ECONOMIC ANALYSIS (SUMMARY)

I. INTRODUCTION

1. This sector assessment (summary) provides the background to the identification of issues, constraints, and threats to, as well as the government's priority reforms in support of fiscal sustainability, macroeconomic stability and public finance. It focuses on key cross-cutting strategic issues such as macroeconomic institutions and monetary policy, tax policy and administration, and public financial management. This assessment draws on the sector assessment for Macroeconomic Assessment and ongoing ADB diagnostic work/.[1]

II. SECTOR ASSESSMENT: CONTEXT AND STRATEGIC ISSUES

A. Context

2. **Economic growth**. Myanmar's disengagement with global markets has meant that the Myanmar economy has not been able to benefit from globalization in terms of increased trade, investment, technology transfer and acquisition of knowledge of good practices in a wide range of sectors including public governance. This disengagement has resulted in weak institutions, relatively low economic growth and high incidence of poverty. While caution should be taken with interpreting national income accounts data, ADB staff estimate that based on current data, the longer term or potential economic growth rate is in the order of 4.0% to 5.0% per annum. Frequent episodes of macroeconomic instability have contributed to this lower longer term economic growth performance.

3. **Macroeconomic instability**. Maintaining macroeconomic stability – low price inflation and stable exchange rate – has been a major challenge for the Myanmar authorities. Myanmar has experienced frequent episodes of very high inflation in the last two decades. This in turn has triggered exchange rate instability as reflected in the movement in the unofficial or parallel exchange rate. In recent years, the government has managed to lower inflation to single digit figures on the back of lower money supply growth from less deficit financing by the Central Bank of Myanmar (CBM).

4. **Fiscal policy**. Poor fiscal policy management coupled with poor monetary policy management are the main contributors to macro-economic instability in Myanmar. The Government has been operating fiscal deficits in the range of 2.0% to 6.0% of GDP since 2005. The estimated deficit for the fiscal year ending March 2012 is 4.5% of GDP, down from a deficit of 6.0% for the year ending March 2011. While deficits of this magnitude are not unusual for low income economies, in Myanmar the Government finances the deficit by selling treasury bills to the Central Bank of Myanmar (CBM), which is monetizing the deficit or printing money to pay the deficit. In the past, the consequence of monetizing the fiscal deficit has been a persistently high expansion in money supply leading to macroeconomic instability as reflected in the parallel market exchange rate instability and periods of very high inflation. For the first time in FY2009/10, the Government financed one third of the deficit from the issuance of treasury bonds to domestic banks and this has helped contain the expansion in money supply and lowered inflation.

5. The weak fiscal situation is primarily due to poor tax revenue performance. Total national budget revenues were recorded as approximately 7.0% of GDP in the FY2011, of which tax revenue collection only accounts for half of budget revenues. Transfers from state enterprises

[1] ADB. 2012. *Macroeconomic Assessment*, Manila. ADB.

and other non-tax revenues account for the other half of total revenue. Caution should be taken with the budget revenue data prior to FY2012/13 as foreign currency denominated revenues and expenditures were converted to Kyat at the official rate of 6.4 kyat to the dollar rather than the much higher parallel market exchange rate in the range of 800 to 900 kyat to the dollar. Even so, clearly more tax revenues are required to support the Government's priority development spending initiatives over the medium term.

B. Strategic Issues

6. This section discusses key medium term policy issues for macroeconomic performance and Government reforms to address institutional, policy and structural weaknesses in the macroeconomic framework. The assessment also provides suggestions for ways to improve macroeconomic framework. This covers fiscal policy, public financial management, public debt management, and monetary policy. While Myanmar has achieved macroeconomic stability in recent years, it faces long term risks to stability. These arise from fiscal risks related to: (i) increased reliance on resource revenues in the state budget, which are vulnerable to the volatile commodity price cycle and (ii) continued partial monetization of the budget deficit. Limited available monetary policy levers to contain money supply growth also poses risks to maintaining macroeconomic stability.

7. **Fiscal Policy**. The two major medium term fiscal issues are i) lifting priority spending through further efforts to raise revenues, and ii) more effective debt management

8. **Lifting priority spending through further tax revenue effort.** Limited tax revenue collection has resulted in suppressed public spending and especially in the social sectors of education and health. The Myanmar government recognizes the urgency of raising tax revenue to meet its development goals. Revenue management is challenged by: i) limited sources of tax revenue, ii) a complicated tax structure that encourages tax avoidance, iii) generous income tax exemptions and incentives that have eroded the tax base; iv) weak tax administration resulting in a small taxpayer base, and v) a lack of transparency in the collection and recording of income taxes collected from the resources sector. For example:

(i) **Sources of revenues are limited**. The Ministry of Finance and Revenue (MOFR) two main sources of tax revenues are direct income tax and commercial taxes on goods and services, combined accounting for about 90.0% of MOFR tax revenue collection. It also collects stamp duty and funds allocated from the state lottery. Commercial taxes account for 80% of total indirect tax income. Share of customs duties applied to imported goods (8.0% of total indirect tax collections) is low by developing country standards. There is no valued added tax and no excise taxes.

(ii) **The tax structure is complicated**. The corporate tax rate (25%) is competitive with other countries in the region. The personal income tax rates are also very competitive with the region with highest marginal tax rate at 20.0% for incomes over 20 million kyat (approximately $28,000 at current exchange rate). However, the structure of personal income tax rates does reduce the tax base and collections. For example, most taxpayers fall within the lowest tax brackets and with the 20.0% personal income exemption on taxable income and other allowances most tax payers would be paying well below 3.0% of personal income in taxes. Average effective tax rate is below 8.0%. Complicities in the design of corporate income taxation encourage tax avoidance; the largest share of income tax collections are form the state economic enterprises. The commercial tax structure is complicated. The schedules have both negative and positive schedules

stating which goods and services are subject or exempted from to commercial taxes, rather than having a simple exemption schedule. Different commercial tax rates are applied to different categories of goods and services making the tax difficult to administer. The commercial tax is also inefficient as it taxes the value of goods and services at different points in the distribution channel rather than taxing value added. A simpler system would be to convert the commercial tax into a value added tax with an exemption schedule for basis foodstuffs. A specific excise tax on volumes could be applied to alcohol and tobacco products.

(iii) **Tax administration is weak**. The taxpayer base is very low. Some weaknesses contributing to the low taxpayer base include (i) tax authorities have limited administrative autonomy in setting staff requirements, competitive remuneration for staff, among others; (ii) tax authorities are under-funded and staff under-trained in carrying out tax functions; (iii) taxpayer database is a manual system and the database is not frequently updated. It is common for taxpayers to hold multiple tax numbers; (iv) there are weak systems for monitoring tax exemptions and incentives, management of tax arrears, and tax audits; and (v) tax authorities' policy of mandatory audits of tax payers stretches its administrative capacities and can lead to governance problems.

9. **Medium-term sustainable priority spending requires improving efficiency in public expenditure management.** On the expenditure side, there is a need to ensure a balanced public expenditure program between capital spending and recurrent expenditures, as well as between discretionary and non-discretionary spending items (interest payments and wages). This will require continuing to reorient spending towards priority sectors of education, health and productive public infrastructure. There are significant weaknesses in budget transparency, budget planning, execution, and reporting and accounting. Ministries do not have effective internal audit and control systems.

10. **Public Debt Sustainability**. According to the *IMF Debt Sustainability Analysis (DSA) 2010*, Myanmar remains in debt distress due to substantial external arrears and rising real interest on public debt. Based on 2010 data supplied by the Government, public external debt (including arrears) was estimated at $9.2 billion (or 21.4% of GDP), of which about 45.0% is in arrears. Actual arrears are likely to come in higher as Government completes reconciliation of differences in arrears valuation with bilateral and multilateral creditors. At the same time, in recent weeks some progress has been made by the Government and external creditors in developing strategies to resolve external arrears. The Government of Japan recently announced steps to forgive up to $3.7 billion equivalent in arrears. A revised DSA taking into account agreements on arrears clearance is expected to be completed by the World Bank for preparations for the proposed policy-based loan as part of debt arrears clearance by the ADB, World Bank and bilateral development partners.

11. **A key medium term policy reform to support fiscal sustainability will be public debt management**. The Government has initiated some basic reforms such as the shift to partial bond financing of the state deficit and away from CBM financing of the deficit. MOFR will need to strengthen public debt management. This will require strengthening the institutional framework including a public debt office with clearly delineated functions for the back office (accounting and recording debt), a middle office (providing debt policy and strategies) and front office (issuance of treasury bonds). The Government will need to establish a government bond market comprising of an auction (primary market) and a secondary market. Interest rates will need to be liberalized for a bond market to function.

12. **Monetary and Exchange Rate Policy.** Central Bank financing of the fiscal deficit has been the primary cause of Myanmar's high inflation regime in the last two decades. The Government recognizes the urgency of re-orienting monetary policy away from the primary function of financing the fiscal deficit to developing an effective monetary policy to create a low and stable inflation environment. The Government has articulated a far reaching reform strategy and if implemented will anchor a stable macroeconomy in the medium to long term. The Government's reform agenda comprises of the following measures:

(i) The first major reform is the unification of the official administered exchange rate with the parallel market exchange rate and the managed floating of the unified exchange rate.

(ii) A second reform that has been initiated is the drafting of the new central bank law, which will provide operational autonomy to the Central Bank. Under the law, the central bank would have autonomy over monetary policy, internal structures, staff remuneration and human resource development. This is a major reform that would allow the Central Bank to focus its efforts on creating a low and stable inflation environment. It would also allow the central bank to implement a sound and independent bank supervision framework. It is expected that the draft law will be submitted to the parliament in July 2012.

(iii) At the same time CBM is looking at ways to implement an effective monetary policy framework. It may start with implementing tools to manage reserve money, which has been the key influence on money supply, inflation and exchange rate depreciation in the past. Key to an effective monetary policy will be improving transparency in publication of monetary data.

III. GOVERNMENT'S SECTOR POLICY AND PLANNING FRAMEWORK

13. The Government has identified macroeconomic stability as a core priority of its economic agenda. Reforms to macroeconomic institutions have been impressive and wide ranging. As noted above key reforms include:

(i) Monetary policy. Unification of exchange rate, amendments to then central bank law providing the Central Bank of Myanmar with operational autonomy, recent Government approval for reorganization of the central bank. It intends to develop more effective monetary tools over the longer term.
(ii) Fiscal policy. Government is shifting away from monetizing its budget deficit towards funding through domestic sources. Amendments to central bank law will also impose constraints on central bank financing the deficit. The Government is also looking at ways to improve transparency and integrity in revenue mobilization and management.
(iii) Public financial management. The Government has initiated first steps to improving transparency in public financial management. For the first time ever, it had the Union budget for FY 2012/13 approved by Parliament and published. It has undertaken its first Public Expenditure and Financial Accountability (PEFA) assessment with the World Bank. Results from the PEFA will provide the basis for articulating a public financial management reform agenda.