FISCAL REFORMS AND IMPACTS
(Republic of the Marshall Islands: Public Sector Program)

A. Overview

1. There is a renewed effort in the Republic of the Marshall Islands (RMI) to revisit the reform agenda, drawing on lessons from past efforts.[1] To assist these reform efforts, the Government formed two key groups: the Comprehensive Adjustment Program (CAP) Advisory Group and the Tax Reform and Modernization (TRAM) commission.[2] These groups reported in late 2009 and early 2010, respectively.

2. The CAP Advisory Group proposed expenditure rationalizations that could achieve a net fiscal gain of $4.0 to $10.5 million annually within 3 years.[3] Key potential reform areas identified were: excessive employment levels; public sector pay rates; housing and allowances paid to members of the Nitijela (the Parliament) and public servants; compensation to landowners for access by the Marshalls Energy Company; operating expenditure on utilities, communication, vehicles and fuel; travel expenses; subsidies to state-owned enterprises; and the consolidation of public agencies and facilities. Potential improvements to fiscal legislation to strengthen budgeting were also identified. The committee recommended that a 3 year implementation period be followed by rigorous fiscal discipline.

3. Key proposals of the TRAM commission were the: adoption of a broad based consumption tax as a replacement of the gross revenue tax (except as a presumptive tax for small businesses), hotel and resorts tax, local sales taxes, and standard import duties; the replacement of import duties and local government taxes on alcohol, tobacco, motor vehicles and fuel with excises at similar rates; the introduction of a net profits tax for large businesses (that is, businesses with annual turnover greater than $100,000); retention of the gross revenue tax for businesses with turnover less than $100,000; and modification of the wages and salaries tax to improve its coverage and progressivity. The TRAM commission also made recommendations on improving tax administration.

4. Implementation of the CAP Advisory Group and TRAM commission reports will commence with the FY2011 Budget. The recommendations adopted have the potential to achieve a sustainable fiscal position over time.

B. The CAP Advisory Group

5. The CAP Advisory Group was tasked to achieve two main goals: (i) to provide the Government with a well-defined series of actionable measures to recover from the recent (and continuing) deterioration in the fiscal position of the Government and, following a period of fiscal restraint, to put the Government on a path toward long-term fiscal sustainability while also

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[1] RMI's reform experience is reviewed in ADB. 2009. *ADB Support for Public Sector Reforms in the Pacific: Enhance Results through Ownership, Capacity, and Continuity*. Manila; ADB. 2001. *Special Evaluation Study on Program Lending*. Manila (November); ADB. 1999. *Reforms in the Pacific: An Assessment of the Asian Development Bank's Assistance for Reform Programs in the Pacific*. Manila.

[2] The CAP Advisory Group was initiated in April 2009 with ADB's support and the TRAM commission was initiated in July 2008. The decision to commence the reform plan was in line with the recommendations of an expert team fielded in 2008 that emphasized the need to go beyond short-term stabilization and adopt a longer-term and more comprehensive approach involving dialogue with major donors to deal with fiscal sustainability, external debt and economic growth.

[3] Comprehensive Adjustment Program Advisory Group. 2009. *Final Report*. Majuro (September).

placing the RMI economy on a path toward sustained growth; and (ii) to provide the Government with an internally designed program that can better guide its relations with development partners.

6. The CAP Advisory Group analyzed the fiscal position and budget processes, including the main causes of fiscal imbalance. The CAP Advisory Group concurred with earlier analysis by international agencies that the RMI was facing a fiscal crisis. The most severe impacts of this crisis were brought about by the surge in global fuel prices combined with the indirect effects of the global recession on the RMI economy. However, and perhaps more importantly, the strongest factors leading to fiscal deterioration were identified as internal. Specifically, through loose and unconstrained fiscal policies over an extended period of time, RMI had been left with diminished reserves, increased external and internal debt and unsecured debt guarantees. The result is an emerging structural fiscal problem that the CAP Advisory Group concluded must now be addressed.

7. The Group argued that RMI needs to “over-adjust” in the medium-term in order to restore fiscal reserves that have been depleted and to prepare for the continued impact of Compact funding decrements and partial inflation adjustment. The CAP Advisory Group recommended that if any borrowing is to be undertaken, it should be done in a strategic manner to: (i) consolidate higher cost loans, and (ii) reduce the total net external debt position.

8. It was recommended that fiscal adjustment be guided by the following principles:

- i. the larger share of the fiscal adjustment be achieved through expenditure reduction, with significant, but lesser, reliance upon revenue increases;
- ii. fiscal adjustments should be undertaken in two phases, with the items having the greatest fiscal savings/earnings prioritized for phase 1;
- iii. fiscal adjustments that require lengthy technical review and preparation should be considered for phase 2 implementation. However, the preparatory work should begin as part of phase 1 operations. Furthermore, Cabinet’s commitment to implement both phases should be explicit from the outset;
- iv. all RMI’s commitments for implementing its own internally-designed CAP should be shared with its major development partners so that RMI can benefit from coordinated and enhanced development partner assistance; and
- v. all elements of the CAP, and all RMI’s future fiscal operations should be consistent with: a 'Decrement Management Plan' to be developed with the US and an 'External Debt Management Strategy'.

9. The CAP Advisory Group recommended a fiscal adjustment in the range of $7 to $8 million, to be achieved over 1-3 years. The Group also recommended that the implementation period be followed by rigorous fiscal discipline. The total, potential expenditure reductions identified were in the range of approximately $4.0 million to $10.5 million annually (see Table 4). Based on a mid-point reform effort that yielded $7.25 million in annual savings, and extra revenue effort, it was concluded that RMI's fiscal gap could be closed.

Table 4: CAP Expenditure Reforms

Reform areas	Possible reforms	Annual savings ($ million) Minimum estimate	Annual savings ($ million) Maximum estimate
The civil service	Reductions in force, including through enforcement of a mandatory retirement age of 60 years and voluntary early retirement; the elimination of vacant positions; a reduction in work hours for non-essential positions; and a reduction in wage and salary rates.	1.70	4.90
Nitijela Member compensation	Reduction in lump sum allowances, reduction in allowances for non-attendance, and removal of benefits and allowances not provided for in legislation.	0.14	0.17
Housing allowances	Removal of allowances for public officials and elected representatives that live in Majuro	0.25	0.27
Electricity allowances	Reduction in number of Majuro landowners receiving free electricity, and a reduction in the level of the allowance (from 1,000 kwh per year)	0.50	1.52
Leased and rental housing	Reduction in allowances provided to expatriate workers, or replacement of expatriate workers	0.07	0.15
Utility bills	Adoption of energy efficiency measures	0.25	0.75
Communications	Better management of usage	0.05	0.10
Vehicles	Better management of usage	0.05	0.10
Fuel	Better management of usage	0.07	0.10
Travel and per diem	Better management of usage	0.10	0.20
Professional services	Better management of usage	0.03	0.06
Grants and subsidies	Improve financial and operational performance of state-owned enterprises to reduce the need for subsidies and transfers	0.60	1.80
Organization/ facilities consolidation	Merging of ministries and agencies and overseas missions; move Ministries and agencies to one area	0.15	0.30
Total		**3.96**	**10.42**

kwh = kilowatt hour.
Source: Comprehensive Adjustment Program Advisory Group. 2009. *Final Report*. Majuro (September).

C. The TRAM Commission

10. The core mandate of the TRAM commission was to deliver to the Government, a proposal for consideration to reform the current tax system and structure that are appropriate and suitable for the purpose of meeting the current and future financial needs of the RMI and a tax and revenue design conducive to current realities and circumstances.

11. Building on a public engagement program, the TRAM commission set itself the task of designing a new tax system that would be: clear and simple for those paying and collecting taxes; broad enough to capture taxes on all segments of the economy; fair and equitable to all taxpayers; financially neutral to the existing taxpayers as a group; redistribute the existing level of taxes among taxpayers in the fairest manner possible by recognizing an ability to pay; and be

favorable to the private sector so as to encourage development and be attractive to foreign investors. The commission recommended that:

i. tax reform be revenue neutral to existing taxpayers as a group;

ii. increased tax revenues should come from enforcement of those not currently paying or underpaying; and

iii. tax regulations should be applied equally to the private sector, national and local governments and state-owned enterprises.

12. The TRAM commission adapted advice for broad ranging tax reform finalized by the International Monetary Fund's Pacific Financial Technical Assistance Centre in September 2009.[4] The key policy actions recommended by the TRAM commission were:

i. a broadening of the tax base to minimize tax burden;

ii. consideration of the introduction of a Revenue Authority with a governing board of directors, which shall also oversee the mandate to provide for rules and approval of tax exemptions;

iii. reform of the personal income tax by: expanding the range of taxed income to include allowances and in-kind benefits; expanding the tax free threshold and applying it to all taxpayers; and adding an additional tax bracket at high incomes;

iv. replacing the gross revenue tax by the income tax;

v. introducing a consumption tax in the form of a sales tax (as opposed to a value added tax) to replace the hotel and resort tax, standard rate import duties, and local government sales taxes;

vi. retaining the gross revenue tax only as a presumptive tax for small businesses (that is, those not covered by the income tax); and

vii. replacing the existing import duties on alcohol, tobacco, motor vehicles, and fuels with excise taxes.

13. The net revenue gain from these changes was estimated to be an additional 1.3% of gross domestic product (GDP). It was also noted that enforcement of tax laws had the potential to raise taxes as a percentage of GDP to the 20% level recommended by the International Monetary Fund.

D. Adopted Actions

14. Implementation of the CAP and TRAM will commence with the FY2011 Budget. The policy actions adopted for implementation in the FY2011 Budget and the expected fiscal impact is summarized at Table 5. Table 6 presents projections of the expected medium term fiscal outturn. With the benefit of further growth in GDP, the combination of expenditure restraint and an improved revenue performance are projected to result in a steady rise in the overall budget surplus. The projected budget surpluses would allow rising deposits to the Compact Trust Fund, and key imbalances in the budget (e.g., the high ratio of wages and salaries to GDP) would be corrected gradually.

[4] Tax and Revenue Reform and Modernization commission. 2010. *RMI: A Holistic Approach to Reforming the Tax System*. Submitted to the Minister of Finance. Majuro (February) and PFTAC. 2009. *Republic of the Marshall Islands: Reforming the Tax System*. Aide-mémoire. Suva (September).

Table 5: Adopted Fiscal Reforms

Policy action	Features	Cumulative saving ($m)		
		FY11	FY12	FY13
Tax system improvements		**0.00**	**0.84**	**1.71**
Introduction of new taxes	Revenue neutral	0.00	0.00	0.00
Taxing the untaxed	Revenue raising	0.00	0.00	0.87
Improved compliance	Revenue raising	0.00	0.84	0.84
Expenditure rationalization		**2.63**	**2.63**	**2.63**
Civil service	Freeze	0.00	0.00	0.00
Nitijela member compensation	Freeze	0.00	0.00	0.00
Housing allowances	Freeze	0.00	0.00	0.00
Electricity allowances	One off 50% cut to 500 kwh/recipient then freeze	0.65	0.65	0.65
Leased and rental housing	One off cut then freeze	0.20	0.20	0.20
Utility bills	One off cut then freeze	0.25	0.25	0.25
Communications	One off 50% cut then freeze	0.14	0.14	0.14
Vehicles	One off cut then freeze	0.04	0.04	0.04
Fuel	One off cut then freeze	0.09	0.09	0.09
Travel and per diem	One off cut then freeze	0.24	0.24	0.24
Professional services	One off cut then freeze	0.09	0.09	0.09
Grants and subsidies to SOEs	One off cut then freeze	0.93	0.93	0.93
Total		**2.63**	**3.47**	**4.34**

FY = Fiscal Year, GDP = gross domestic product, kwh = kilowatt hour, SOEs = state owned enterprises.
Source: Asian Development Bank estimates based on data from Ministry of Finance.

Table 6: Medium Term Projections with Proposed Fiscal Reform (ratio to GDP, %)

Item	Estimates		Projections[a]				
	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Revenue and grants	**67.9**	**66.1**	**64.8**	**63.9**	**63.2**	**62.1**	**61.1**
Revenue	24.0	24.5	24.5	25.0	25.5	25.5	25.5
Tax revenue	15.2	16.2	16.2	16.7	17.2	17.2	17.2
Nontax revenue	8.8	8.3	8.3	8.3	8.3	8.3	8.3
Grants	43.9	41.6	40.3	39.0	37.7	36.7	35.6
Total expenditure	**68.1**	**64.9**	**61.2**	**59.4**	**57.6**	**55.8**	**54.8**
Recurrent expenditure	54.4	51.2	47.5	45.6	43.9	42.1	41.0
Wages and salaries	22.5	22.3	21.6	20.7	19.9	19.3	18.6
Goods and services	22.9	18.0	16.7	16.0	15.4	14.9	14.4
Interest payments	0.8	0.8	0.5	0.5	0.5	0.4	0.4
Subsidies and transfers	8.2	10.1	8.7	8.4	8.1	7.5	7.6
Capital expenditure	13.7	13.7	13.7	13.7	13.7	13.7	13.7
Overall balance	**-0.2**	**1.2**	**3.6**	**4.6**	**5.6**	**6.3**	**6.3**
Memo items:							
Amortization	0.8	1.2	1.4	1.3	1.3	1.3	1.4
Compact Trust Fund deposits	0.0	0.0	2.2	3.2	4.3	5.0	4.9

FY = Fiscal Year, GDP = gross domestic product.
[a] Projections would need to be adjusted for any difference in the revised estimate for FY2010 from that shown.
Source: Asian Development Bank estimates based on Economic Policy, Planning and Statistics Office. 2009. RMI Economic Statistics Tables, August (Majuro) and IMF. 2010. *IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of the Marshall Islands:* Public Information Notice (PIN) No. 10/30. Washington D.C. (February).