Figure 1.2). Tax revenues in the Marshall Islands are low, even by the standards of small island developing states (SIDS). Grants are exceptionally high, though they are also significant on average in other Asian SIDS, while being very small in the SIDS in the rest of the world. Other revenues are comparable to Asian SIDS but far exceed those of SIDS in the rest of the world. Overall, these comparatively high nontax revenues might explain the low tax ratios. However, much of the grant revenue is earmarked for specific purposes or subject to complex rules under the compact with the United States. Moreover, revenue needs to address climate change are high. Hence, despite high grant revenue, there is a strong need to develop stable domestic resources.

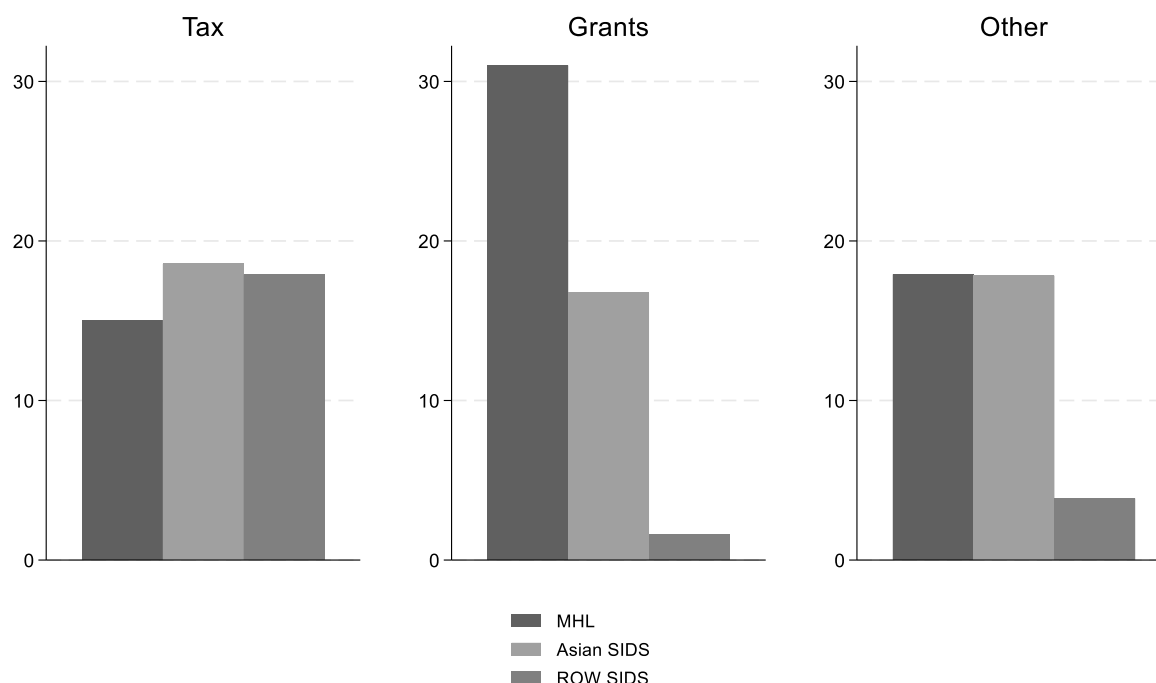
8. The Revenue and Taxation Unit (RTU) of the DCTRT is a small administration that compares unfavorably with the tax administrations of peer SIDS. It operates in a constrained environment and is structured around compliance and audit functions, with a limited staff number as shown in Table 1, high staff turnover and reliance on manual systems. The Marshall Islands' taxpayer base is narrow and composed of a few numbers of local and foreign entities and individuals—as of September 30, 2023, 642 taxpayers were registered for the GRT, 844 for the Marshallese wages and salaries tax, and 450 for the expat wages and salaries tax.

Table 1.1. Examples of Number of Staff in SIDS' Tax Administrations (FY2022)

	Fiji	Kiribati	Marshall	Micronesia	Nauru	Niue	Palau	Samoa
Number of Staff	695	28	11	53	16	6	22	230

Source : CIAT, IOTA, IMF, OECD, International Survey on Revenue Administration, <https://data.rafit.org>

Figure 1.2. Revenue Structure in the Marshall Islands and Comparators, 2019



Source: IMF staff estimates based on WoRLD.

Notes: averages for SIDS in Asia Pacific and the rest of the world (ROW) exclude the Marshall Islands.

B. Technical Assistance

9. The Marshall Islands received extensive technical assistance on tax reform, leading to a concrete reform proposal that was meant to be implemented in 2013, but was never adopted. The reform proposal built on advice by PFTAC (Mullins and McNeill 2009) and was further developed by Graduate School USA in 2013. More recently, Graduate School USA has updated their modelling of the original reforms.

10. Capacity development support on tax administration has also been substantial. Since late 2000s, IMF has provided technical assistance to modernize the tax system. PFTAC assistance has helped strengthen the capabilities and effectiveness of the RTU, including advice on reform planning and implementation, taxpayer compliance and information system strategy. In addition, the RTU benefited from technical assistance from long-term advisors with funding from the Asian Development Bank (ADB).

In November 2024, PFTAC provided support to implement Phase one of the reform approved in October 2024.

11. The substance of the previous advice and reform proposal remains highly relevant:

- The turnover tax on businesses (and a related tax on hotels) should be abolished, except as a presumptive tax for small businesses. It should be replaced by a profit tax and a broad-based consumption tax.
- Local sales taxes and standard import duties should also be replaced by the broad-based consumption tax.
- Special import duties and local government taxes on alcohol, tobacco, motor vehicles, and fuel should be replaced by excises.
- The personal income tax should be broadened beyond wages and salaries. Its rate structure should be revised to remove a harmful threshold effect (resulting from sudden withdrawal of the benefits of the zero-rate band) and by adding an additional higher tax rate for high income earners.
- Additional resources should be secured to support stronger rate of return for the tax administration.
- Taxpayer service improvement initiatives and supporting products should be developed to increase the level of voluntary compliance.
- Bold initiatives should be taken to modernize business processes and implement ITAS to enhance tax administration effectiveness, improve taxpayer compliance and reduce costs.

12. The successful implementation of the Marshall Islands' ambitious tax system reform program will require intensive and sustained external capacity development support. During the mission, the Minister expressed interest in IMF and PFTAC technical advice for developing and implementing the reforms. While the tax policy aspect is mostly covered in this report and will need only limited follow up, on the administrative side much remains to be done, and while draft laws exist from previous advice, they will need to be updated. The scope and modalities of the support needed have yet to be discussed and agreed upon. However, given the authorities' ambitious reform agenda, and aggressive implementation timelines, IMF and PFTAC CD support will likely commence before the end of IMF FY2025. Given the scale of the reform and the capacity constraints of the Marshall Islands, additional support, including appointment of long-term experts and temporary capacity supplementation from other partners will be needed.

13. The social security system may require specialized technical assistance. While beyond the scope of this report, the pension scheme appears to face significant medium and long-term solvency risks. These would require in depth technical assistance to determine solvency-enhancing reforms.

14. Other capacity development partners support tax reform initiative in the Marshall Islands. These include the Asian Development Bank, Australian Government and World Bank. Collaborative efforts and a robust coordination mechanism will be needed to ensure consistency and complementary of advice, and to avoid overlaps.

II. Current Indirect Taxes

A. Import Duties

15. Purchase taxes levied by the national government currently take the form of import duties, which provided 21.6 percent of total tax revenue in FY2024. An 8 percent tariff applies to general imports, with a 5 percent rate applying to most imported foodstuffs, subject to some exemptions described below.

16. Differential rates apply to certain other imported commodities. Imported fuels are subject to specific duty rates that are low by international standards—diesel duty is \$0.08 per gallon, for example. Public transport vehicles attract a 5 percent duty and other motor vehicles are subject to a 15 percent duty on their value determined by the Kelley Blue Book.² Alcoholic drinks and tobacco are taxed using specific rates, aside cigars which attract a 151 percent duty and mixed drinks which receive a 26 percent tariff. Soft drinks are also taxed according to a mixture of specific and ad valorem tariff rates.

17. Exemptions from import duty exist for a number of goods. Foodstuffs exempt from import duties include milk, rice, flour, vegetables, fruit, poultry, and canned fish. Other import duty exemptions include aviation imports (e.g., fuel, components), fuel imported by the Marshalls Energy Company (MEC) or for the Kwajalein Atoll Joint Utility Resource Inc. (KAJUR), fishing equipment, renewable energy and energy-efficient equipment, and inputs imported by local manufacturing industries.

B. Sales Taxes

18. There is no national sales tax in the Marshall Islands. Two local governments—Majuro and Kwajalein—levy and collect sales taxes, however. In Majuro, a 4 percent rate applies to retail sales, while in Kwajalein the rate is 10 percent and applies to wholesalers. Majuro applies a rate of 3 percent to professional services, 35 percent to tobacco and liquor products, and a hotel room tax of \$3 per room daily. Kwajalein additionally imposes local taxes: as of 2012 these were a 4 percent gross rent tax, fuel taxes at \$0.06 per gallon, a hotel room tax of \$2 per room daily, and specific tax rates on alcohol.³

19. A Gross Revenue Tax applies nationally and functions comparably to a non-reclaimable and thus cascading sales tax. This is described in Section V.

² When the value cannot be determined, a tax of \$2,500 is applied to new motor vehicles, and \$1,500 for used vehicles.

³ More recent details on the tax rates applied in Kwajalein were not made available to the mission.

III. Tax Policy Aspects of Indirect Taxes

A. Problems of the Current System

Import Duties—General Rates

20. The main advantage of imports duties as tax policies is administrative feasibility. With collection occurring at a limited number of entry points, focused collection and enforcement efforts are facilitated, which can help to limit evasion possibilities. However, import duties have many drawbacks as a major component of fiscal systems or when relied upon as the main form of indirect taxation.

21. Import duties are an economically inefficient source of tax revenue. They apply to all types of purchases, including imported capital goods and intermediate inputs. This raises the cost of investment and production, reducing economic activity and growth.⁴ These economic costs may be particularly large in a small, open, and import-dependent economy like the Marshall Islands. Terms-of-trade gains are unlikely and domestic substitutes for most capital goods and intermediate inputs are not available.

22. Import duties also apply to goods imported for consumption but only partially tax the resulting final consumption. Any domestic value-added embedded in final consumption is untaxed, narrowing the overall tax base. This also has unequal effects across domestic producers: those with high rates of domestic value-added face lower effective tax rates, all else equal. This is likely to put new businesses making investments or building inventories using foreign inputs at a disadvantage, for example.

23. While some domestic producers may benefit from the protection afforded by import duties, this comes at a cost to consumers. Domestic producers—such as local agricultural producers—in the Marshall Islands may benefit somewhat from trade protection. But consumers suffer from higher prices, and lower competition for domestic producers reduces incentives to increase efficiency. There are also unequal effects across consumers, with those with a preference or a need for imported products disproportionately taxed.

24. The import duty regime also has implications for the participation of the Marshall Islands in international fora and agreements. The country is not a member of the World Trade Organization (WTO) and has not signed or ratified the PICTA/PACER regional trade agreements. Under the Compact of Free Association (CoFA), most categories of exports to the United States are not subject to duty, but this is not reciprocal. Most Favored Nation rules in the CoFA mean that participation of the Marshall Islands in regional trade agreements would require extending similar treatment to imports from the United States, implying significant revenue implications under the current tax structure.⁵

⁴ A wide-ranging empirical literature illustrates the economic costs of trade barriers. See, for example, Furceri and others (2020).

⁵ See <https://www.fao.org/faolex/results/details/en/c/LEX-FAOC170019/>.

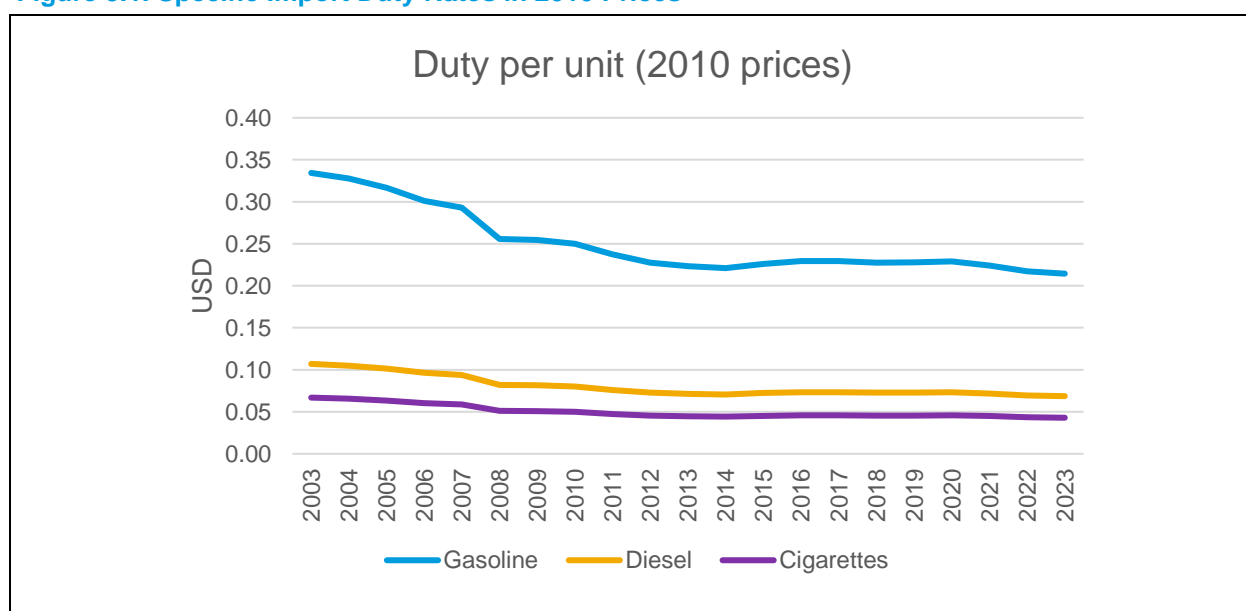
Import Duties—Differentiated Rates

25. Different rates of import duties apply to goods that carry notable social costs, or negative externalities. While the principle of applying differentiated rates to such goods is appropriate, the current calibration of these duties leaves much room for improvement.

26. It would be preferable to utilize excise duties—which apply to both domestic and imported varieties of dutiable products—than import duties alone. For the Marshall Islands, domestic production of the relevant goods is limited, and thus in practice the distinction is not currently consequential in all cases, but locally produced spirits and liquors should be subject to taxation. Moreover, excise duties are admissible under international trade practices and would make the tax system more robust towards any domestic market developments in future.

27. The specific import duty rates used in the Marshall Islands are not indexed to inflation and thus have been eroded in real terms over time. The specific (unit-based) import duties applied to fuels, alcohol and tobacco have largely remained the same in nominal terms over time. As a result, the inflation-adjusted value of these duties has fallen by more than a third in the last 20 years (Figure 3.1). While relatively stable consumer prices during the 2010s limited this effect, periods of stronger price growth quickly erode the price signal and real revenue returned by specific duties.

Figure 3.1. Specific Import Duty Rates in 2010 Prices



Note: Units are per gallon for gasoline and diesel and per cigarette for cigarettes. Prices adjusted using CPI index.

Source: IMF staff calculations, ADB.

28. The current taxation of vehicles and motor fuel is poorly suited for tackling the costs associated with motoring. While vehicle usage provides important mobility to residents, it also incurs social costs including local air pollution, congestion, and accidents. Tax policy should incentivize market participants to take these costs into account when making decisions by putting a price on the activities that give rise to these costs. The enhanced import duty for vehicles, which is proportional to vehicle value,

does not effectively incentivize choosing cleaner, smaller, or safer vehicles. More fundamentally, taxing vehicle purchases does not affect incentives to use vehicles once they are bought, and it is usage which creates these costs. Taxing fuel better targets incentives to use vehicles—at least given the current stock of vehicles which are predominantly internal combustion engine vehicles—but fuel taxes in the Marshall Islands are very low and have fallen in real terms over time due to a lack of inflation adjustment. In 2018,⁶ among 21 Pacific nations covered, the Marshall Islands had the fourth lowest taxes on unleaded motor gasoline, and the second lowest on diesel—though retail prices are comparatively high (Pacific Fuel Price Monitor, 2019).⁷

29. Exempting fossil fuel used in energy generation is inconsistent with the Marshall Islands' climate ambitions and local environmental preservation. The country's Nationally Determined Contribution (NDC) commits to reducing greenhouse gas emissions by at least 32 percent below 2010 levels by 2025, and a 45 percent decrease by 2030. The Tile Til Eo 2050 Climate Strategy finalized in 2018 set out a goal to reach net zero emissions by mid-century. Yet according to the Global Carbon Budget, CO₂ emissions from fossil fuels and industry rose by 13 percent between 2010 and 2023, and more than half of national emissions are due to electricity generation.⁸ Local fossil fuel combustion also produces pollutants which are harmful to human health. The duty exemption provided for fuel imported by MEC and KAJUR prevents price signals reflecting these social costs that would encourage both producers and consumers to reduce fossil fuel use.

30. National tobacco taxes are also low by international standards and have been eroded in real terms over the years by a lack of indexation. The World Health Organization (WHO) recommends that excise taxes account for at least 70 percent of the retail price of tobacco products, and total taxes at least 75 percent. As of 2018, the Marshall Islands was assessed to have an excise tax share of between 30 and 40 percent, and only 3 countries in the world were given a lower “cigarette tax score” by Economics for Health (Chaloupka and others, 2020).⁹ As a result, the tax system currently insufficiently discourages smoking given the significant social costs of such health behaviors. Local governments in Majuro and Kwajalein impose their own tobacco taxes too, but this leads to an uneven pattern across the country and opens the door to intra-country cross-border shopping. With nearly 30 percent of the population using tobacco, this is an important public health issue that the tax system can better address, while raising more revenue in the process.

31. National alcohol taxes are also low by international standards and are uneven between and within types of alcohol. Setting the appropriate rate of duty for alcoholic beverages is a complex task but current practice has several important gaps. First, rates in general are likely too low to properly reflect the externalities and internalities of alcohol consumption. Alcohol taxes in the Marshall Islands are the lowest as a share of retail prices among Western Pacific countries with available data (Figure 3.2, left panel). Again, local governments also impose alcohol taxes, but more robust and consistent national tax

⁶ The latest data available to the Mission. Notably, fuel taxes in the Marshall Islands have declined in further real terms since.

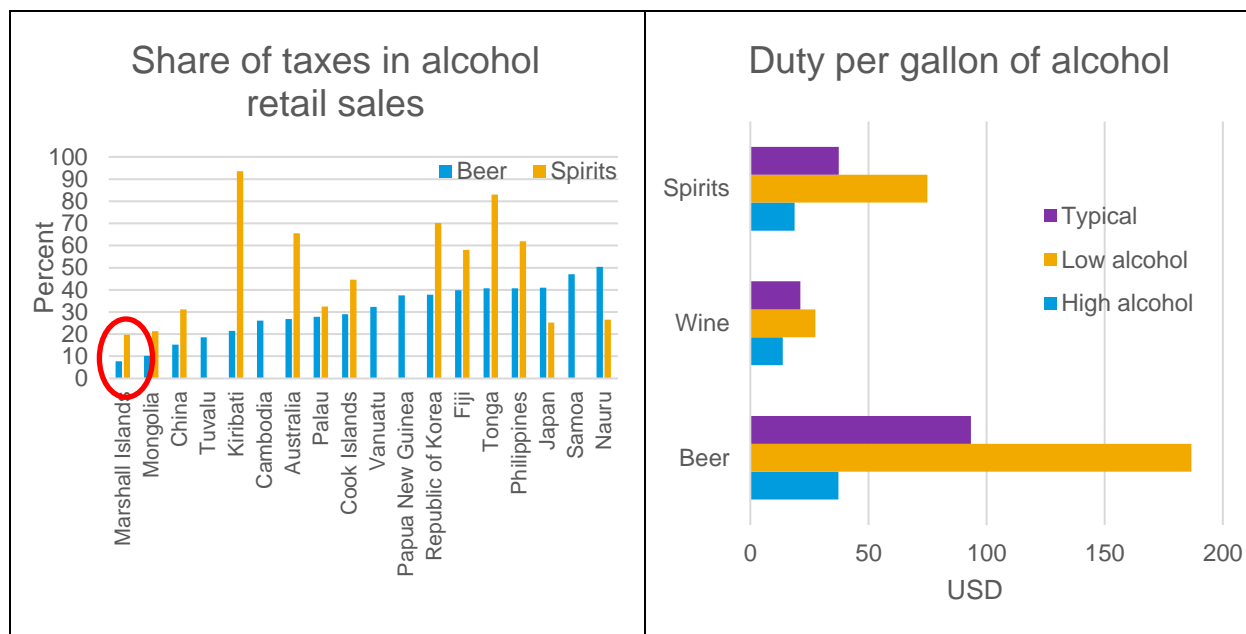
⁷ Annual vehicle registration fees are low: \$10 for motorcycles, \$25 for passenger vehicles, and a schedule rising with weight for larger vehicles like trucks and pickups.

⁸ See <https://ourworldindata.org/co2/country/marshall-islands#what-are-the-country-s-annual-co2-emissions>; and “RMI 2020 Paris Agreement NDC Update”, 30 December 2020. Available at: https://unfccc.int/sites/default/files/NDC/2022-06/RMI%20NDC-UpdateUPDATED_01.20.2021.pdf.

⁹ Economics for Health was formerly known as Tobacconomics.

policies would be preferable. Second, as with fuel and tobacco, non-indexation of specific alcohol duties has led to them being eroded in real terms over time. Third, the current design of alcohol import duties results in wide variation in the duty per unit of alcohol across drinks, which is the relevant source of the harms of alcohol. Relative to alcohol content, beer faces the highest taxes, while wine is taxed lightly (Figure 3.2, right panel). Within each type of drink, lower strength varieties are subject to much higher taxes per unit of alcohol. Lastly, as these duties only apply to imports, any domestic alcohol production is untaxed. While most alcohol is imported, some spirits are produced locally.

Figure 3.2. National Alcohol Import Duties

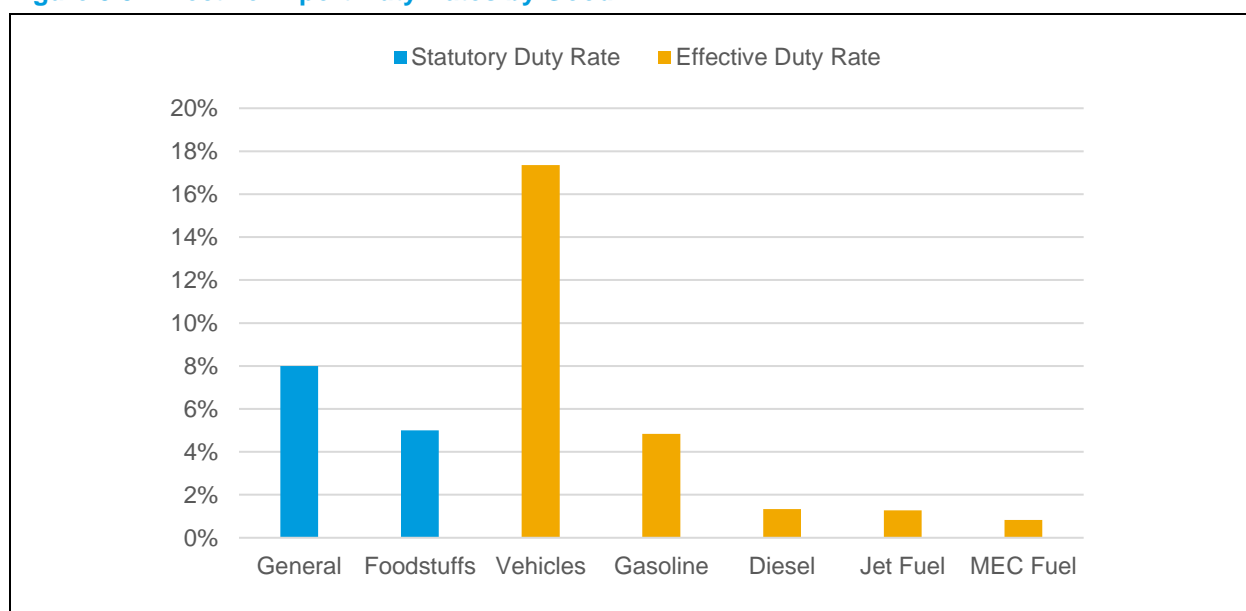


Note: Left panel is based on most popular drink of each type sold in each country; missing bars reflect data availability. Right panel is based on hypothetical drinks under import duty structure of Marshall Islands. Low, typical, and high alcohol scenarios are: 20, 40 and 80 percent for spirits; 10, 13, and 20 percent for wine; and 2, 4, and 10 percent for beer.

Source: IMF staff calculations, WHO.

32. Effective duty rates are in fact lower on some goods with large social costs than for imports in general. This is the case for diesel and for fuels imported for energy generation by MEC, both of which are taxed even more lightly than most imported foodstuffs (Figure 3.3). This is highly distortive, with the tax system encouraging the use of fossil fuels rather than discouraging them. Goods with social costs should be subject to excise duties in addition to broad-based indirect taxes.

Figure 3.3. Effective Import Duty Rates by Good



Note: Effective Duty Rates calculated using total duty collections and CIF value of imports. Calculations based on data from FY23 for all cases except vehicles, where data from FY17 is used due to data availability.

Source: IMF staff calculations.

Local Sales Taxes

33. General sales taxes imposed by local governments are a form of Retail Sales Tax (RST).

In spirit, these are similar to a VAT in that they intend to tax consumption only. Insofar as this is achieved, these sales taxes avoid many of the efficiency costs associated with import tariffs by eschewing taxation of capital goods and intermediate inputs.

34. In practice, sales taxes like these have several disadvantages compared to a VAT. First, it can be challenging to determine which transactions are taxable, leading to taxation of intermediate transactions. The sales tax levied in Majuro is charged by retailers, but when other businesses make purchases from these retailers, tax cascading can result. Second, such taxes lack the desirable self-enforcement properties of a VAT. With the sales tax collected only on retail sales, noncompliance risks are high because neither seller nor buyer wishes to pay and collect the tax. While this is also generally the case for sales to consumers (or unregistered businesses) under a VAT, the multi-stage collection and input tax credit mechanism of a VAT leads to upstream tax withholding and self-enforcement that limits the revenue loss from tax evasion on retail sales.

35. Differentiated sales taxes within the country incentivize purchasing in lower-taxed municipalities. Residents of the two municipalities that levy local taxes may in principle seek to make purchases in municipalities of the Marshall Islands without local taxation, particularly for alcohol and tobacco where local taxes can account for a large portion of the retail price. Cross-municipality shopping like this undermines local tax bases and implies efficiency costs due to the additional acquisition costs that arise. The extent to which this concern is prevalent in the Marshall Islands in practice is unclear given the potentially large transaction costs involved in moving commodities between municipalities.

36. The GRT also taxes local sales and consumption but does so inefficiently. The GRT is an origin-based tax—it taxes sales based on where they are made, not where they are consumed. This means that local exporters pay GRT, as well as any destination-based taxes (such as VAT) in countries they export to. In contrast, local consumers that import goods do not pay GRT unless this is done via a local wholesaler or retailer. It is also charged by sellers throughout the supply chain, leading to tax cascading and inefficiency arising from incentives for sellers to vertically integrate and self-supply inputs.

B. Reform Options

Introducing VAT

37. The Marshall Islands should introduce a broad-based consumption tax in the form of a VAT to replace its extensive import duties and the GRT. Adoption of VAT should be accompanied by the implementation of a tax on business profits, as discussed in Section VI. VAT is a centerpiece of most modern fiscal systems, with 175 of 193 countries with United Nations (UN) membership having adopted VAT as of 2023. It is the largest source of tax revenue in many countries around the world. Indeed, a reduction in import duties alongside the widespread adoption of the VAT are two of the most significant fiscal trends of the last half-century.

38. VAT is a destination-based consumption tax. It is charged on taxable imports and domestic taxable supplies, but exports are zero-rated. In addition, registered VAT taxpayers are permitted to claim back VAT they have paid on their (intermediate and capital) inputs in the form of input tax credits which are offset against the VAT charged on their sales. As a result, collection of VAT is a multi-stage process, and the tax base to determine the liability of a given taxpayer is their taxable value-added.

39. Adopting a VAT would increase the efficiency of the tax system and avoid the main shortcomings of import duties and the GRT:

- Capital investments and intermediate goods would not be taxed as taxpayers would be able to deduct VAT paid on capital purchases from the VAT charged on their sales. This would support domestic investment and production.
- Exporters would face lower input costs due to lower import tariffs and VAT input credits and would not face domestic sales taxes on their sales overseas with the removal of the GRT.
- The system would be more neutral and equitable over businesses with differing levels of profitability and cash flows.
- The consumption tax base would be broadened, and different types of consumption treated more equally.
- The Marshall Islands would be on firm ground in international trade negotiations and fora regarding trade tax practices, as VAT is neutral over imports and domestic production.

40. With the right registration threshold, the advantages of VAT apply in SIDS, without creating excessive compliance or administration costs. In fact, small economies with high import shares can be well-placed to realize effective, revenue-productive VAT systems. Imports provide a first point of VAT withholding, facilitating a high level of collection and encouraging domestic VAT registration. The many firms that are likely to remain of small scale in SIDS will fall under the registration threshold and

therefore would not be obliged to adopt a VAT. While the relative inefficiency of import tariffs is smaller in SIDS with smaller shares of domestic production and higher shares of imported consumption than in other economies, a system based on tariffs and cascading sales taxes is still less efficient and an obstacle to expanding domestic production, especially for exports. Efficient tax administration to minimize any fixed component of tax collection costs—which may be higher for VAT than import duties—is likely more important in SIDS.

41. A broad-based VAT would provide a platform for robust revenue collection. When designed and implemented well, VAT is a revenue-efficient tax. Its properties support self-enforcement through the supply chain, with registered firms incentivized to request VAT invoices to claim input tax credits, and the multi-stage process of tax collection limiting the revenue risks from final sales to consumers. VAT invoices generated through the supply chain also provide a strong basis for enforcement activities where needed. Empirical evidence for the Asia-Pacific region suggests general goods and services tax revenues are substantially more buoyant than trade tax revenues, especially over the long run (Jalles, 2021).

42. Legislation previously drafted provides a strong basis for consumption tax reform in the Marshall Islands. The drafted *Marshall Islands Consumption Tax Act, 2012* (hereafter MICT Act) proposed the MICT as a new tax regime to replace national import duties and local government sales and services taxes. It envisaged a broad-based consumption tax for the Marshall Islands, the main features of which remain highly relevant still today.

43. The base of VAT should be as broad as possible, with only very limited exemptions or reduced rates. In select cases, there are good administrative reasons to exempt supplies from VAT, such as for margin-based financial services where value-added can be challenging to establish. Fee-based financial services should be subject to VAT, however. Residential rent should be excluded from VAT to ensure equal treatment with owner-occupied housing, and so should property resales, but sales of new constructions should be subject to VAT. A broad base means that smaller rate adjustments are required to achieve a given goal of increased revenues if required in future.

44. VAT exemptions and reduced rates are a poorly targeted way of supporting poor households. Often, they are not progressive—especially in low-income and emerging market economies (Bachas and others, 2024; Warwick and others, 2022)—and richer households nearly always benefit the most in cash terms. Exemptions or reduced rates also bring efficiency costs, tax system complexity, and cost substantial tax revenue by narrowing the tax base. Distributional concerns are much more effectively addressed by using the tax revenue raised through VAT to redistribute resources. The Universal Basic Income (UBI) policy (known as the “Enra” plan) is a good example of this. This policy—alongside other pro-poor policies including increased minimum wages and income tax thresholds—strengthen the case to keep the VAT base as broad as possible. Unlike in the MICT Act, goods subject to excise duties (currently differentiated import duties) should be subject to VAT, as should supplies of electricity and passenger transport. Many countries exempt health and education services, though this is not always necessary.

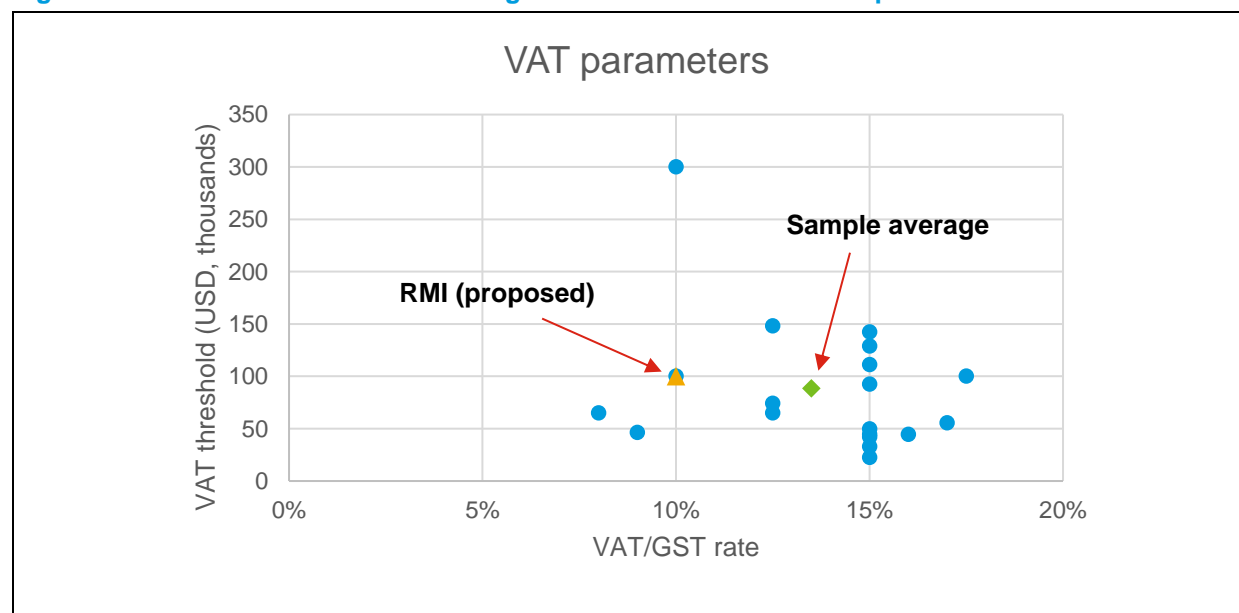
45. There should be no exemption for small imports under the VAT (except for travelers). Under the import duty regime, consignments that would otherwise attract total duties of \$20 or less are exempt from tax: under the 8 percent general rate this implies an exemption for consignments up to \$250.

This is a per-consignment provision that is not limited at the individual level. Under the VAT, this exemption should be eliminated to ensure that domestic purchases are on a level playing field with those from abroad. Foreign suppliers can be required to register and charge VAT to reduce the administrative burden. Maintaining an exemption for small imports carried by travelers remains advisable in recognition of administrative constraints.

46. Provisions should be made for VAT to be charged on digital services provided by foreign sellers. Digital services (e.g., digital entertainment) have become an increasingly important source of consumption around the world and solutions are now available to ensure that these are brought into the VAT system. For sales of digital services by foreign sellers to domestic consumers, simplified VAT registration should be provided for foreign sellers and VAT charged at the standard rate. The VAT collected would be remitted to the revenue authority, and registration should be made very simple, given that no input tax credits arise for foreign businesses, greatly reducing any risks. For sales to domestic businesses, two options are available. Foreign suppliers could be required to charge VAT on these sales too, with domestic businesses claiming this as an input tax credit in their returns. Alternatively, a “reverse charge” could be implemented, whereby foreign suppliers would not charge VAT on sales to VAT-registered Marshallese businesses, but Marshallese businesses would file both an output tax liability and an equivalent input tax credit in relation to the purchase. The choice between these two approaches has technical implications for tax administration.

47. The rate of VAT should be set according to revenue needs. The broader the base, the lower the rate of VAT that can be selected to attain a given revenue requirement. Mission recommendations aim for a revenue-neutral set of reforms, with the revenue goal for VAT thus depending on the rest of the tax system. The MICT Act set a tax rate of 10 percent, which is a relatively low rate internationally. Figure 3.4 compiles VAT rates in a sample of 19 Pacific and Small Island states, showing that 15 of these have VAT or GST rates above 10 percent, with 15 percent being the modal choice.

Figure 3.4. Standard VAT Rates and Registration Thresholds in Comparator Countries



Note: Sample includes: Antigua and Barbuda, The Bahamas, Barbados, Dominica, Fiji, Grenada, Jamaica, Kiribati, Maldives,

Mauritius, Palau, Samoa, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Tonga, Trinidad and Tobago, Vanuatu.

Source: IMF staff.

48. The sales threshold at which VAT registration becomes compulsory should be aligned with the new business profits tax. It is common to make VAT registration voluntary for businesses below a specific sales threshold. This reflects a consideration of the collection costs of VAT (for both the government and the taxpayer) against the revenue yield. The MICT Act proposed a threshold of \$100,000, which would be fairly typical among peer countries (Figure 3.4). Palau, which only recently implemented a VAT, is the outlier with a registration threshold of \$300,000. However, the distribution of taxable sales—which is strongly concentrated in large taxpayers under the GRT—suggests that setting a comparatively higher registration threshold would not have large revenue implications. Table 3.1 shows that in FY22, a \$100,000 threshold would have required VAT registration from taxpayers responsible for 94.1 percent of taxable sales, while a \$300,000 threshold would have still covered 90.1 percent of sales. While a lower threshold broadens the VAT base and brings revenue and efficiency gains, the initial choice of registration threshold takes into account the capacity of the tax administration—this is discussed in Section IV.

49. Regardless of this choice, voluntary VAT registration for businesses below the sales threshold should be provided for, subject to some restrictions. Businesses may wish to register for VAT for many reasons, including because they are exporting goods or because they are selling to other VAT-registered businesses. In general, businesses should be able to opt into the VAT system as a result. However, voluntary registration must be subject to certain checks. For example, taxpayers should be able to maintain adequate books to be able to effectively implement VAT; they must be verified as a genuine business to prevent abuse of the refund system; and they should not be able to switch in and out of the VAT system.

Table 3.1. Covered Businesses under VAT and Profit Tax for Different Values of Sales Thresholds

	\$50,000	\$100,000	\$200,000	\$300,000
Number of businesses				
FY20	144	85	60	50
FY21	160	94	61	50
FY22	158	89	63	49
Percent of aggregate sales				
FY20	96.8	94.1	91.2	90.2
FY21	96.8	94.0	91.1	89.4
FY22	97.1	94.1	92.0	90.1

Source: IMF staff calculations based on data from national authorities.

50. Mission estimates suggest that a broad-based VAT set at a rate of 10 percent could raise tax revenue of 4.34 percent of GDP (\$12.14 million in 2024). This estimate is based on a scenario with a broad tax base: all consumption is subject to VAT, aside (actual and imputed) rents, and health and education services. The estimate accounts for some consumption not being subject to VAT—due to businesses being unregistered or consumption sourced from home production or barter trade—and excludes any VAT that would be paid on government purchases. This revenue estimate is very similar to

that offered in a policy note prepared by Graduate School USA in May 2024. This is despite the methodology and assumptions being substantially different, increasing confidence in the anticipated magnitude of revenue gains.

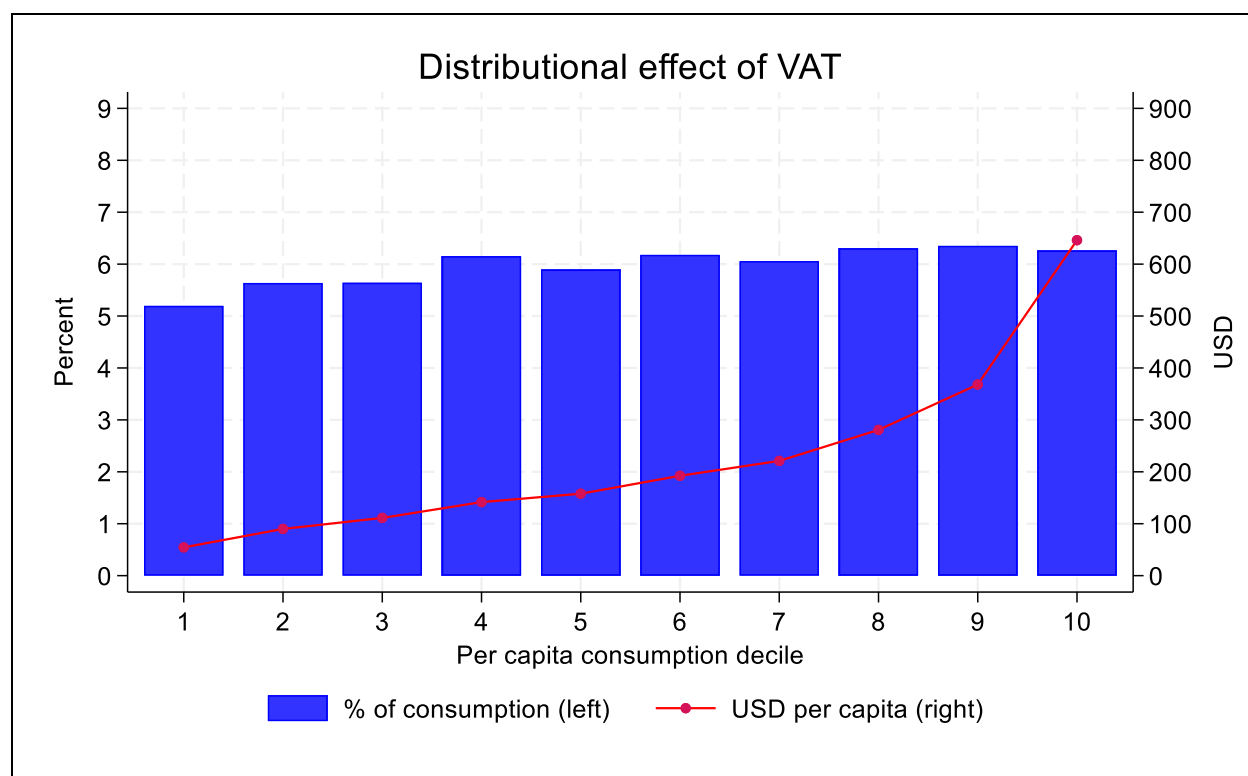
51. This revenue yield would be sufficient to replace abolished import duties, and the sales taxes imposed in Majuro and Kwajalein. The mission estimates that abolishing general import duties (with others converted to excise duties, as discussed below) would cost revenue of 2.43 percent of GDP, while removing local sales taxes may cost around 1.58 percent of GDP. A uniform national system of sales taxation would be economically preferable. In order to secure the buy-in of these local governments, it will be necessary to design a revenue-sharing agreement that ensures that local municipalities receive part of the revenue proceeds from the VAT. Such an agreement must balance the need to compensate local governments for revenue losses with fair treatment of different municipalities in the context of national revenue and spending priorities. This is not a simple task and was a significant impediment to previous tax reform efforts in the Marshall Islands.¹⁰

52. Other revenue-raising measures would be needed to cover lost revenue from the GRT. A business profits tax—discussed in Section VI—would increase revenue but its yield is subject to high uncertainty given data constraints. Other indirect tax reforms recommended in this section have the potential to raise substantial revenue, which could offset much of the loss from GRT. Another option is to consider a higher rate of VAT. The mission estimates that a broad-based VAT at a rate of 15 percent would yield tax revenue of 6.26 percent of GDP, compared to the 6.86 percent GDP loss from removing general import duties, local sales taxes, and the GRT. A rate of 15 percent would not be unusually high, as shown in Figure 3.4, and could be considered if authorities do not pursue other recommended revenue-raising measures or wish to increase overall tax revenues.

53. Mission estimates suggest that this VAT would be mildly progressive among poorer households, and distributionally neutral in the top half of the distribution. The broad tax base with a single rate means that strong progressivity or regressivity are unlikely, and as discussed above, VAT is not an effective tool for direct redistribution. The pattern of mild progressivity is likely driven by a greater dependence on home-produced goods among poorer households, and/or by the limited exemptions for health and education services. While the overall distributional pattern is not strong, richer households would pay the substantially more VAT in cash terms. The richest tenth of the population would pay nearly 12 times more per capita than the poorest tenth, and more than all of the poorest half of the population combined (Figure 3.5).

¹⁰ Detailed recommendations on this revenue-sharing arrangement are beyond the scope of this report. The authorities may wish to consider requesting technical assistance on the broader context of funding arrangements between the national and local governments.

Figure 3.5. Distributional Effect of a VAT in the Marshall Islands



Note: Estimate based on simulating a 10 percent VAT on all consumption except rent, health, and education services. Underlying data is adjusted to align with national accounts aggregates in 2024. Bars show total estimated VAT as a percentage of total consumption in each decile; line shows estimated VAT per capita in each decile.

Source: IMF staff calculations using HIES 2019.

54. The overall impact on inflation should be limited. A revenue-neutral package of tax reforms should not be expected to change the overall price level substantially.¹¹ However, there may be changes in relative prices from a change in tax structure from import tariffs and turnover taxation to VAT. For example, all else equal one would expect relative prices to rise (fall) for goods and services that are: currently subject to lower (higher) import duties; produced via fewer (more) stages of production; or have higher (lower) shares of value-added.

Introducing Excise Taxes

55. Import duties applying at differentiated rates to fuels, vehicles, alcohol, tobacco, and soft drinks should be converted to excise duties. This change would mean that any domestically produced varieties of these products would also be subject to taxation. This is largely a legalistic distinction because most of these goods are imported into the Marshall Islands. However, in select cases the change would ensure consumption of domestically produced alternatives is also discouraged. Perhaps more importantly, replacing import duties with excise duties would support the Marshall Islands in trade

¹¹ The Graduate School USA estimated a small deflationary impact of -0.4 percent from a package of tax reforms—including the introduction of VAT—that reduced overall tax revenue slightly.

integration and increased participation in trade agreements and fora. This could support national development objectives relating to boosting exports set out in the National Strategic Plan 2020-2030.

56. All specific excise duties should be indexed to inflation and automatically updated on an annual basis. Non-indexation of specific duties has eroded both the price signal of the tax system with respect to activities with external social costs, and the real tax revenues raised. Many governments around the world have provisions to ensure that specific duty rates are updated on a regular basis according to changes in the measured price level—for example, in reference to the Consumer Price Index (CPI). The Marshall Islands could institute a rule where specific excise duties are updated (e.g., by the issuance of a regulation) at the beginning of the fiscal year by the year-on-year change in the CPI taken from the previous calendar or fiscal year. The importance of this for protecting (real) revenues will depend on the rate of inflation: in higher-inflation periods, non-indexation leads to larger revenue losses. Moreover, the effect compounds over time. The mission estimates that non-indexation leads to tax revenue losses of 0.04 percent of GDP in the first year, but after five years the annual revenue foregone could climb to 0.17 percent of GDP. These estimates do not account for any of the level increases in excise taxes recommended below, which would further increase the revenue importance of indexation.

57. Fuel taxes should be increased to bring them closer to reflecting the social costs of fuel usage and offset years of real terms tax decreases. The tax rates applied to gasoline, diesel and jet fuel are extremely low in the Marshall Islands and fail to encourage producers and consumers to reduce fuel usage or invest in more sustainable alternatives. The *Marshall Islands Excise Tax Act 2012* proposed per gallon tax rates of \$0.45 for gasoline and \$0.28 for diesel and aviation. Accounting for inflation up to 2024, these equate to \$0.50 and \$0.31, respectively. Mission estimates suggest that implementing these updated fuel tax rates could raise revenue of 0.17 percent of GDP. Over time, the Marshall Islands should seek to bring the tax rates applied to jet fuel and diesel at least in line with those of gasoline.

58. Tax exemptions for domestic energy generation warrant review. The exemption from import duty for fuel imported by MEC and KAJUR means that fossil fuels used in electricity generation are generally subject to no taxation at all.¹² The exemption means that fossil fuel usage is taxed more lightly than nearly all other types of purchases, and again blunts price signals that could incentivize greater energy efficiency and more sustainable energy technologies. The exemption is also expensive: fuel imports by these utilities account for the majority of overall fuel imports: MEC alone accounted for 72 percent of the total volume of fuel imports into the RMI between FY18 and FY23 (comparable data for KAJUR was not made available to the mission). The mission estimates that applying the rates recommended above of \$0.50 per gallon for gasoline and \$0.31 per gallon for diesel, plus \$0.12 per pound of LPG, would yield 1.54 percent of GDP in additional tax revenue. Particularly in light of the fact that energy prices are already high in the Marshall Islands, a phased approach may be necessary, however. Starting by applying the fuel duty rates currently in place would raise revenue of 0.32 percent of GDP and would be a useful first step.

59. Tax increases on domestic energy could be staggered and/or moderated to enhance acceptability and to take account of prevailing economic conditions. In common with many small island nations, the Marshall Islands is currently highly dependent on fossil fuel imports and fuel prices

¹² In practice it appears that import duty is collected on some fuel imports made by MEC. See Figure 3.3, which shows a 0.8 percent effective duty rate in FY23.

remain high relative to pre-pandemic levels. The retail prices paid by consumers for motoring fuel and residential electricity are relatively high by international standards. Taxes are not the cause of these patterns: factors like high unit and transport costs, limited competition, and poor utility performance have been identified as factors in the past (ADB, 2018). While fuel taxes can help address some of these challenges in the medium-term—by encouraging investment in renewable energy technologies, for instance—these conditions may make further increases in fuel and energy prices more challenging, which may provide a rationale for a staggered and/or moderated approach. In addition, the RMI can consider using some of the revenue gains from higher fuel taxes to compensate households.

60. Tobacco taxes should be increased. An increase is long overdue in light of low national rates, real terms erosion of nominal rates by inflation, and the continuing costs to public health of smoking in the country. An excise duty per pack of 20 cigarettes of \$2 would push national cigarette taxes firmly towards the recommended WHO target for taxes to make up 75 percent of the retail price of a pack of cigarettes. The duty for other tobacco should also be increased, perhaps to \$5 per 1.2oz. The mission estimates that these changes could yield additional revenue of 0.11 percent of GDP.

61. Alcohol taxes require refinement and increases. In the short term, the Marshall Islands should focus on increasing excise tax rates on wine and spirits because for typical drinks, the current duty structure implies much lower rates of tax per unit of alcohol for these drinks than for beer. The mission recommends increasing excise duty rates to \$40 per gallon for spirits, \$13 per gallon for wine, and \$4 per gallon (\$0.375 per 12oz can) for beer. This would equate to \$100 per gallon of alcohol for beverages of a typical alcohol content in each category. The mission estimates that this would yield tax revenue of 0.24 percent of GDP. Again, ongoing indexation is important to maintain real revenues.

62. Going forward, alcohol taxation should aim to equalize the treatment of drinks within categories too. This can be achieved by applying a fixed tax rate of duty per unit of alcohol content. This would ensure that consumers are incentivized to choose lower-strength beverages both across and within categories. This duty should also be applied to any ethyl alcohol imports, with provisions for refunds for any domestic alcohol producers. The mission was unable to assess the revenue implications of these changes due to a lack of data.

63. It would be preferable for taxes on alcohol and tobacco to be aligned across the municipalities of the Marshall Islands. The governments of Majuro and Kwajalein currently levy local taxes on these products, which creates some risk of “cross-border” shopping. The government may wish to explore folding local taxes on these products into national tax policies and compensating local governments as part of the revenue sharing agreement envisaged for VAT.

64. The government could consider shifting the tax burden from purchasing cars to using cars. Drivers in the Marshall Islands face low ownership fees and low fuel taxes and thus are not strongly discouraged from using cars. In contrast, relatively high up-front taxes disincentivize the replacement of older vehicles. Alongside higher fuel taxes increased annual ownership fees or taxes could disincentivize holding on to surplus or marginally used vehicles. Ownership fees could also be calibrated to vehicle type, according to emissions standards, for example, in addition to existing differentiation by vehicle size. Such a reform could be designed in a revenue-neutral way to increase efficiency and might include transition provisions to exempt those who had paid higher import duties in recent years from enhanced

ownership fees. Many non-tax policies are also available for supporting safer, cleaner, and more efficient transport systems in the Marshall Islands, including public transport investment.

Recommendations

- 3.1** Remove import duties and local sales taxes, plus the GRT for businesses that register for VAT.
- 3.2** Introduce a broad-based VAT using the destination-based, credit-invoice design for commencement in October 2026, with a standard rate of 10 percent and compulsory registration for businesses with turnover of \$100,000 or above (aligned with the profit tax).
- 3.3** Make VAT registration voluntary for all other businesses with turnover of at least \$10,000, an established place of business, and sufficient bookkeeping. Maintain the GRT for businesses that opt to not enter the VAT system.
- 3.4** Introduce automatic indexing of all specific duty rates, with annual adjustments at the start of each fiscal year to alter specific duty rates in line with the change in the CPI in the preceding year.
- 3.5** Introduce fuel excise tax rates of \$0.50 per gallon for gasoline, \$0.31 per gallon for diesel and jet fuel, and \$0.12 per pound for LPG. In the medium-term, raise rates for diesel and jet fuel to be at least in line with gasoline.
- 3.6** Abolish exemptions for fuel imports by energy utilities (or start by reducing them).
- 3.7** Introduce a tobacco excise tax of \$2 per pack of 20 cigarettes and \$5 per 1.2oz pack of tobacco, maintaining the 151 percent rate on cigars.
- 3.8** Introduce alcohol excise taxes of \$0.375 per 12oz can of beer, \$13 per gallon of wine, and \$40 per gallon of spirits. In the medium-term, seek to apply a fixed rate per unit of alcohol of \$100 per gallon, adjusted for inflation.
- 3.9** Consider national harmonization of tobacco and alcohol taxation in collaboration with the governments of Majuro and Kwajalein, including through revenue-sharing agreements.
- 3.10** Consider lowering purchase taxes on vehicles and increasing ownership fees or taxes, with differentiation by size and fuel efficiency.

IV. Tax Administration of Indirect Taxes

A. Current Situation

65. The DCTRT has limited experience with the administration of consumption taxes. No consumption tax is currently administered at the national government level. However, local governments and municipalities (Majuro and Kwajalein) impose sales taxes that are administered at the local level. This lack of experience compounded by the insufficient capabilities of the DCTRT will pose increased challenges to the introduction of consumption taxes in the Marshall Islands.

66. However, though largely manual, procedures needed to administer consumption taxes already exist. The current taxes administered by the DCTRT are self-assessed and paid with limited intervention of tax officials.¹³ The DCTRT has developed procedures to register foreign businesses and integrate the Employer Identification Numbers (EINs) issued by the Marshall Islands Social Security Administration (MISSA) to its taxpayer register, and to follow up on non/late filing and payment. These features are critical for the introduction of the consumption taxes.

67. An ITAS acquisition project to support tax administration reform is underway. Authorities have undertaken market research to find suitable ITAS options. During the mission, the Minister mentioned that initial plans to add revenue administration modules to the Financial Management Information System were abandoned, and that discussions with an ITAS provider are ongoing.

B. Key Issues and Challenges

68. The foremost challenge that the DCTRT will face is ensuring business continuity and preparing for the introduction of new taxes in a relatively short period of time. Typically, VAT introduction, including legislation and administrative preparation takes 24 - 36 months (see Annex 3). With a staff of only seven working in a manual environment, conducting day-to-day tax administration and mobilizing tax revenues to support the Government's development goals is already a considerable challenge. Setting aside staff time and resources to prepare for and ensure the successful implementation and administration of new consumption taxes may exacerbate the DCTRT's existing limitations.

69. Administrative challenges to a successful consumption tax reform could arise during the preparation and implementation phases.¹⁴ These include reform project management, organization, taxpayer registration, procedures, and manuals, staffing and training, taxpayer education and publicity, information technology (IT) systems, taxpayer compliance and post-implementation monitoring.

70. Introducing VAT is a significant endeavor which requires good preparation. The administrative phase can take 18 months, or more, depending on the specific circumstances, including (1)

¹³ Though taxpayers assess the amount of tax due and complete their tax returns available at the front desk of the DCTRT, they are required to submit them for accuracy checks and validations by tax compliance section staff before payment at the Treasury unit.

¹⁴ For simplicity, VAT will be used as a proxy for consumption taxes.

experience with the operation of broad-based indirect taxes; (2) experience with self-assessment and a tax credit mechanism; (3) existence of a modern tax administration IT system; (4) political commitment; (5) experience with implementing large-scale tax changes; (6) availability of high-quality personnel for developing VAT; (7) availability of financial resources; (8) complexity of the VAT legislation; and (9) availability of technical assistance support. Given its limited experience, resources, and institutional capacity, the DCTRT will likely face significant challenges in implementing the VAT reform. Therefore, good, and early preparation is needed to mitigate the risk of implementation woes. Annex 3 proposes an indicative timeline for the implementation of the VAT.

Project Management

71. Strong project management mechanisms need to be instituted to support the VAT reform efforts. A formalized and detailed approach to project management is critical to success. An early priority will be to establish a small Reform Project team within the DCTRT that has the necessary resources and responsibilities and utilizes project management methodologies as proposed in Annex 2. Ideally, the project team will comprise staff from both the RTU and customs unit. The first task for this group will be to develop a comprehensive project document to reflect criticality to key outcomes, absorptive capacity, and resource availability in terms of financing, staff, technical assistance, and infrastructure.¹⁵

72. Achieving the sound policy outcomes and revenue objectives outlined in Section III will not be possible without an effective DCTRT. Once key design features of the consumption taxes—the rates, registration threshold, exemptions, and refund system—have been decided, the bulk of the preparations for the consumption taxes will shift to the DCTRT. Following the adoption of the above policy recommendations, the effort will need to concentrate on the administrative preparations, including registering the potential consumption taxpayers, designing procedures and forms, developing compliance programs and IT systems, recruiting and training staff, and implementing well designed taxpayer education and registration programs based on a sound and realistic implementation plan. External technical assistance support, including a long-term expert may be needed during this phase.

Taxpayer Registration

73. Robust taxpayer registration is crucial for an effective VAT administration. It is the basis for supporting self-assessment, compliance management, third party reporting, matching, and refund management. Once the appropriate VAT registration threshold is determined, the DCTRT should commence the registrations of the expected VAT taxpayers. While the existing registration system is a good foundation,¹⁶ it needs improvements to meet the requirements for effective administration of the VAT. For example, only registered VAT taxpayers should be allowed to issue VAT invoices and claim refunds, and the registration process should contain sufficient controls to prevent registration of bogus businesses.¹⁷ Improvements should focus on enhancing the quality, adequacy and accuracy of the information captured.

¹⁵ For more details on this topic, see the Reform Management Fundamentals Module of the Virtual Training to Advance Revenue Administration, <https://www.imf.org/en/Capacity-Development/Training/ICDTC/Schedule/OL/2024/VITARA-RMFOL24-194>.

¹⁶ The current registration system is administered by MISSA, which issues an EIN to employers and self-employed workers and a social security number (SSN) to employees.

¹⁷ Experience shows that bogus companies register for VAT for the sole purpose of creating fictitious sales invoices.

74. A timely registration of all VAT taxpayers is essential for the successful implementation of the VAT. Based on the information available, all potential VAT taxpayers are likely registered in the MISSA system. However, not all registered employers will be VAT taxpayers. Also, experience shows that in some cases, new taxpayers are detected through the introduction of VAT. Therefore, identifying the VAT taxpayers will be critical to managing their compliance with filing, reporting and payment obligations. The DCTRT should ensure that all taxpayers required to register for VAT are identified. Ideally, VAT registration campaigns should commence 6-9 months prior to the start date.

75. Experience shows that successful implementation of VAT will depend on the appropriateness of the VAT registration threshold. Given current staff constraints in the RTU and the lack of effective tax administration systems, adoption of a high threshold to limit the number of businesses that will be registered for VAT and claim VAT refund is critically important to cope with the additional workload and resource needs. Based on the data available (see Table 3.1), an annual turnover threshold of \$100,000 would have required 89 taxpayers (94.1 percent of total taxable sales) to register for VAT in FY2022.¹⁸ A lower threshold (e.g., \$50,000) would lead to a misallocation of RTU's resources and hampers its effectiveness. For example, the RTU would disperse its resources in controlling the VAT obligations of a large number of enterprises with a very low yield in terms of revenue. It may also increase the administrative burden of the small businesses and encourage them to join the informal sector. A \$100,00 threshold will support a smooth and successful introduction of the VAT, lower resistance to the reform, as numerous small businesses are omitted, and allow the RTU to improve the effectiveness of its compliance programs to broaden the VAT base at a later stage.

76. Voluntary registration for businesses with an annual turnover below the set threshold could have significant administrative consequences, necessitating the design of effective mitigation measures. The credit invoice mechanism incentivizes large businesses to select their suppliers among those registered for the VAT. It may also encourage small businesses with a turnover below the threshold to opt in the VAT system to increase their sales to large businesses, thereby increasing the number of VAT taxpayers. Limiting the voluntary registration option to businesses with an annual turnover above \$10,000 will help mitigate this risk. However, the RTU should develop additional measures to ensure high compliance levels. Voluntary registrations should be subject to tax administration approval. Approval criteria will include a commitment to remain in the VAT system for at least three years, a good tax compliance history, book and record-keeping capacity, and a commitment to issue invoices.

Organization, Staffing, and Training

77. The VAT should be administered within the RTU. Despite its current insufficient capacity, the RTU should be responsible for the administration of VAT. It is already dealing with the taxpayers who will be liable for VAT.

78. The DCTRT needs additional staff during the preparation and implementation stages of the VAT. The ratio of staff to VAT taxpayers varies widely among countries and depends on the level of digitalization. The RTU is currently understaffed and needs additional resources. In addition to filling the

¹⁸ This threshold aligns with the MICT Act's proposal.

two positions that are currently vacant to address the urgent staffing needs,¹⁹ the recruitment of two additional staff will be necessary to support implementation of the VAT. The estimate of the additional staffing needs to launch the VAT is based on the requirement for effective implementation of the VAT components of the compliance programs that need to be developed with a VAT register comprising 90 – 100 businesses. Given that the local governments have experience with managing sales taxes, the Ministry of Finance could consider recruiting some of their experienced staff to support the introduction of VAT.²⁰

79. Training for VAT administration is a priority. VAT is a new tax for both the tax administration and taxpayers. The Customs unit should also be ready to collect the VAT on all goods at import. At least two levels of training are needed for VAT staff, including (1) initial training of new recruits and of those transferred to VAT duties (RTU and Customs unit); and (2) ongoing training of staff. Extensive training should be provided to DCTRT staff on the VAT system. This includes understanding the legislation, compliance requirements, and the use of technology. Training and experience sharing opportunities with the local governments should be explored. Additional training could be requested from external technical assistance providers.

Compliance Programs, Forms, and Procedures

80. Strong compliance programs will be needed in the initial stages of the implementation of the VAT. The administration of the VAT will require the development of effective education and services strategies as well as well-designed audit programs supported by IT systems and the use of risk management to improve the selection of cases to be audited. Similar programs supported by IT and based on risk management will also be critical for the implementation of an effective refund system. Effectively applying VAT at customs is critical. The introduction of the Automated System for Customs Data (ASYCUDA) provides a solid foundation for this application. Moreover, to facilitate the processing of refund claims, enhanced information exchange with Customs on imports and exports will also be essential. In that regard, the fact that the tax and customs administrations are parts of the DCTRT and are physically collocated is a significant advantage.

81. The development of effective compliance programs begins with good tax policy and well-designed forms and procedures. VAT procedures and forms should support full self-assessment. Therefore, the VAT return form should be relatively simple (one page). The information requested from the taxpayer should be limited to what is needed for processing the return and risk assessment by the tax administration. The relevant customs forms should also be amended to provide lines for the calculation of the VAT on imports.

82. A comprehensive approach to training, education, and outreach is essential to ensure taxpayer compliance. This includes educating taxpayers as well as customs brokers about their obligations under the new tax system through workshops, seminars, and online resources, and conducting outreach programs to support taxpayers during the initial phase of the new tax system. The

¹⁹ Given the challenges being faced by the Revenue and Taxation Unit in improving compliance with the GRT and labor taxes, existing vacancies for critical positions in the compliance and audit sections need to be urgently and effectively dealt with.

²⁰ The mission team discussed this option during its meetings with the Minister and the Chief Financial Officer of the Majuro local government.

focus should initially be on supporting taxpayers to ensure accurate filings and payments, gradually transitioning to audit and penalty regimes as compliance becomes more established.

Publicity Campaign

83. Development of an effective campaign to prepare the public and the business community will require significant effort. Past attempts to introduce tax reform appear to have been unsuccessful in large part due to the lack of understanding of the concepts and benefits of the reforms. By taking a more deliberate approach to public awareness this can be overcome. This is different to the public consultation process during the formulation of the VAT policy. Its objective is to inform and educate the public rather than solicit their input and views. The DCTRT will need to engage with the business community to understand their concerns and provide them with the necessary information and support to comply with VAT. Beyond the technical issues that will need to be handled by the DCTRT to launch a well targeted VAT education and registration program, the publicity and general information for consumers will require direct involvement of the MFBPS and political leaders. This campaign will aim to educate the public about the characteristics of VAT and the rationale behind the Parliament's approval of this reform. Issues such as the necessary adoption of a threshold to simplify the compliance costs of small businesses and the possible impact of VAT on household budgets should also be addressed during this campaign. Additionally, the Marshall Islands can draw valuable lessons from Palau's experience with VAT implementation.²¹

System Development

84. Information technology is fundamental to VAT introduction. Ideally, the Integrated Tax Administration Technology System (ITAS) and the tax system reform should be concurrently implemented. However, if the ITAS is not yet operational, the new taxes may be administered manually for a limited period, considering the taxpayer base size. System development should commence well in advance of the finalization of legislation based on policy design. Business process reengineering will be a critical initial step, utilizing the selected Commercial Off-the-Shelf (COTS) ITAS as a foundation. (McAlister, 2024). Given the small number of taxpayers likely to be VAT registered, the absence of an ITAS should not impede implementation of the VAT, instead manual processing can be undertaken until the ITAS is in place.

Recommendations

4.1 Seek external technical assistance support, including the appointment of a long-term advisor or temporary supplementation to help with the development and implementation of the VAT project.

4.2 Strengthen project management by establishing a dedicated Tax Reform Project section comprising RTU and customs unit staff within the DCTRT to oversee the VAT reform efforts. This section should develop a comprehensive project document outlining critical outcomes, resource availability, and project management methodologies.

²¹ The mission was informed that a delegation from the Marshall Islands will visit Palau in January 2025 for peer-to-peer engagement purposes.

- 4.3** Enhance administrative capacity to address the current staffing limitations by recruiting additional staff and providing extensive training on VAT administration. This includes initial training for new recruits and ongoing training for existing staff. Include communications experts in the Tax Reform Project section.
- 4.4** Improve taxpayer registration by launching a robust taxpayer registration campaign well in advance of the VAT implementation. Ensure that only registered VAT taxpayers can issue VAT invoices, claim refunds, and implement controls to prevent the registration of bogus businesses.
- 4.5** Conduct publicity campaigns and engage with the business community and the public to inform and educate them about the VAT. Address concerns, provide necessary information, and highlight the benefits of the VAT reform.
- 4.6** Develop effective compliance programs supported by IT systems and risk management techniques. This includes designing simple VAT return forms, providing support to taxpayers to them comply, developing audit programs, and facilitating information exchanges with Customs.
- 4.7** Progress with the ITAS acquisition project to leverage IT to support the VAT administration. If ITAS is not operational, consider manual administration for a limited period while ensuring the system development is aligned with policy.

V. Current Income Taxes

A. Personal Income

85. Labor income is taxed at progressive rates of 0, 8 and 12 percent. A reform, passed in October 2024 and coming into effect from April 2025, raises the tax-free threshold significantly from \$1560 to \$8320, to coincide with the annual income that people on the new minimum wage of \$4 per hour receive—which in turn aligns with the poverty line. The reform also raises other thresholds and adds a new top rate at 16 percent. It is, however, currently foreseen that an amendment will be passed in January 2025, removing the new top rate, but keeping all other changes. Prior to the reform, thresholds had been stable since 1989.

86. One notable feature of the Marshallian income tax is that taxpayers lose entitlement to the tax-free band if they earn more than \$5200. In the legislated reform, the threshold for losing this entitlement will coincide with the upper threshold of the zero band, implying that taxpayers earning more than the tax-free threshold immediately pay tax of 8 percent on all their earnings.

87. Certain remunerations are exempt from tax. A rental allowance or the value of provided housing up to \$9,000 per year is exempt. Pensions and annuities that are funded in whole or part by taxable wages are exempt, as are payments for medical expenses or any sick pay that exceed normal wages. Domestic services provided in a home are and wages of certain religious workers are also exempt.

88. Non-resident workers are subject to a gross withholding tax of 10 percent, while expats working in US military bases are taxed at a flat rate of 5 percent. The latter is part of the compact with the United States and hence hard to change.

89. Most capital income is untaxed. The exception is business income, which is taxed as under the GRT as noted above, or as the mixed income of self-employed managers, which is covered in the labor income tax. Dividends, interest, and capital gains are not taxed. Land rents are taxed at 3 percent on a gross basis. Rents for buildings and improvements are not taxed.

90. Labor income is also subject to social security contributions, which add up to 23 percent, but are subject to an upper limit. Social security includes the retirement fund to which the employer and employee each contribute 8 percent of wages of up to \$10,000 per quarter. Self-employed people contribute the full 16 percent on their presumed wage. Social security also includes the health fund, to which both the employer and employee contribute 3.5 percent of wages up to \$5,000 per quarter. The upper earning limits are not indexed to inflation; for the retirement fund the upper earnings limit was doubled to its current value in 2017. The contribution rate for the retirement fund, which stood at 3 percent in 1987 has been gradually adjusted upward over the years, with the last increase (from 7 percent) in 2017. Contributions to the health fund have been stable since 2002.

B. Business Income

91. Businesses are currently taxed under the Gross Revenue Tax (GRT), which is based on turnover rather than profit and is charged at a rate of 3 percent. For businesses with turnover below \$10,000, there is a flat tax of \$80. For hotels and resorts, there is an additional tax set at 8 percent of the room rate.

92. There is one significant tax incentive, and various exemptions:

- Any new business with an investment of at least \$1 million or domestic payroll of at least \$150,000 is entitled to a GRT holiday for its first five years of operation. In case of businesses engaged in offshore or deep-sea fishing, manufacturing that leads to exports, agriculture, and hotels, the tax holiday applies without a specific minimum investment or payroll.
- Public utilities (water, electricity, and telecommunications) are exempt.
- Domestic air transportations and any government-owned air transport are exempt.
- Government-owned copra processing is exempt.
- Charities, religious, scientific, and educational non-profit organizations are exempt.

93. Deep seabed mining is subject to an alternative regime involving royalties, production charges, and/or profit sharing. This regime is beyond the scope of this report.

VI. Policy Aspects of Income Taxes

A. Problems with Personal Income Taxation

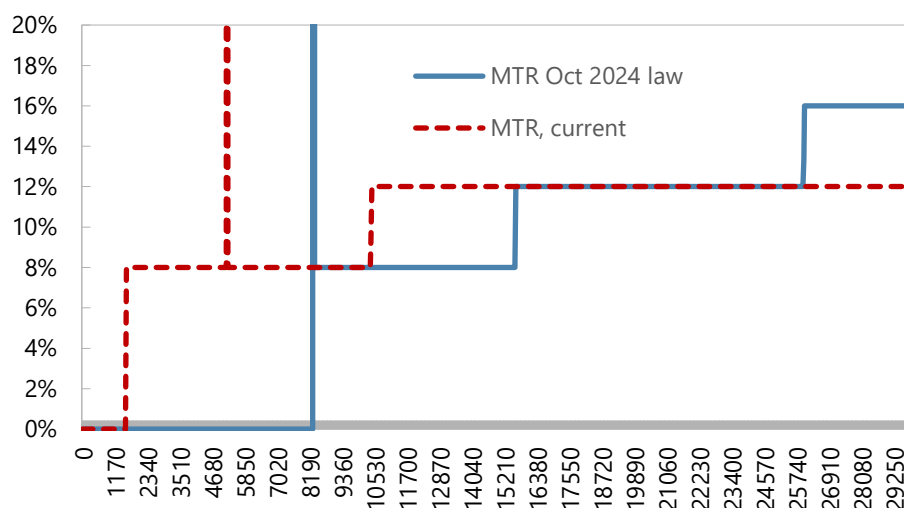
Large Threshold Effects

94. The key problem of the Marshallese income structure is that the sudden withdrawal of the tax-free allowance creates a tax notch with an exceedingly high marginal tax rate (MTR). As shown in Figure 6.1, in general the MTR rises with income. However, at \$5200, where the tax-free allowance is withdrawn, the MTR is extremely high (and outside the chart's scale). Specifically, earning one more dollar, increases the tax liability by \$125 (8 percent of \$1560). Figure 6.2 shows the corresponding average tax rate (ATR). This generally rises smoothly—as is desirable under progressive tax system—but at the threshold, the ATR suddenly jumps up to 8 percent.

95. A high MTR, especially when exceeding 100 percent, is inefficient and inequitable. The inefficiency arises, because taxpayers earning near the notch are discouraged from working more and face strong incentives to evade taxes. It is also inequitable because taxpayers with marginally higher incomes are left worse off.

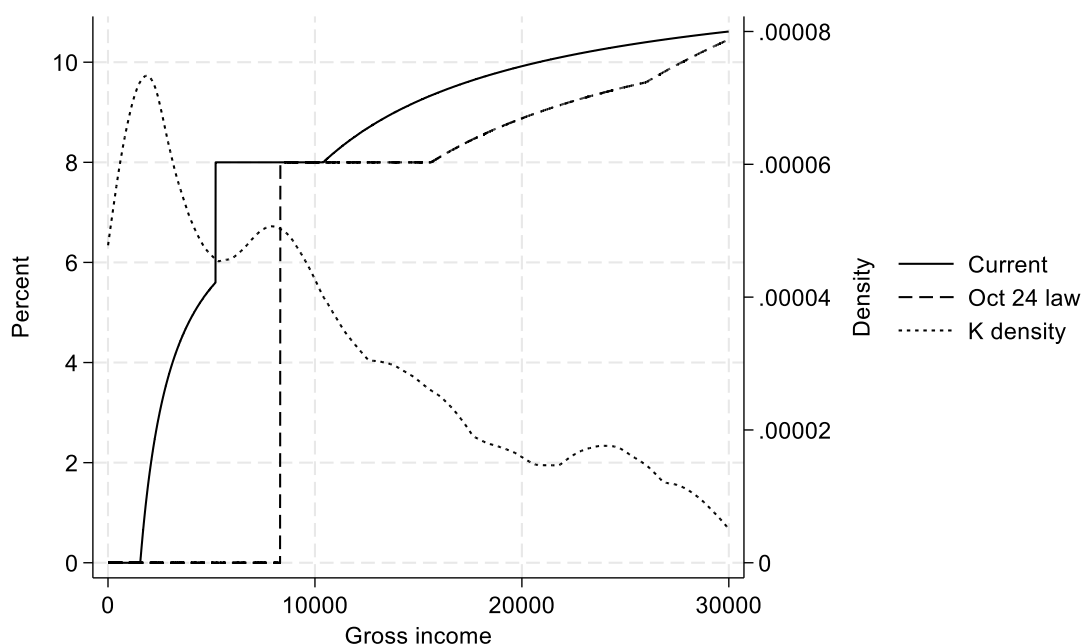
96. The reform legislated in October 2024 strengthens the system's progressivity but exacerbates the anomaly in the tax structure. The added higher tax rate and the increase in the tax-free allowance make the system more progressive. However, the tax-free allowance is still withdrawn in one sudden step. Given that it now aligns with the upper limit of the tax-free threshold, which in turn represents the minimum wage, many more people will be affected by it—as can be seen from the higher density of the income distribution at the new notch (Figure 6.2). Moreover, the MTR is even greater, as now earning one additional dollar at the notch, raises the tax liability by \$666.

Figure 6.1. Marginal Tax Rates



Source: IMF staff calculations.

Figure 6.2. Average Tax Rates



Source: Mission calculations.

Note: K density is the estimated kernel density (from social security data), shown on the right hand side.

Narrow Tax Base

97. Tax exemptions and the non-taxation of in-kind benefits create incentives for tax avoidance. With housing allowances tax exempt up to \$9000 per year, there is a strong incentive to remunerate staff partly with such allowances rather than base salaries. This exemption is, moreover, regressive, as people on low-paid jobs are much less likely to be recipients of housing allowances. There appear to be no rules covering the taxation of various in-kind benefits, such as company cars that can be used privately. Again, taxing the related benefit would raise revenue and address a regressive tax avoidance opportunity.

98. The nontaxation of most capital income significantly weakens the progressivity of the tax system and creates tax avoidance opportunities. The wealthiest households receive significant shares of their incomes in the form of dividends, rents, capital gains, and interest, of which only land rents are taxed (and only at the low rate of 3 percent). The nontaxation also means that there are no data on such flows, making it difficult to estimate the revenue that could be obtained from taxing them. Once a profit tax is introduced, the non-taxation of interest creates a major tax avoidance opportunity, because interest is deductible under profit tax.

99. Even labor income may not be covered comprehensively by the tax. The tax law spells out pro-rated monthly and weekly thresholds to allow determining tax withholding. It is not clear that an annual adjustment is undertaken. While the law clarifies that workers with multiple jobs may only claim the tax-free allowance in one job, it does not clarify whether a worker can benefit twice from the introductory rate—which would imply horizontal inequality compared to workers earning the same income from just

one employer. On the other hand, people with periodic earnings are overtaxed, as their monthly incomes are not representative of their yearly income.

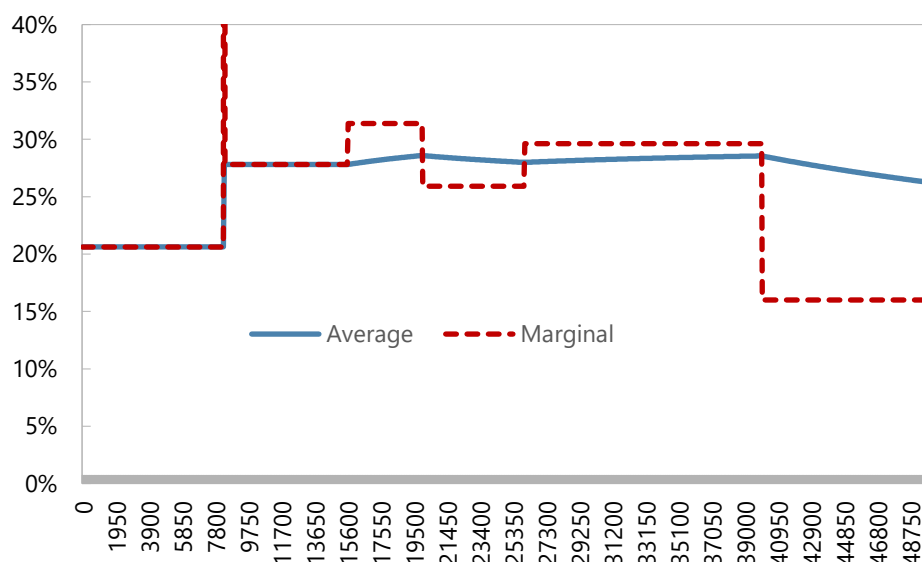
Inflation

100. The tax system is not adjusted for inflation, implying that tax thresholds are eroded over time. Current thresholds were set in 1989, since when the dollar has lost just over 60 percent of its purchasing power. The non-adjustment of thresholds implies a significant tax increase, with the non-adjustment of the zero-rate band putting more poor people inside the tax net. This “bracket creep” is an opaque way to raise effective tax rates on the population.

Social Security

101. When considering the combination of personal income taxes and social security, the resulting marginal tax wedge has an erratic shape and is regressive over parts of the distribution. This is caused by the upper earnings limits (Figure 6.3). In the case of pension contributions, this is less concerning, because those contributions lead to future pension entitlements and hence represent—at least to some extent—compulsory savings rather than contributions to a general budget. The health contributions, however, are qualitatively much closer to taxes, because the amount of contributions does not determine the quality of care, so that any additional dollar contributed has no benefit to the individual.

Figure 6.3. The Tax Wedge



Source: Mission calculations.

B. Reform Options for Personal Income Taxes

102. To avoid the notch in the marginal tax rate schedule, the tax-free allowance should be granted to every taxpayer, financed by higher marginal tax rates. Some countries withdraw the tax-free allowance over a certain range of incomes. While this removes the threshold effect from immediate withdrawal, it still creates an odd schedule of marginal rates, which first rise as the withdrawal phase

begins and then fall again, when the withdrawal is complete. A preferable solution is to simply raise the top tax rate, which recovers more of the revenues from those with the highest incomes.

103. The mission advises against the removal and the new 16 percent top rate and instead prepared two reform options that aim to remove the notch while minimizing revenue losses.

Removing the already-legislated 16 percent rate would be a regressive, especially in the context of introduction of VAT, which is not an effective tool for redistribution. The starting point is thus the reform, which was legislated in October 2024. Proposal A (Table 6.1) removes the withdrawal of the tax-free threshold and recovers revenues by reducing the tax-free allowance by \$1000 and raising raise tax rates to 12, 16, and 20 percent. The reduction in the tax-free threshold can be justified by the new Universal Basic Income, which is foreseen at \$1,000 per person, so that a worker will effectively reach the poverty line without paying tax once the income from working and the basic income are combined. Given that the 16 percent rate of the current legislation has proved controversial, and a January amendment is planned to remove it, the mission also prepared proposal B that avoids further increases in top tax rates. Instead, all thresholds are reduced by \$1,000 each. To further reduce the revenue loss, this scenario abolishes the 8 percent rate and begins immediately with the 12 percent rate.

Table 6.1. Tax Schedule Reform Options
(percent of GDP)

October 2024 law		Mission Proposal A		Mission Proposal B	
Income range (\$)	MTR (%)	Income range (\$)	MTR (%)	Income range (\$)	MTR (%)
0-8320	0	0-7320	0	0-7320	0
8320-8321	66560	7320-15600	12	7320-25000	12
8321-15600	8	15600-26000	16	>25000	16
15600-26000	12	>26000	20		
>26000	16				

Sources: Tax law and mission proposals.

104. The mission's preferred proposal is revenue neutral, while the alternative proposal implies a small revenue loss. Note that these estimates are based on gross income data for fiscal year 2022, the latest year for which the mission has micro data. These incomes were increased by nominal growth to fiscal year 2025, and comparisons with the latest aggregate outturn data for fiscal year 2024 suggest that this approach likely yields a slight under-estimate of revenues.²² Hence, differences across scenarios are likely more informative than the calculated aggregate revenue figure. As shown in Table 6.2, Proposal A raises almost the same revenue as the currently legislated reform. Proposal B loses almost \$2 million dollars in revenue—\$1 million more than the amendment considered by authorities for January. It should therefore only be adopted in combination with other, revenue-raising, measures.

²² Specifically, the revenue estimated using the current tax system is \$14.4 million, but outturn data for fiscal year 2024 stood at \$15.2 million.

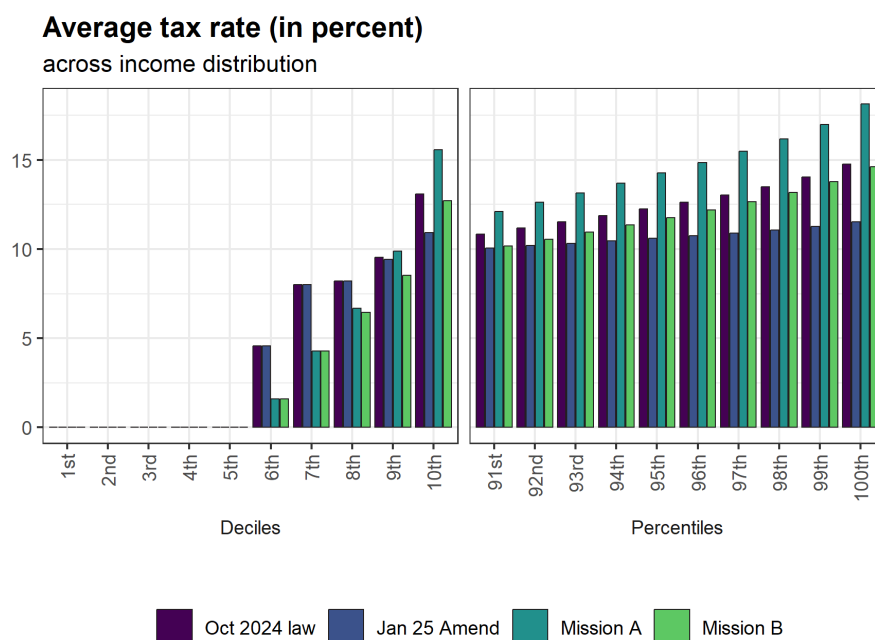
105. The missions' proposals make the tax system more progressive. As shown in Figure 6.4, both reforms reduce average tax rates for lower incomes, with the increase in the starting tax rate far outweighed by the non-withdrawal of the tax-free band. Proposal A also raises average tax rates at the top, Proposal B only does so compared to the January amendment under consideration. More technical measures of progressivity, as reported in Table 6.2, also confirm that there is a clear ranking, with Proposal A the most progressive, Proposal B second, the October law third, and the January amendment last.

Table 6.2. Comparison of Reform Scenarios
(percent, unless otherwise indicated)

	Oct 2024 law	Reform scenarios		
		Jan 2025 Amendment	Mission A	Mission B
Tax system characteristics				
Revenue (\$, millions)	13.3	12.4	13.2	11.4
Change in tax revenue (\$, millions)	0.00	-0.9	-0.1	-1.9
Share outside of tax net	46.2	46.2	41.0	41.0
Average tax rate	8.8	8.3	8.8	7.6
Average tax rate, above threshold	10.1	9.4	9.7	8.4
Redistribution (based on estimated distribution)				
Post-tax income share of top 1 percent	8.68	8.92	8.38	8.60
Post-tax Gini coefficient	55.72	56.12	55.06	55.62
Redistributive capacity	2.02	1.61	2.67	2.12
Progressive capacity	19.75	17.82	24.88	23.66

Source: Mission calculations based on official data.

Figure 6.4. Average Tax Rates over the Income Distribution



Source: World Inequality Database, IBFD, IMF-staff computations

106. To broaden the labor tax base, the housing allowance should be abolished. Shelter is a necessity, similar to food, and best addressed by an adequate tax-free threshold. Addressing it instead through the current housing allowance has the drawback of accruing predominantly to better off workers with more generous compensation packages. While administrative data on the amount of tax-exempt housing allowances are not available, the 2019 Household Income and Expenditure Survey provides estimates. For the cash housing allowance, it reports \$890,000 for 288 people (these figures are after applying survey weights and hence represent the full population).²³ As none of the reported figures hit the \$9,000 limit, we can assume that the overall value rose in line with nominal GDP, reaching \$1.1 million in 2024. For in-kind housing, the figure stands at \$2.6 million (based on 30 responses). Some values are at the \$9000 limit, so to estimate the 2024 values, the individual figures were uprated with nominal GDP growth, but never beyond \$9,000, yielding a total of \$2.9 million. The total value of the housing allowance is just \$4 million. Assuming that this would currently fall under the top rate of 12 percent, this thus represents a tax expenditure of about \$0.5 million. This could thus finance an increase in the general tax-free allowance. In combination with the proposed reform to abolish the withdrawal of the tax-free allowance, the removal of the housing allowance will not weigh too heavily on affected taxpayers, because they will be partly compensated by now qualifying for the general tax-free allowance, which has the advantage of being provided to everyone irrespective of whether paid in wages or housing benefits. Ideally, this calculation should be updated with administrative data if they can be collected, given the uncertainties with the survey data.

107. In-kind benefits should be reviewed with a view to making most of them fully taxable. Unless there are very strong externalities, there is no need to provide tax advantages to in-kind over in

²³ As these figures were weighted up from just 10 observations, the reliability is doubtful.

cash remuneration, although for practical purposes some items may be exempted (e.g., entertainment up to an upper limit to allow occasional work celebrations). Administrative data are not available, but the household survey provides some information on their likely magnitudes (Table 6.3). These data suggest that the key priority is to address company-provided vehicles. Other items, notably food, may not raise much as they might be handed out to relatively low-paid workers and might fall under the new higher tax-free threshold.

Table 6.3. Employer-Provided In-Kind Benefits
(\$, data from 2019)

Electricity	Food	Telephone	Fuel	Vehicle	Other
495275	505276	93615	82341	2461096	19246

Source: Household Income and Expenditure Survey 2019.

108. Beyond labor income, capital income should also be included in the tax base. This is particularly important for interest income because it is deductible under the profit tax. Hence, most urgently domestic capital income should be taxed as soon as the profit tax is implemented. Ultimately, most countries tax the worldwide income of individuals, giving a credit for foreign source taxes paid (though no refunds in case foreign taxes exceed domestic ones). Nontaxation of foreign source income creates avoidance opportunities and, in the process, reduces incentives for domestic investment of capital.

109. Initially, a simple solution with flat capital income tax rates would work well. Taxing capital income comprehensively in combination with labor income achieves horizontal equity across taxpayers with different sources of income. However, it is quite complex to administer, as each capital income needs to be allocated to a specific taxpayer, while a flat rate can be more easily collected through final withholding. Moreover, there are some arguments in favor of lower marginal capital income tax rates to reduce distortions to savings decisions. Overall, especially in a country where such a tax is new, the best starting point is a relatively low flat rate, with the option of raising it or fully integrating it into a comprehensive income tax at a later stage.

110. The initial rate can be low, though it should be increased over time to be close to or align with the top rate on labor income and the profit tax. In an economy in which capital income has not been taxed before, little is known about the flows at stake. Moreover, taxpayers are not used to reporting such incomes. A low tax rate of about 10 percent would allow taxing such incomes, without creating strong incentives for tax evasion. Dividends paid by firms out of taxed earnings can be exempt (or subject to a lower rate). Taxpayers who receive rents can be given a choice between either documenting exact rental profits or an allowance for costs of 30 percent of the rent. Increases in the capital income tax rate can be considered later, when authorities know more about the flows at stake, and taxpayers have learned how to report such income.

111. To increase neutrality of the tax system with respect to inflation, the thresholds should be updated regularly, ideally through an automatic annual process. Just as uprating excises is important to maintain their real value, so is uprating threshold to avoid taxpayers shifting into higher tax

brackets over time without their real incomes haven't risen ("bracket creep"). An automatic process is ideal, since there is no policy decision involved in keeping the tax system constant in real terms (see Beer, Griffiths, and Klemm, 2023). If ever the government wishes not to update thresholds in a particular year so as to raise more revenue, this is a policy choice and can be legislated whenever needed.

112. The social security system requires reform, which will likely require further technical assistance. As noted, the overall tax wedge is regressive. While fully addressing this would be difficult, at the least this provides an additional argument, not to lower the top tax rate back to 12 percent. Moreover, and beyond the scope of this report, the pension scheme appears to face significant medium and long-term solvency risks. These would require in-depth technical assistance to determine solvency-enhancing reforms, which likely will require adjustments not just on the revenue side, but also regarding entitlements (amounts and minimum ages).

Recommendations

6.1 Abolish the withdrawal of the tax-free allowance, financed by an increase in tax rates to 12, 16, and 20 percent and a reduction in the tax-free allowance by \$1000.

6.2 Abolish the tax exemption for the housing allowance and use the revenue gain to increase the tax-free threshold.

6.3 Review employer-provided in-kind benefits for inclusion in the tax base, starting with the private use of company vehicles.

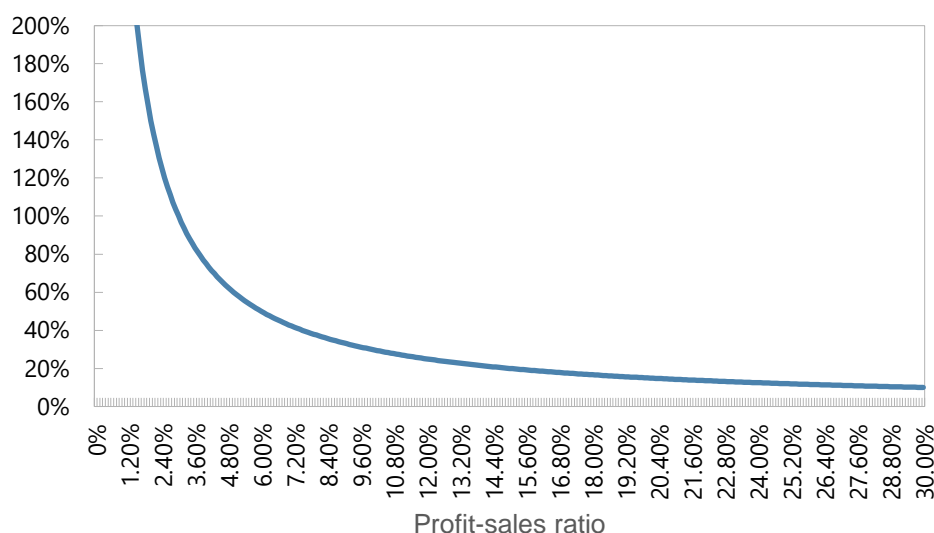
6.4 Introduce a 10 percent flat capital income tax covering interest, rents, and capital gains, exempting dividends.

6.5 Automatically adjust annually all thresholds for inflation.

C. Problems with the Current Approach to Business Taxation

113. The GRT favors successful and established firms and can be exceedingly highly for struggling firms, increasing the risk of firm bankruptcies. As it is based on turnover rather than profits, for successful businesses it represents a small share of their profits, while for businesses that are struggling it will be a very high share, as illustrated in Figure 6.5. For businesses with very small profits, payment of the tax can create a post-tax loss (shown by tax rates exceeding 100 percent of profit) and thus lead to bankruptcy. In the extreme case of a pre-tax loss, the tax also still applies, further increasing post-tax losses. New businesses often struggle in their first years, during which a turnover tax adds to the difficulty. The tax holiday for new firms does not address the issue for any small local startups, given the high minimum investment or payroll requirements. Established firms, including those that might have some monopoly power, benefit.

Figure 6.5. Effective Profit Tax Rates over Profit Margins



Source: Mission calculation.

Note: For visibility, the left-hand axis was truncated at 200 percent. As the profit-sales ratio falls further toward zero, the effective tax rate on profits goes toward infinity. And even for negative profits, positive tax payments occur.

114. The GRT is distortive across different sectors of the economy. High-margin businesses, i.e., those where costs are low and hence a large share of turnover represents profits, face low effective taxation. An example would be service providers such as law or consulting firms. The opposite is true of low-margin businesses, such as retailers, where there is only a small margin between turnover and the costs of goods sold, so that the tax effectively represents a very large share of profits.

115. A further inefficiency caused by the GRT is that it discourages specialization and favors vertically integrated businesses. Because it applies on turnover, it cascades through the production chain. As discussed in Section III, this means that it is not a good proxy for a consumption tax. But it also is not a neutral business tax, because it favors integrated industrial structures over production that is divided across various independent, and potentially more specialized, firms.

116. The GRT is also problematic from an international perspective because creditability is not assured. Foreign investors from countries with worldwide taxation (e.g., the United States) operating in the Marshall Islands risk that the tax is not recognized as corporate income tax that is creditable against any tax liability they face at home for their foreign operations.

117. The GRT will likely also not be creditable under the new global minimum tax. The 2023 Inclusive Framework agreement foresees the introduction of a global minimum tax ensuring that profits of large multinationals (i.e., with global turnover > €750 million) face an effective tax rate of at least 15 percent in each country they operate. It is now being implemented, with various countries in Europe and Asia having already passed or announced the relevant legislation.²⁴ If a country—even a non-member of

²⁴ The United States has not legislated the global minimum tax, but its GILTI regime has a similar impact in that it also ensures the US multinational pay a minimum tax in foreign jurisdictions (though unlike the global minimum tax, the GILTI regime is assessed at the global level rather than on a country-by-country basis).

the Inclusive Framework like the Marshall Islands—does not collect at profit tax of effectively at least 15 percent, other countries can collect it, most importantly the country of the multinational's headquarters.

118. Mission estimates suggest that large multinationals operating in the Marshall Islands may face additional taxes of around \$3.5 million abroad as a result of their profits not being taxed in the Marshall Islands. This figure is highly uncertain. First, the country-by-country reporting (CBCR) data used in the estimation are not fully reliable, and indeed some of the figures do not appear plausible.²⁵ Second, not all countries may implement the global minimum tax (under the agreement they are not obliged to do so, they only must accept implementation by others). If a country of headquarters does not introduce the minimum tax (specifically the “Income Inclusion Rule” (IIR)), other countries in the production chain may be able to collect it, but it is less certain that that this provision (the “undertaxed profit rule” (UTPR)) will be widely adopted. The highest revenue at stake, however, relates to German firms (1 percent of GDP), and given that Germany has legislated the IIR, this provides a strong case for reacting. Third, given data constraints, calculations reported in Table 6.4 made some simplifying assumptions. Notably, the minimum tax foresees a substance-based income exclusion, which provides an allowance for tangible capital and payroll, but data on the latter are not available and were estimated from per capita GDP and the number of employees.

²⁵ For example, the very high turnover of Bermudan multinationals in Marshall Islands does not appear credible. Most countries report zero income tax accrued in the Marshall Islands suggesting that they do not consider the GRT and income tax, except the United Arab Emirates, which report significant tax payment (this might reflect a different interpretation of the GRT, or they might be involved in extractives where income taxes are due).

Table 6.4. Revenue Potential from Global Minimum Tax, 2021

Ultimate Parent Entity	Number of CbCRs	Number of CbCRs with + Profits	Total Revenues	Profit (Loss) before Income Tax	Income Tax Accrued Current Year	Jurisdiction ETR	Top-up Tax	Substance-based Income Exclusion		Excess Profit	Minimum Tax Due	
								10 % of payroll	8% of tangible assets		\$	% of GDP
Germany	3	n.a.	22,518,000	17,155,000	0	0.0	15.0	0	0	17,155,000	2,573,250	1.0%
Greece (2020)	2	2	653	255	0	0.0	15.0	0	0	255	38	0.0%
Japan	10	3	18,462,425	1,669,962	0	0.0	15.0	0	1,957,620	0	0	0.0%
Bermuda	7	3	3,067,540,518	259,987,142	0	0.0	15.0	0	257,063,441	2,923,701	438,555	0.2%
China	10	7	128,738,882	21,972,240	0	0.0	15.0	42,297	43,664,666	0	0	0.0%
Hong Kong, SAR	3	2	3,930,130	1,355,468	0	0.0	15.0	0	895,984	459,484	68,923	0.0%
Indonesia	1	1	46,346,612	3,230,976	0	0.0	15.0	0	779,245	2,451,731	367,760	0.1%
United Arab Emirates	3	3	62,607,321	3,832,946	1,678,854	43.8	0.0	0	56,393,844	0	0	0.0%
Total	39		3,327,626,541	309,203,989	1,678,854			42,297	360,754,801	22,990,171	3,448,526	1.3%

Notes: Revenues and profits are those of profitable firms, except where no breakdown into positive and negative profits is available. Data for total payroll cost were estimated as the product of GDP per capita and the number of employees

Source: Mission estimates based on OECD data from CbCRs.

D. Reform Options for Business Taxes

119. The GRT fulfils the role of neither a consumption nor a profit tax. As argued in Section III, consumption can be taxed much more efficiently under a VAT.

120. The new VAT should be complemented by a profit tax (also often known as corporate income tax). This will ensure that incomes from businesses are taxed, as is labor income under the personal income tax. This is particularly important in a country like the Marshall Islands where dividends and interest are not taxed, but is more generally advisable, because in any case undistributed earnings of businesses would go untaxed without a profit tax.

121. A profit tax would address most of the disadvantages of the GRT.

- It is neutral with regard to the sectoral composition and their different margins because costs are deductible. Some countries address sectoral differences by applying a GRT with rates that vary across sectors, but this is a much less precise solution, and it creates complications and evasion opportunities when firms operate in multiple or hard to define sectors.
- It automatically rises with profitability, while firms that just break even or make losses will not have to pay the tax, thereby avoiding bankruptcies caused by tax.
- It allows specialization and production chains, as profits are taxed only once, irrespective of whether they occur in one conglomerate or are distributed across many firms.
- It is creditable against other countries' profit taxes (including under the IIR). This is even the case if some firms maintain a revenue-based tax because such schemes are generally creditable when part of an overall profit tax.

122. To be efficient, a profit tax needs to be well designed.

- Losses should be allowed to be carried forward to be netted off future profits. This ensures that firms in volatile sectors pay tax in relation to the structural profits rather than based on the arbitrary accounting year. Loss carry forward can be unlimited—which is economically most efficient while also being administratively simple (only the stock of losses needs to be known, not its vintage). For revenue purposes, it can also be limited, for example to 5 years.
- The tax base needs to be carefully defined. The starting point should be company accounts. Most countries require some adjustments, because accounting leaves some room for judgment, while taxes should be more clearly determined. A common deviation from business accounts is to disallow depreciation and instead use statutory depreciation allowances. These can be made intentionally generous as an incentive for investment (see below), but for simplicity one can also allow any depreciation that is acceptable under accounting standards. Another important aspect is to disallow deduction of costs of personal consumption and entertainment.
- Capital income, including rents, interest and capital gains should be included in the tax base, with the exception of inter-company dividends (as those are paid out of taxed profits and will face dividend tax whenever paid out to individuals).
- While it will take time to determine precise rules, some broad principles should be written into the law. There should be, for example a general anti-avoidance rule, that states that arrangement that are

undertaken only for tax avoidance reasons, are invalid. Regarding transactions with related parties, international transfer prices should be required to follow the arm's length principle.

- An important decision is whether the tax should be territorial—i.e., apply to Marshallese source income only—or worldwide—i.e., apply to the global profits of Marshallese firms (with a nonrefundable credit for foreign-source taxes). A relatively simple solution would be to exempt foreign profits, subject to some anti-avoidance rules, such as closed foreign company (CFC) rules and the ability to tax profits in countries with no or a negligible profit taxation.

123. A profit tax, however, also has drawbacks. Most importantly, it is far more complex than the simple GRT. To allow calculation of profits, firms need to have a full set of accounts, keeping track of all their costs in addition to revenues. In case of investment, they need to keep track over various years while they depreciate their capital assets. And in case of losses, they need to document them to carry them forward to future years.

124. A profit tax should thus be restricted to firms that are large, where the efficiency benefits likely outweigh the additional compliance costs from complexity. The threshold for applying the profit tax should be aligned with the VAT threshold. This keeps the system simple, with only one threshold determining the applicable set of taxes. The compliance and administrative requirements are also quite similar, hence firms where for the VAT it is deemed that the efficiency benefit outweighs the compliance cost of a more complex system, are also likely to benefit from the profit tax. Finally, the tax administration already needs to focus on VAT-paying firms and staff specialized in dealing with larger firms can then simultaneously cover the profit tax. To prevent tax avoidance by splitting a business into many small ones, turnover of firms belonging to the same owner should be added up to determine whether the profit tax applies.

125. For most small enterprises, the GRT remains a more practicable option, but voluntary adoption of the profit tax would allow firms that are disadvantaged by the GRT to avoid its drawbacks. This should be allowed under the precondition that the business is able to prepare reliable books. Low-margin businesses, such as small retailers, may prefer to switch to a profit tax, especially if their operations are very simple (sales, cost of goods sold, salaries, and minimal investment). As the purpose of voluntary adoption of the profit tax is to address structural disadvantages rather than to allow short-term tax optimization strategies, firms that voluntarily adopt the profit tax should not be allowed to return to the GRT for at least five years. Moreover, as the GRT covers for both the VAT and the profit taxes, voluntary adoption of either, implies adoption of both.

126. The tax holiday and some of the exemptions can be abolished. The 5-year tax holiday addresses the problem that firms are often not profitable in early years of their operations, making a turnover tax particularly onerous (though, as noted, it does not help small startups given the minimum investment/payroll requirements). As a profit tax automatically implies that only profitable firms need to pay tax, there is no need to maintain the tax holiday, not least as it is very crude, in that some firms are immediately profitable and do not require an exemption to be worthwhile undertakings. Similarly, there is no need any more to exempt air transport or public copra production. While these sectors play an important role and may struggle to be profitable, a profit tax will not apply if they are not making profits (and allowing losses to be carried forward, they will not face taxes even if they occasionally make small profits in some years).

127. More generally, pressure to introduce tax incentives should be resisted. Businesses often lobby for tax incentives, but their impact is often limited and does not outweigh the revenue cost. Moreover, under a given revenue requirement, selective tax incentives for some sectors imply higher taxation in others. Instead, a better strategy is to maintain a broad tax base and a low rate. If tax incentives are nevertheless to be introduced, it is best to focus on those that directly encourage investment without discriminating across sectors and without creating complex procedures and judgmental authorizations. Accelerated depreciation (or in the extreme case expensing of investment) is therefore preferable to most other incentives, and also permitted under the global minimum tax.²⁶

128. One aspect in determining the rate of the profit tax is the desired revenue, notably in comparison to the revenue of the current GRT. To get some indication of likely effects, there are three possible approaches—none of which is fully satisfactory:

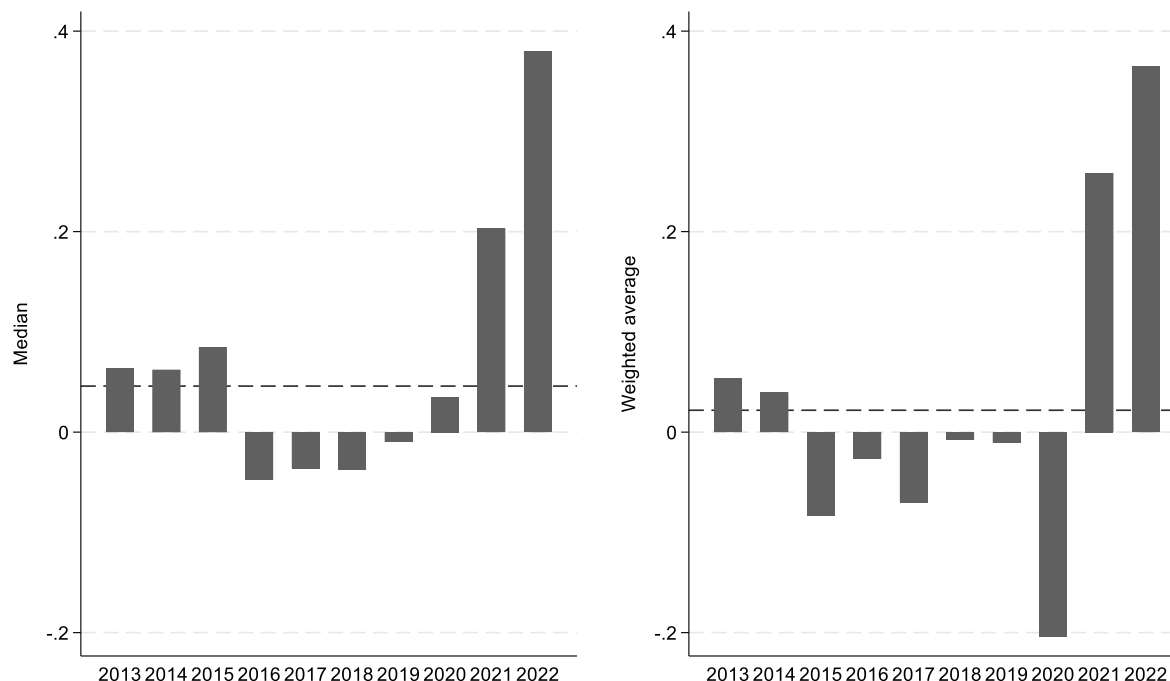
- **Macroeconomic data:** The rate of the private operating surplus to turnover reported by GRT payers averages 31.4 percent between FY2017 and FY2022 (ranging from 27.5 percent in FY2018 to 38.1 percent in FY2021). The private operating surplus, however, is an upper bound for the tax base, because it does not reflect interest and depreciation, both of which are deductible. Moreover, it includes mixed income from certain self-employment, which is under the income tax. A lower bound for the revenue-neutral profit tax rate is thus about 10 percent.
- **Company data:** For 38 to 49 Marshallese companies per year Orbis provides accounting data from annual reports. As these represent the global operations of these firms, and not their operations in the Marshall Islands only (their total sales are far greater than aggregate sales reported under the GRT), we cannot use their profit data directly as an estimate of the tax base. However, we can look at the ratio of profits before taxes to sales, which turns out to show much variation over the years (Figure 6.6). Note that a negative average ratio does not mean that no tax is collected, because any profitable firms would still be liable for taxation. This analysis, however, does suggest that profit revenues will be more volatile.
- **International comparators:** Globally, profits before taxes but after all operating expenses and depreciation average around 10.6 percent of turnover.²⁷ If that ratio applies in the Marshall Islands, too, it implies that the 3 percent turnover tax is on average equivalent to a profit tax of 28 percent.²⁸
- Considering these diverse findings from different approaches, suggests that the best strategy is to set the VAT in such a way that it recovers most of the GRT revenues, while being more cautious about revenue expectations from the profit tax.

²⁶ For a detailed discussion of tax incentives and their pros and cons, see IMF, OECD, UN, and WB (2015).

²⁷ See data published by Aswath Damodaran at https://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html.

²⁸ A more precise estimate could be obtained if the sectoral composition of Marshallese firms were known. The international data by Damodaran are available at the sectoral level, with large differences across sectors.

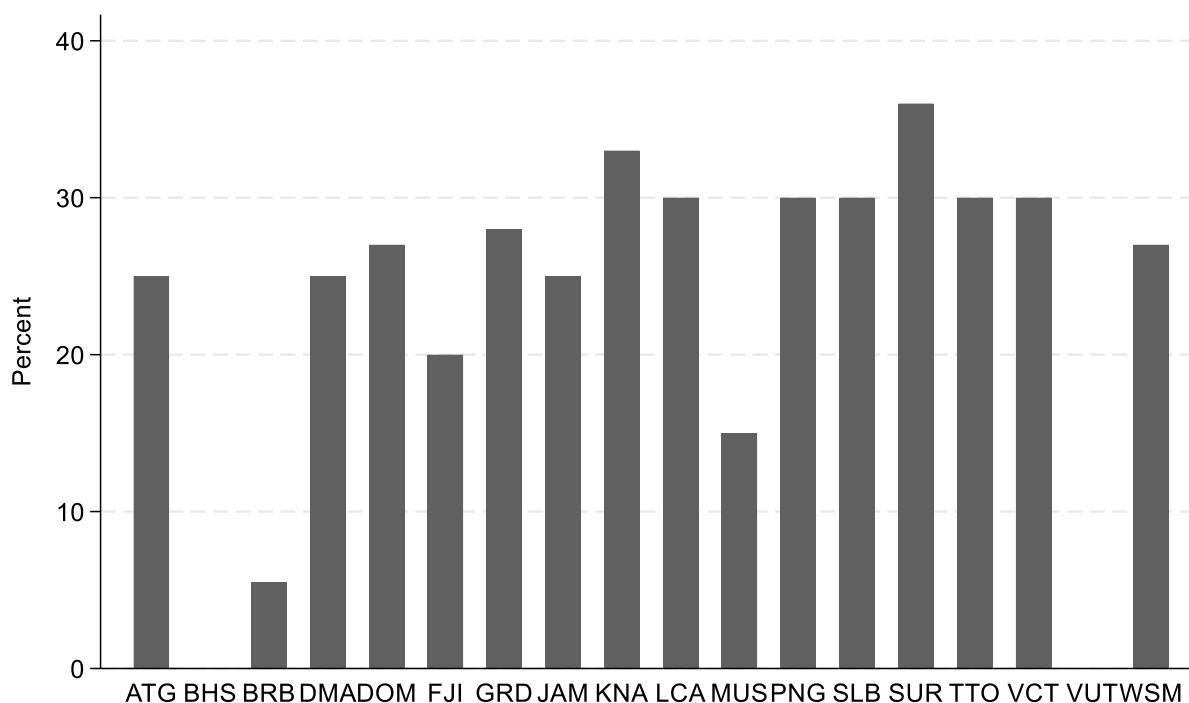
Figure 6.6. Ratios of Profits before Taxes to Sales



Source: Mission estimates based on Orbis data.

129. Another consideration is the international competitiveness of the rate. A comparison with other small island developing economies shows that the majority of them apply tax rates in the range of 20 to 30 percent (Figure 6.7). A few countries apply much lower or no tax on profits, but—with the exception of Vanuatu—they are not in the Asia-Pacific region.

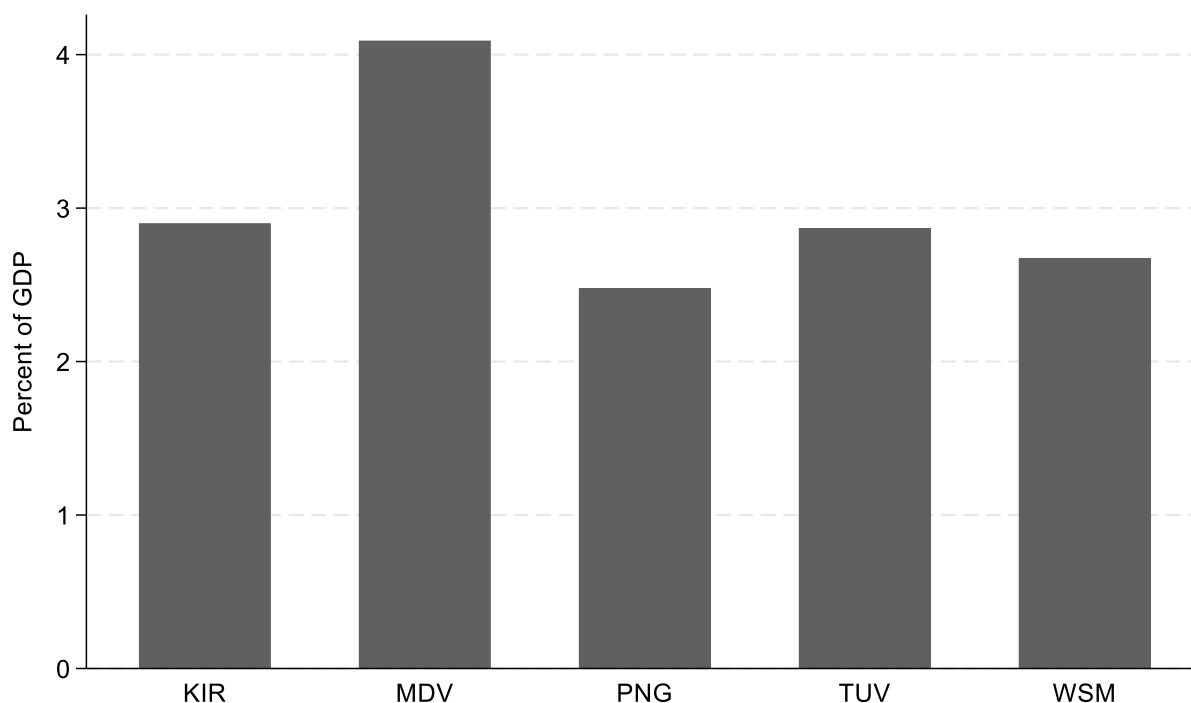
Figure 6.7. Corporate Income Tax Rates in Small Island Developing Economies, 2022



130. Considering both revenue and international considerations, as well as interactions with the personal income tax, a tax of 20 percent would be a good starting point. Going below 15 percent would not be advisable in a global environment where an effective minimum rate of 15 percent applies. With a rate of 20 percent, the Marshall Islands would still be among the lowest in the region. A higher rate could ultimately be feasible, but one risk is that it would trigger calls for tax incentives, and it would be preferable to maintain a broad base and low rates. Another consideration is the integration with the personal income tax, to minimize tax avoidance through incorporation or by paying oneself a salary as an owner. Hence, the profit tax could be aligned with the 16 or 20 percent personal income tax rate (however, if the top rate cut back to 12 percent—which is not in line with mission recommendations—then this would be too low for a profit tax rate).

131. Regarding revenue expectations, country-specific estimates are difficult to obtain given the lack of data, but international comparisons suggest a medium-term potential of around 2 percent of GDP. Figure 6.8 shows that other Asia-Pacific SIDS that have a profit tax, raise between 2.5 and 4 percent of GDP in revenue. However, they mostly have higher rates (Kiribati 35 percent, Papua New Guinea and Tuvalu: 30 percent, Samoa: 27 percent). The Maldives, however, have a low rate of 15 percent and the highest revenue, which shows that projections should ideally focus on the domestic tax base, rather than international comparisons to countries with potentially different circumstances. Initially, it would in any case be safer to assume lower revenues until compliance and enforcement reach maturity, hence assuming an immediate revenue impact of 1 percent of GDP would be a prudent choice, with upward potential.

Figure 6.8. Corporate Income Tax Revenue in Asia-Pacific Small Island Developing Economies



Source: WoRLD.

Recommendations

6.6 Replace the GRT by a profit tax at a rate of 20 percent for firms with turnover exceeding the VAT threshold from October 2026.

6.7 Allow voluntary adoption of the profit tax in line with VAT, for firms that have the necessary accounting in place. Do not allow switching back to the GRT for at least five years.

6.8 Allow loss carry forward, either unlimited or for up to 5 years.

6.9 Abolish the tax holiday for new firms, grandfathering existing beneficiaries if they remain in the GRT. Refrain from adopting tax incentives other than accelerated depreciation. Review exemptions for potential removal, starting with the exemption for air transportation.

VII. Administration of Income Taxes

A. Current Situation

132. The GRT and wages and salaries taxes are administered by the RTU of the DCTRT. At the end of FY2022-2023, 642 businesses were registered for the GRT and 1,294 for the labor taxes.

133. Unlike consumption taxes, the DCTRT has some experience with the administration of income taxes. Procedures are in place to monitor taxpayers' compliance with their filing, reporting and payment obligations. An audit section of four conducts tax audit activities. A basic segmentation program has been developed for compliance risk management and optimal resource allocation purposes. However, the current administration of income tax is predominantly paper based, requiring taxpayers to physically attend the tax office to fulfill their tax obligations.

134. The taxpayer compliance rate for income tax is relatively low. In FY2022-2023, 14.7 percent of registered GRT taxpayers and 18.7 percent of registered labor taxpayers did not file their tax returns on time. Though Marshall Islands law requires businesses to maintain accurate and up-to-date accounting records that reflect their financial transactions and positions, there are no mandatory specific accounting standards or filing of financial statements with the government.

135. The administration of social security contributions falls under the purview of MISSA. MISSA and the revenue administration have established a framework for collaboration in order to exchange information and data.²⁹ This relationship should continue to be enhanced with data exchange through digitalization.

B. Key Issues and Challenges

136. The income tax reform will introduce changes with administrative implications. Phase 1 passed in October 2024, has little impact on the current administration of income taxes. While aiming for more equity, the mission's proposal for personal income tax reform would eliminate the threshold effect and broaden the tax base. These changes will require modifications to the calculation methods and the design of new forms and procedures but should not pose significant challenges to their administration. However, replacing the GRT with profit tax for large taxpayers is a major reform that will introduce new obligations for taxpayers and challenges for the tax administration. Careful implementation planning and deployment will be needed and will need to be carefully sequenced with other revenue reforms especially VAT introduction.³⁰

137. The reform of the personal income tax will align the Marshallese tax system with international good practice. The proposed policy options, including the elimination of the threshold effect, broadening of the labor tax base, expansion of the tax-free allowance, and taxation of capital income will improve the current tax system and its administration. However, the main challenge of

²⁹ This relationship is governed by a memorandum of understanding.

³⁰ The implementation challenges and recommendations discussed in Section IV are relevant for the introduction of the profit tax.

progressivity is taxpayer non-compliance, especially when the MTR is high—taxpayers subject to high marginal rates tend to evade taxes. Critical measures to ensure the successful implementation of this reform should include (1) training of taxpayers to help them understand the changes; and (2) adjusting taxpayer's systems to integrate these changes into the calculation of the amount of tax due.

138. Simplifying taxpayers' PIT obligations is essential for ensuring compliance. Advanced tax administrations take initiatives, such as eliminating the need for PIT taxpayers to file tax returns when withholding obligations are accurately complied with by employers. This helps to promote voluntary compliance and reduce compliance costs for wage and salary tax earners.³¹ Therefore, the RTU should keep the withholding systems, without filing obligations for individuals to reduce the risk of non-compliance and facilitate the administration of the personal income tax. However, and particularly for the labor tax, individuals who earn income from several sources (e.g., individuals with more than one employment contracts), should be required to file their personal income tax returns to ensure effective functioning of the progressivity principles.

139. The introduction of a profit tax will pose more challenges to the RTU. The profit tax is different from the GRT. The underlying rules and principles of the profit tax are more complex than those of the GRT. Its implementation will require significant work in terms of procedures and form design, training of staff on new concepts such as income tax base determination, accounting principles, and assets and liabilities, as well as the development and implementation of taxpayer compliance programs. Timely implementation of the ITAS will be needed to support the effective administration of the profit tax. (McAlister, 2024)

140. Implementation of the profit tax will also likely trigger the obligation of filing of financial statements with the tax administration. Accounting standards should align to the requirements of the CoFA reporting. To enforce this obligation, the determination of bookkeeping accounting standards for the Marshall Islands will need to be made by regulations.

141. Extensive education programs will be needed for business tax taxpayers. The requirements for self-assessing and paying profit tax liabilities are more complex than those of the GRT. Taxpayer education will be a critical component of the successful implementation of these changes. Businesses will require comprehensive training focused on record keeping, withholding calculation and compliance with filing, accurate reporting, and payment.

142. The RTU needs to lift the level of tax compliance. While most large business taxpayers have a high filing compliance rate (98.6 percent in FY2022 – 2023), small and medium-size businesses lag behind (56 percent and 89 percent respectively). Given the small size of the taxpayer base of the Marshall Islands, there should be no room for non-compliance. The tax administration should ensure all registered businesses meet their obligations. Compliance improvement programs, including enhanced communication and education (Shrosbree, 2024), targeted follow up activities, collaboration with industry groups and penalties should be in place to improve compliance. If resources allow, these activities should commence in advance of the profit tax introduction to help build better compliance behaviors across the taxpayer population.

³¹ See Tax Administration Diagnostic Assessment Tool Field Guide. April 2019 Edition.

Recommendations

- 7.1** Plan for careful implementation including development of a detailed plan for tax reforms, including staff training and a timeline for rollout.
- 7.2** Establish and enforce mandatory accounting standards aligned with Compact of Free Association (CoFA) requirements, for businesses to ensure the maintenance of accurate financial records.
- 7.3** Digitally transform the tax administration and implement ITAS, moving from a paper-based system to a digital platform and ensure timely implementation of the ITAS to manage profit tax complexities and improve efficiency. If ITAS is not operational, consider manual administration for a limited period while ensuring the system development is aligned with policy.
- 7.4** Implement taxpayer education and provide extensive support and training programs to help taxpayers understand new tax obligations and processes.
- 7.5** Enhance compliance monitoring including strengthening compliance risk management using data analytics to risk assess and address non-compliance effectively.

VIII. Cross Cutting Tax Administration Issues

143. The Marshall Islands tax administration has made progress overtime in implementing the Marshallese tax system and collecting tax revenues. However, without fundamental changes, it will struggle to meet the demands of modern tax systems. In addition to the specific measures recommended for reforming income and consumption taxes, the mission identified the need for administrative enhancements that are crucial for effective tax administration.

A. Governance and Organization

144. Though small, the RTU needs improvements to its organizational structure to effectively deliver its mandate. The current structure composed of only Compliance and Audit sections does not support modern tax administration. There is no dedicated section or personnel for taxpayer services and assistance, or for managing the ongoing reform projects. These two functions are essential, particularly during this critical period of development of large-scale reforms and should be added to the RTU's structure. The key functions of a taxpayer service section are provided in Box 1. Annex 1 provides guidance on reform management governance based on VITARA (Virtual Training to Advance Revenue Administration) modules.

Box 1. Key Roles of a Taxpayer Service Section

The key roles of a taxpayer service unit in a tax administration include:

- **Providing Information and Assistance:** Helping taxpayers understand and comply with tax laws by offering clear and accurate information through various channels such as websites, call centers, and in-person assistance.
- **Taxpayer Education and Outreach:** Conducting educational programs and outreach activities to inform taxpayers about their rights, obligations, and any changes in tax laws or procedures.
- **Processing Tax Returns and Payments:** Ensuring efficient and accurate processing of tax returns and payments, including handling inquiries and resolving issues related to filings.
- **Managing Taxpayer Accounts:** Maintaining and updating taxpayer accounts, addressing discrepancies, and ensuring that records are accurate and up to date.
- **Resolving Taxpayer Issues:** Providing support to resolve taxpayer issues and disputes, including offering guidance on how to correct errors and navigate the appeals process.
- **Promoting Compliance:** Encouraging voluntary compliance by making it easier for taxpayers to meet their obligations and by providing support to those who need assistance.

145. Adequate staffing and strong project management and communication skills are crucial. The taxpayer population to administration staff ratio varies significantly across countries. For example, in 2017, the ratio of the median core taxpayers to FTE was 434.³² This ratio tends to be lower in SIDS due to the lack of IT systems, the need for more personalized services and the challenges of managing tax

³² ISORA 2018 "Understanding Revenue Administration."

compliance in disperse populations. With only seven employees, the DCTRT is understaffed and there are two current vacancies. In addition, securing additional resources could yield significant returns. Experience shows that increasing tax administration staffing level up to a threshold of 0.25 percent of the labor force improves revenue performance (Chang and others, 2020). The Ministry of Finance should consider recruiting three or four additional personnel with project management and taxpayer service expertise to ensure effective cross-functional development, communication, and implementation of compliance strategies.

146. Focus on the large taxpayer segment should continue. Initiatives have already been taken to divide the taxpayer base into large, medium, and small segments. Given the limited resources available, priority should be on achieving higher levels of compliance from the large taxpayers. This includes ensuring not only timely filing and payment but also accurate reporting. High compliance from the large taxpayers will be critical throughout the reform development and implementation phases as these taxpayers provide the bulk of the tax revenue.

B. Core Functions

147. An enhanced collaboration with MISSA is needed to ensure effective management of the tax registration database. A modern, risk-based tax administration requires knowing who must contribute through taxes, duties, and other lawful impositions. Recognizing who is and who should be in the tax system is crucial. Maintaining a high-integrity registration database enhances revenue system effectiveness. Without accurate data, voluntary compliance and confidence in the tax system may decline.

148. Efficient filing management is crucial for a tax administration to ensure that taxpayers can file their returns with ease and in a timely manner. Streamlining the process reduces the burden on taxpayers and improves compliance. Leveraging technology, such as e-filing systems and electronic signatures, automates the process and reduces errors. Integrating the filing system with other tax administration systems ensures all relevant information is available in one place, making management and monitoring easier. Implementing compliance risk management strategies helps identify and mitigate risks associated with filing, promoting voluntary compliance.

149. Facilitating payment for taxpayers is essential for ensuring timely and accurate payments. Utilizing technology, such as online payment systems and electronic funds transfer—including mobile money,³³ particularly for the largest taxpayers, automates the process and minimizes errors. Integrating the payment system with other tax administration systems consolidates all relevant information in one place, simplifying management and monitoring. Promoting electronic and online payment options for large taxpayers offers them convenient and secure methods to meet their tax obligations.

150. Efficient processing of tax refunds is crucial for maintaining taxpayer trust and compliance. Verifying refund claims through automated systems may help ensure legitimacy and reduce fraud. Timely disbursement, especially through electronic and online payment methods, enhances reliability. Integrating refund processing with other tax systems provides a comprehensive view of

³³ Several developing countries, including Benin, Kenya, Mauritius, the Philippines enable taxpayers to use mobile money to pay their taxes.

taxpayer accounts, streamlining management and reducing errors. Implementing compliance risk management strategies helps identify and mitigate risks, promoting voluntary compliance.

151. Providing support and services to taxpayers to help them understand and meet their tax obligations is also important. This must include offering guidance, answering queries, and providing educational resources. Effective public information and services encourage voluntary compliance by making it easier for taxpayers to meet their obligations.

152. Conducting audits to ensure compliance with tax laws and regulations is a critical function of tax administration. Utilizing a risk-based approach to select audit cases improves efficiency by focusing on high-risk taxpayers or industries. Integrating third-party data sources, such as customs import data, aids in detecting non-compliance. Providing ongoing training for audit staff enhances their ability to conduct thorough audits. Implementing clear and consistent audit guidelines ensures professionalism and standardization in the audit process.

153. Providing affirmative dispute resolution procedures is essential for handling disputes between taxpayers and the tax administration. Clear and transparent mechanisms for taxpayers to appeal decisions and resolve conflicts ensure fairness and build trust. Ensuring timely and efficient resolution processes maintains taxpayer confidence and compliance. These procedures help create a fair and transparent environment for resolving tax disputes. Though important, dispute resolution systems are not critical for the reform and may be developed at a later stage.

C. Monitoring and Evaluation

154. Establishing a robust monitoring and evaluation framework is essential for tracking the progress of reform implementation and making necessary adjustments. This involves developing key performance indicators (KPIs) to measure achievement of planned milestones.

155. Regular reviews to assess implementation progress and identify any challenges or areas for improvement should be conducted. Use the findings from these reviews to make necessary adjustments and improvements. Establish mechanisms for taxpayers and tax administration staff to provide feedback on the new system. This feedback can help to identify any issues and make necessary adjustments to improve the system.

Recommendations

8.1 Enhance the RTU organizational structure by adding dedicated sections for taxpayer services and assistance, as well as for managing ongoing reform projects.

8.2 Recruit three or four additional personnel with project management and taxpayer service expertise to ensure effective cross-functional development and implementation of compliance strategies.

8.3 Implement e-filing systems, electronic signatures, online payment systems, and automated refund processing to streamline processes, reduce errors, and improve compliance.

8.4 Develop key performance indicators (KPIs) to measure success along with regular reviews mechanisms to track progress and make necessary adjustments.

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Annex 1. Reform Management Governance

The IMF's VITARA (Virtual Training to Advance Revenue Administration) modules provide comprehensive guidance on reform management governance for tax administration reforms. Here are the key recommendations from the VITARA modules:

Key Concepts

The VITARA modules emphasize the importance of a structured and systematic approach to managing tax administration reforms. This includes understanding the key concepts of reform management, the process of developing a reform program, and the necessary management and governance arrangements.

Governance Infrastructure

The governance infrastructure required to ensure reforms are delivered on time, within budget, and of acceptable quality includes the following elements:

- **Steering Committee:** A high-level body that provides strategic direction and oversight for the reform program. The committee should include representatives from key government ministries, the tax authority, and the private sector.
- **Project Management Office (PMO):** A dedicated team responsible for coordinating and managing the reform program. The PMO ensures that all projects are aligned with the overall reform objectives and are progressing as planned.
- **Working Groups:** Specialized teams that focus on specific aspects of the reform program, such as legislative changes, IT systems development, and capacity building. These groups report to the PMO and ensure that their respective areas are progressing as planned.

Roles and Responsibilities

The VITARA modules outline the roles and responsibilities of key players in the reform management governance structure:

- **Steering Committee:** Sets the strategic direction, approves major decisions, and monitors the overall progress of the reform program.
- **Project Manager:** Oversees the entire reform program, coordinates between different teams, manages resources, and addresses any issues that arise during the implementation.
- **Tax Policy Advisor:** Provides expert advice on tax policy and legislation, ensuring that the reforms align with international good practices.

- **IT Systems Manager:** Manages the development and implementation of the tax administration system, ensuring system security and providing technical support.
- **Training and Capacity Building Coordinator:** Manages the training and capacity building efforts for tax administration staff and taxpayers.
- **Public Awareness and Education Officer:** Manages public awareness campaigns and educates taxpayers about the new tax system.
- **Compliance and Enforcement Manager:** Ensures compliance with tax regulations and manages enforcement activities.
- **Finance and Budget Officer:** Manages the financial aspects of the reform program, preparing budgets and monitoring expenditures.
- **Legal Advisor:** Provides legal support and advice on tax-related issues.
- **Stakeholder Engagement Coordinator:** Manages engagement with key stakeholders, including government officials, businesses, and the public.
- **Risk Management Officer:** Identifies and mitigates risks associated with the reform program.

Practical Guidance

The VITARA modules provide practical guidance on how to prepare and execute a reform project plan. This includes outlining the five key phases of a project and the planning documentation required. The modules also review tools and methods available in the areas of planning, monitoring, and reporting reform programs and projects, risk management, change control, and resolution of issues.

References

[VITARA - Reform Management Fundamentals: Setting up a Reform Program - IMF](#)

Annex 2. Proposed Implementation Team Roles

To effectively implement a VAT system, a well-structured team with clearly defined roles and responsibilities is essential. Here is an ideal team structure along with brief position descriptions:

Project Manager / Assistant Secretary Reform Office

- **Role:** Oversees the entire VAT implementation project, ensuring that all tasks are completed on time and within budget.
- **Responsibilities:** Coordinates between different teams, manages resources, monitors progress, and addresses any issues that arise during the implementation.

Tax Policy and Legal Advisor

- **Role:** Provides expert advice on VAT policy and legislation along with legal support and advice on VAT-related issues.
- **Responsibilities:** Draft the VAT legislation, advises on tax policy issues, and ensures that the VAT system aligns with international good practices. Reviews and drafts legal documents, ensures compliance with legal requirements, and addresses any legal challenges that arise.

IT System Manager

- **Role:** Manages the development and implementation of the VAT administration system.
- **Responsibilities:** Oversees the design, development, and integration of the tax administration system, ensures system security, and provides technical support.

Development Partner, Training and Capacity Building Coordinator

- **Role:** Ensures that development partner activities are coordinated and aligned to the project outcomes and deliverables. Manages the training and capacity building efforts for tax administration staff and taxpayers.
- **Responsibilities:** Coordinate all partner contributors' engagement and activities, including regular multilateral meetings. Develops training programs, organizes workshops and seminars, and ensures that staff and taxpayers are well-informed about the new VAT system.

Stakeholder Engagement, Public Awareness and Education Officer

- **Role:** Manages engagement with key stakeholders, including government officials, businesses, and the public. Manages public awareness and education campaigns.

- **Responsibilities:** Organizes stakeholder meetings, gathers feedback, and ensures that stakeholders are informed and involved in the implementation process. Develops communication strategies, creates educational materials, and engages with the public to build support for the VAT system.

Risk, Compliance and Enforcement Manager

- **Role:** Identifies and mitigates risks associated with the VAT implementation. Ensures compliance with VAT regulations and manages enforcement activities.
- **Responsibilities:** Conducts risk assessments, develops risk mitigation strategies, and monitors risks throughout the implementation process. Develops compliance strategies, conducts audits, and enforces penalties for non-compliance.

Finance and Budget Officer

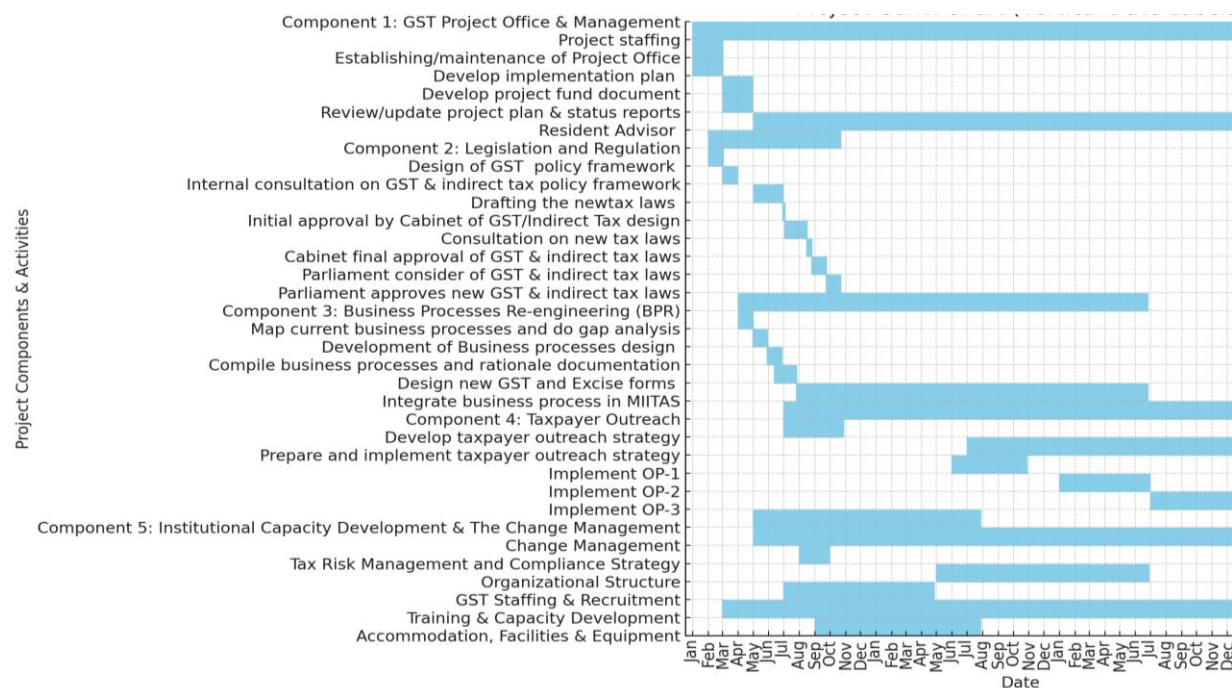
- **Role:** Manages the financial aspects of the VAT implementation project.
- **Responsibilities:** Prepares budgets, monitors expenditures, and ensures that the project stays within financial constraints.

Annex 3. Draft Implementation Plan for VAT

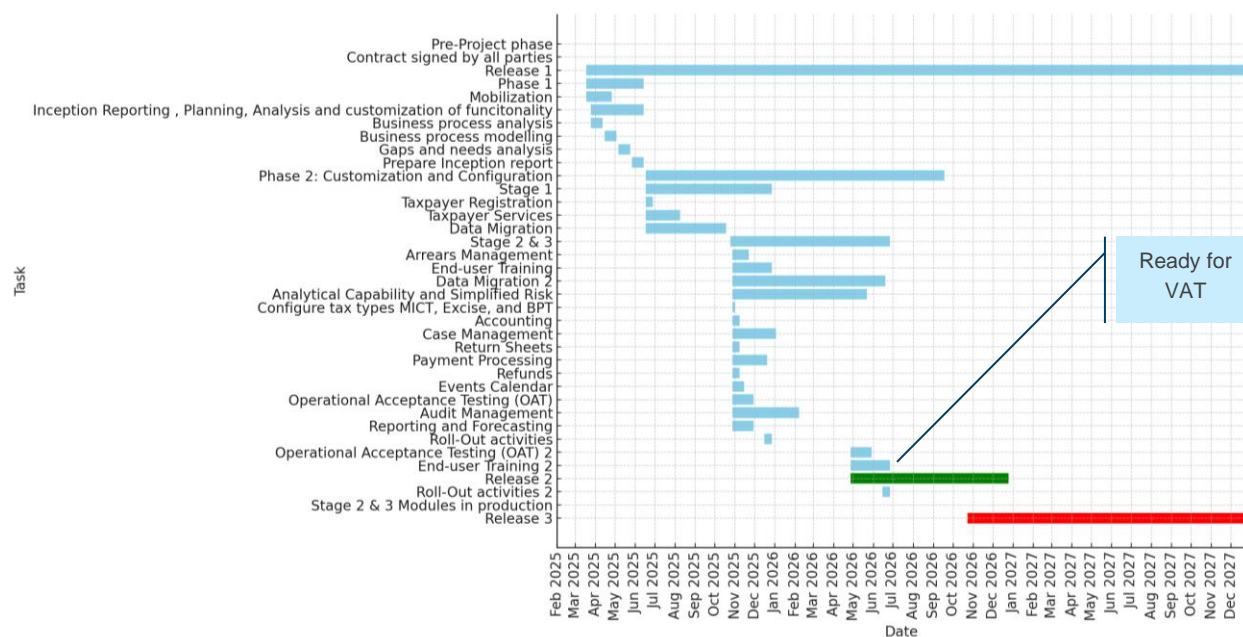
Phase	Tasks	Details and Outcomes
Phase 1: Preparation	Establish Project Team	Form a dedicated VAT/GST implementation team, confirm approach with key stakeholders, recruit long-term advisors, and set up governance arrangements.
	Develop Tax Reform Principles	Create guiding principles focusing on simplicity and reduced compliance costs.
	Technical Assistance	Identify and secure technical assistance requirements, including training for project staff.
	Communication Strategy	Develop a comprehensive communication strategy for internal and external stakeholders.
Phase 2: Policy Design	Cross-Government Discussions	Confirm VAT/GST policy design through discussions with government departments.
	Legislative Drafting	Begin drafting the necessary legislation for VAT/GST implementation.
Phase 3: Capacity Building	Training and Capacity Building	Conduct extensive training for tax administration staff and other stakeholders.
	IT System Upgrades	Implement necessary IT system upgrades to support VAT/GST administration.
Phase 4: Implementation	Pilot Testing	Conduct pilot testing of VAT/GST systems and processes.
	Full Implementation	Roll out VAT/GST across the country, ensuring continuous support and monitoring.
Phase 5: Monitoring and Evaluation	Continuous Monitoring	Regularly monitor and evaluate the implementation process, adjusting as needed.
	Compliance Improvement	Develop and implement strategies to improve compliance and address challenges.

The high-level plan outlined in the following charts is based on previous experience but will require a dedicated project team and adherence to project discipline to complete. The GST and Excise could be implemented around August or September 2026, while the BPT requirements for business record keeping need to be finalized and available to BPT businesses before the start of the FY2025-2026 year, with return forms and system readiness by September 2026. Other taxes could be progressively transitioned through 2027.

Range of ‘typical’ activities to meet the required time frame



Simplified chart for a typical ITAS implementation



Annex 4. Draft Implementation Risk Register

Risk	Description	Likelihood	Consequence	Mitigation
Political Instability	Changes in government or political opposition to VAT/GST implementation.	High	High	To mitigate political instability, it is crucial to secure strong political commitment and support from all major parties through continuous dialogue with political leaders to ensure alignment and support throughout the implementation process.
Limited Administrative Capacity	Insufficient skills and resources within the tax administration to manage VAT/GST.	High	High	Addressing limited administrative capacity involves providing extensive training and capacity building for tax administration staff, as well as seeking technical assistance from international organizations to provide valuable support and resources.
Public Resistance	Lack of public support and understanding of VAT/GST.	Medium	High	To overcome public resistance, launch a comprehensive public awareness campaign to educate taxpayers about the benefits and requirements of VAT/GST. Engaging with community leaders and influencers can help build support and address concerns.
Compliance Risks	Low compliance rates due to lack of understanding or willingness to comply.	Medium	High	Mitigating compliance risks requires providing clear and accessible information on compliance requirements. Establishing robust enforcement mechanisms and penalties for non-compliance can also help ensure high levels of compliance.
Technical Challenges	Issues with the development and implementation of the tax administration system.	Medium	High	Addressing technical challenges involves conducting a thorough needs assessment and pilot testing of the tax administration system. Ensuring integration with existing systems and providing ongoing technical support can help address any issues that arise.
Economic Impact	Negative impact on businesses and the economy due to the introduction of VAT/GST.	Medium	Medium	To minimize the economic impact on businesses, implement transitional provisions and phased implementation. Providing support and guidance to businesses can help them adapt to the new system.

Fraud and Evasion	Increased risk of tax fraud and evasion.	Medium	High	Mitigating the risk of fraud and evasion involves developing robust audit and compliance processes. Utilizing technology and data analytics can help identify and address instances of fraud.
Legislative Delays	Delays in passing the necessary legislation for VAT/GST implementation.	Medium	High	To address legislative delays, engage with legislators early in the process to build support. Providing clear and comprehensive draft legislation for review can help expedite the legislative process.
Resource Constraints	Insufficient financial and human resources to support implementation.	High	High	Addressing resource constraints involves securing adequate funding and resources for the implementation. Seeking support from international organizations and regional partners can provide additional resources and expertise.
System Integration	Challenges in integrating the new VAT/GST system with existing systems.	Medium	High	To address challenges in system integration, ensure thorough planning and coordination with IT teams. Conducting pilot testing and providing ongoing technical support can help address any integration issues.