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MEMORANDUM TO

H. E. Minister U Soe Win
Minister of Finance

cc: Daw Mya Mya Oo
Internal Revenue Department

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Subject: One Approach to Tax Reform in Myanmar

One strategy for tax reform in Myanmar is provided here. This document is supplied to provide additional context for the working group's recommendations for tax law changes to be introduced after the election and to begin a discussion about longer-term planning for reform. This document is a revision of a memorandum I supplied to the MOPFI and RI management in the past. Neither my views nor the fiscal situation in Myanmar have changed since that time, so I believe the approach to be just as relevant today.

Tax reform is a messy undertaking, to say the least. All sectors of the economy have an interest in taxation, political factors are often important, and various international organizations (such as the IMF, World Bank, and other donor agencies) are eager to provide input. In addition, tax reform must occur when most sectors of Myanmar's governmental structures will undergo dramatic change. Coordination, where possible, will be necessary, but it should be clear that any approach should be realistic. Mistakes will be made, but I believe that by using transparent methods, progress can also be made.

The content provided below is intended to be general in scope, as opposed to a detailed technical discussion of particular tax provisions or administrative rules. Technical discussions will be supplied by the working group for each tax.

The material contained in this memo is presented in three sections:

1. Section I contains my initial views about the issues that should be addressed given Myanmar's current economic situation.

2. Section II details what I think the objectives of the reform should be.

3. One approach to the tax reform effort is described in Section III; and

4. Section IV outlines a suggested sequence.

My hope is that this material can be used as a framework to form the actions for the next major tax initiative and to serve as a basis for a broader public discussion about the role of taxation in Myanmar's evolution.

I. Issues to be Addressed

While unique, Myanmar's tax regime shares several aspects of other pre-reform tax systems.

a. Poor Diversification of Revenues

A disproportionate share of tax revenue in pre-reform systems accrues from only one or two economic sectors, or from one or two tax instruments. Much revenue in Myanmar is concentrated in the natural gas, mining, and renewable resource-based sectors.

Some consequences of poor diversification include:

i. Variability of revenues depending on the sector. As a result, government revenues fluctuate in response to changes in one sector and thus are more volatile than expenditures.

ii. Low (or non-existent) effective tax rates relative to statutory rates.

iii. Adverse economic incentives, including high rates of nominal and effective protection, rent seeking, and misallocations of resources.

b. Low Revenue Yield

Reported revenues in Myanmar are not sufficient to finance deficits and are certainly not enough to support an anti-poverty development and growth agenda.

It is often claimed that tax reform strategies are designed to be revenue neutral. This should not be the case in Myanmar. There are significant infrastructure needs and expenditures on human development (health and education) are necessary. In addition, significant expenditures will be needed to provide a basic reform infrastructure, including legal frameworks and administrative systems under which human rights are protected and the economy becomes more accustomed to the rule of law. Thus, revenue should be increased as part of the reform effort and tax policy design should reflect those expenditure requirements both in the short and medium terms.

c. Narrowly Defined Tax Bases

Low revenue yield and a restricted tax base might result in a narrow, or inappropriate, definition of the base for various taxes. Some common examples are described below:

i. The Commercial Tax (CT)

The CT is limited by the schedular nature of the goods and services defined to be taxable.

ii. Personal Income Tax (PIT)

It appears to be the case that most PIT revenue accrues from cash wages in the modern sector, paid to employees.

iii. Enterprise Income Tax (EIT)

The EIT base has been eroded through the adoption of tax incentives for particular types of investments, tax holidays, and accelerated depreciation. The adoption of the investment law has also codified the incentives. In addition, compliance with the income tax for some investors (natural resource producers and state enterprises) needs to be examined.

iv. Tariffs

Tariff rates are variable and create incentives for rent seeking, corruption, and graft. The result is that a potentially large tax base is narrowed.

d. Administrative Difficulties

I believe that administrative difficulties are one factor in the under-performance of the tax system. Tax administrators have begun to develop new methods, given the nature of the previous regime. Thus, any tax reform should accommodate the work program for administrative change.

Specific difficulties include:

i. Continued reliance on an assessment system as opposed to selective audit tools.

ii. Procedures, such as the assessment system, that rely on personal contact between tax administrators and taxpayers (a situation that increases the possibilities for graft).

iii. Some procedures are based on the presumption of noncompliance (such as the reliance on indicators as opposed to information supplied by the taxpayer which could be verified by simple audit techniques); and

iv. Lack of regulations, circulars, and other publicly available materials for both tax administrators and taxpayers, resulting in ambiguity regarding application of the law.

e. Institutional Capacities in the MOPFI

Tax policy development has been assigned to the IRD. This assignment has two adverse consequences. First, IRD management and staff time are diverted from the significant task of reforming the tax administration. The multi-focused workload retards the development of both the tax administration and the skills required for tax analysis. Skills required for tax analysis differ from those necessary to administer the tax system and include particular types of economic analysis, revenue estimating, statutory drafting, and monitoring revenue as well as economic performance. Second, MOPFI's institutional development is retarded because there is no common staff core that can provide analysis of both tax and expenditure. Interaction between tax policy and tax administration is essential, but some specialization is required in order to provide Ministerial oversight of the policy functions while providing appropriate oversight of the tax administration.

f. Economic Inefficiencies

The welfare cost of the tax system may be higher than necessary. These extraneous welfare costs reduce real income and growth. Three types of inefficiencies are frequently observed in pre-reform systems, and Myanmar is probably no exception.

i. Domestic consumption and saving distortions

Welfare costs are measures of the reduction in real income resulting from inefficient price signals to consumers. All taxes distort relative prices, as a practical matter, and thus consumers are provided with signals that encourage certain consumption patterns (either today or in the future) via tax-induced changes in relative prices. Market-determined price signals will become more important with liberalization and the resulting relative price structure might be unduly distorted by the current structure of the Commercial Tax and income taxes as well as inefficient pricing of natural resources.

ii. Intersectoral misallocations of factors

The relative prices of productive factors (labor, capital, and natural resources, generically speaking) are changed depending on the nature of taxation. Consumption taxes reduce real wages and might distort the overall capital-to-labor ratio, for instance.

In addition, capital can be misallocated across productive sectors because of variation in marginal effective tax rates created by business tax incentives and other tax-induced non-neutralities. For example, a tax holiday granted to mining firms can create negative effective tax rates in that sector. Too much scarce capital might be allocated to this sector at the expense of more highly profitable (socially speaking) investments in manufacturing or agriculture. These two effects combine to increase the social cost of production and further distort relative prices.

iii. Trade effects

Significant intersectoral distortions can result from the degree to which the share of goods imported (or exported) is affected by the tax regime.[1] Tariffs are an obvious example. Domestic taxes also may induce trade distortions, such as the use of differentiated excise taxes to discriminate against imported goods.

g. Corruption and Rent Seeking

Corruption is part of any tax system. In general, there is no reason to believe that taxpayers or tax administrators are any more, or less, corrupt than participants in other government functions (procurement, for instance) or private sector companies. Incentives for corruption are enhanced, however, when the tax system is complicated, rules are not clear, and tax administrators are poorly trained and poorly paid.

Rent seeking (the use of resources to capture benefits artificially created by government policy[2]), while linked to corruption, is not necessarily a form of corruption. Rent seeking arises when tax policies might be changed (importers might lobby for protection, for instance) and can be apparent in highly discretionary tax systems. Taxpayers who are not favored by the tax system lobby for incentives offered to others, while favored taxpayers lobby to preserve their special status. Lobbying activities may be legal or illegal and may include bribery and other forms of side payments to politicians, tax administrators, and government officials.

h. Intergovernmental Concerns

A new approach to intergovernmental relationships is envisioned by the new Constitution. I understand that there is now a mismatch between expenditure responsibilities and revenue at various subnational levels. Revenue accruing to subnational levels is either small or zero, creating the need for inefficient bargaining with the central government over budgets and revenue allocations.

i. Distributional Concerns

Two types of distributional inequities may be created by current policy and administration.

i. Vertical Inequities

The tax system, at least the personal income tax system, has a progressive rate structure, but the tax system in practice contains a number of regressive elements. For instance, the PIT is generally applied on a withholding basis and is restricted to the modern sector. High-income professionals (for

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[1] Export-led growth has been one favored approach to development in the recent past. From a microeconomic perspective, the issue is not that development should be export-led, but that the trade sector should be treated in a neutral manner. That is, exports should not be unduly taxed or subsidized. In fact, many donor programs designed to increase trade have included efforts to reduce or to eliminate distortions that inhibit trade (as opposed to promoting trade via subsidies or other methods such as export zones).
[2] For instance, importers may retain lawyers and lobbyists or pay bribes to capture the benefits created by an import quota.

example, doctors and lawyers) might bear a relatively low tax burden either because particular types of income are not taxed (such as income from capital or some types of earned income) or because compliance and enforcement is difficult for these particular groups. Another example of a regressive element is the tax exemption for interest income. It is common in other countries for high-income individuals to arbitrage the rate structures via interest-free loans in exchange for wages and other methods to convert otherwise taxable income into tax-free income.

The cost of evasion and avoidance might be lower (on a relative basis and at the margin) for high-income persons. Such people are better equipped to keep income outside the country, exploit ambiguities in the tax law, under-declare income, or simply pay bribes to keep their effective tax rates low.

ii. Horizontal Inequities

Horizontal inequities are created when taxpayers in similar economic situations are taxed differently, resulting in higher relative tax burdens for some groups compared to others. These inequities may arise from explicit provisions in the statutes, such as tax incentives and special tax breaks, or base mismeasurement. Alternatively, inequities may come about through administrative practice as some taxpayers simply do not fully comply with the tax laws and are not caught. Tax incentives for specific sectors or specific taxpayers create numerous inequities in current law. Targeted tax holidays, exemptions, and special zones may create discrimination for (or against) foreign investment and favor some sectors (manufacturing) at the expense of others.

II. Objectives of Reform

I have recommended that Myanmar officials consider the following objectives in addressing the issues discussed above as part of its reform effort.

a. Increase the Share of Direct and Indirect Taxes Relative to Natural Resource Revenues

It appears that the revenue shares between the Commercial Tax and the Income Tax are similar. Several purposes would be served by shifting the relative emphasis towards domestic indirect taxes (or consumption taxes). First, domestic consumption taxes such as the VAT may be easier to administer relative to income-based taxes, at least as the income tax is currently configured. There are fewer taxpayers to manage (no individuals) and the requirements for producers are not as complicated (much can be achieved with single-entry accounts and simple invoices). As a result of the shift in emphasis, the tax system's administrative resources can be expected to be more revenue productive, other things equal. Second, most consumption taxes are accounts-based taxes. Thus, tax administrators (and taxpayers) will gain additional familiarity with income accounting, experience that can help to develop the income tax system. Third, a broad-based consumption tax can be used to tax, indirectly, the incomes of individuals who do not comply with other taxes. In effect, a broad-based consumption tax can expand the taxpaying population while reducing the number of taxpayers who must officially comply with the law. Finally, consumption taxes (like the VAT and turnover tax) can be collected at the border on imported goods, thus preserving this important point for revenue collection.

In economic terms, a reformed consumption tax system can help accommodate the change in relative domestic prices. A flat-rate general consumption tax will change prices of taxed goods by a constant proportion. Thus, prices of taxed consumer goods will be able to adjust as overall economic reform progresses without unduly interacting with the consumption tax system. Even a low rate turnover tax may not create much of an interactive effect. Cascading may not be a significant issue during the initial reform period because of the relatively few firms and the expected dependence of imported non-labor inputs.

b. Reduction in the Use of the Tax System for Non-Revenue Objectives

In general, a tax system is a poor instrument for objectives such as targeting investment or encouraging the consumption of particular goods or services (food for low-income people or activities sponsored by non-governmental organizations, for instance). Using the tax system to pursue these types of targets is ill-advised for at least three reasons.

i. Mixing non-revenue with revenue objectives unnecessarily complicates the tax system. Administrative costs are increased, and compliance is likely to suffer.

ii. Tax instruments are too crude, in general, to be cost effective. For instance, consider the use of a consumption tax exemption for food. The standard argument in favor of this incentive is to reduce the tax burden on the poor (and perhaps reduce the regressivity of a flat-rate indirect tax).[3] Such an exemption is available to people in all income groups, however. In general, high-income individuals spend more on food, even though the proportion of income spent on food is lower, relative to lower-income individuals. Thus, high-income people tend to benefit from an exemption for food more than the poor.[4]

iii. Tax incentives for investment tend to be anti-competitive. To take advantage of an incentive, taxpayers must first have a tax liability that is eligible to be reduced by the incentive. Thus, larger enterprises are more likely to benefit relative to smaller, more marginal enterprises. Such a result is in fact opposite of what might be most efficient, because these marginal and smaller firms may account for the greatest growth in employment and potential income through time.

c. Elasticity, Flexibility, and Diversification

The revenue system should be elastic in order to be responsive to short-term macroeconomic changes and to provide greater flexibility for government expenditures as the economy grows.[5] The tax

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[3] It is not clear whether a flat-rate comprehensive consumption tax would be regressive in Myanmar. A flat-rate consumption tax is a proportional tax over an individual's life cycle because saving is generally consumed at some point during an individual's life. In addition, a flat-rate consumption tax may be progressive in application. Only official market goods are subject to consumption taxes. Thus, household production is not taxed. As well, goods and services supplied in informal, rural, or other small markets are not taxed. Low-income people tend to consume proportionally more of such goods and services.

[4] Willingness to pay is not based on proportions but on total valuations placed on the consumption of goods and services. Thus, a reduction in a tax rate for food provides a greater increase in purchasing power for the rich than for the poor.

[5] An elastic revenue system increases the government's options through time. For instance, publicly-provided goods such as education might be income-elastic goods; thus, the greater share of GDP accruing to government

structure also needs to be flexible enough to respond to changes in the economic environment. The balance between direct and indirect taxes will change through time, as experience with the reformed tax system is gained, growth continues, and the economy becomes more sophisticated. In addition, the tax system should accommodate changes in the structure of economic investment, such as the desired increase in the share of value added in non-mineral sectors. Such accommodation can best be obtained by using a variety of tax instruments (income taxes, excises, VAT, and other taxes) that can accrue different revenue proportions as conditions change.

The coordinated use of a variety of revenue instruments helps to diversify the government's revenue base. Thus, a type of portfolio effect is possible, whereby the variability of government revenues is decreased. For instance, income and consumption are not perfectly correlated. Under some changing conditions, reductions in consumption tax yield might be buffered by increasing reliance on income taxes. In addition, profits from natural resources and other tradables may be negatively correlated. This may result because changes in mining prices (increases or decreases) may affect the exchange rate (increase or decrease), which affects the profitability (decrease or increase) of the tradable goods sectors. Thus, consumption taxes and profits taxes can buffer revenue changes resulting from changes in natural resource prices.

d. Simplification

There is no such thing as a tax system that is simple to administer. Taxpayers do not want to pay taxes; thus, it is necessary to keep compliance costs as low as possible in order to provide incentives for broad compliance. A simplified tax system will reduce the potential for tax arbitrage via incentives, complicated definitions, rules, exemptions, and other means. As a result, simplification promotes vertical and horizontal equity.

e. Sustainability

Finally, a tax reform should be designed to be sustainable. Taxpayers and tax administrators should be able to undertake medium term (three to five years) planning without concern about radical changes in the post-reform tax system. In addition, the level of public acceptance needs to be sufficient to ensure reasonable compliance. Acceptance increases with familiarity with good practice and accrues over time. Finally, the system should be intended to generate sufficient revenues under a variety of conditions, thus reducing the need for ad hoc structural changes in response to revenue needs.

The above objectives might be achieved by using the following guidelines for tax reform:

i. Use the tax system only for efficient revenue generation with a reasonable degree of progressivity.[6]

ii. Reject fine tuning.

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over time might allow revenues to keep up with expenses. In addition, an elastic revenue system can allow the government to reduce rates, keeping the share of government expenditure constant (or even reducing that share), and leaving a greater proportion of resources to the private sector.

[6] Many macroeconomists would agree that government expenditures are a potentially more effective instrument to achieve distributional objectives.

iii. Create a reasonable balance between administration and policy.

iv. Be pragmatic with respect to the use of tax instruments and seek a diversified revenue base that is relatively efficient.

v. Be as simple as possible.

III. Approach for the Post-Election Period

Myanmar should consider using the following reformed tax instruments in order to develop a portfolio approach for government revenues:[7]

a. A transition to a broad-based consumption tax,

b. An excise tax system limited to a few selected items,

c. An enterprise income tax unified with the personal income tax to reduce double taxation of capital,

d. A personal income tax,

e. A uniform tariff, and

f. A property tax (attributed to local governments).

Desirable properties for each tax are described below.

a. A Broad-Based Consumption Tax

A well-designed domestic consumption tax is an essential component of a shift in relative emphasis in taxation. A consumption-type destination-based VAT has been the dominant instrument of choice for this function throughout the world.[8] Desirable properties of a VAT include:

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[7] Various taxes and fees are generally imposed by various government levels. These charges are payments in exchange for specific benefits and thus are not taxes as such. Pricing for these services should be determined, economically speaking, by rules regarding public sector pricing. The same statement applies to pollution and other environmental charges. Such charges, often called taxes, are really payments in exchange for the use of environmental services (or to repair environmental damage). Therefore, such charges are not taxes but adjustments to market prices needed to internalize the externalities. These marginal environmental charges should be determined relative to the public sector pricing rules. The danger of doing otherwise, or treating environmental charges as taxes, is to lose sight of the function served by such prices. Revenue considerations may begin to dominate at the expense of corrective pricing.

[8] I do not want to imply that a VAT is the best indirect tax system in all situations. The retail sales tax still functions reasonably well in the United States. There are now important questions about whether the VAT is really efficient given the change in industrial structures and changes in tax administration technology. There are local option sales taxes in a number of countries on selected goods, and there is a question about whether the VAT is reasonable for countries with large amounts of trade. Places like Puerto Rico, for instance, import inputs that are then re-

i. A base that is as broadly defined as possible – exemptions should be restricted to financial operations and a selected negative list for items such as supplies for which no payment is made (for example, educational services by government or not-for-profit organizations), among other items,

ii. A single rate (other than a zero rate for exports),

iii. Full accrual accounting for both inputs and outputs,

iv. Use of simplified invoices,

v. Monthly reporting,

vi. A well-established refund process and full credit system for exports,

vii. Use of a minimum turnover level to restrict the number of taxpayers (more than 80% of VAT generally accrues from less than 20% of the taxpayers), and

viii. Voluntary registration for those taxpayers who fall below the turnover threshold.

The VAT will fail to perform its function if credits are not allowed on a regular basis and export refunds are not prompt. These two points have been, and continue to be, major impediments to the VAT in most emerging countries. Governments and tax administrators are reluctant to institute a refund system, even for the most honest taxpayers, because of what is perceived to be a high risk of revenue losses and illegal tax scams, such as fly-by-night firms.[9]

The controversies surrounding the payment of VAT refunds are largely attributable to a combination of miseducation and revenue constraints, however. Collection of tax does not imply government ownership of the revenue. As designed, VAT paid on inputs is a prepayment for VAT collected at the point of final consumption. The VAT collected at the point of final consumption could be greater than prepayments (in which case no refund is due) or less than prepayments (in the case of exports).

By failing to pay legitimate refunds, the government is keeping funds to which it is not legally entitled. When revenues are constrained, however, governments tend to treat all cash receipts as net tax revenues, and there is a tendency to keep the revenue to reduce the deficit. The combination of

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exported. Net VAT might be zero (or even negative) after administrative costs if export refunds are promptly paid. It is not my purpose to discuss the tradeoffs between a VAT and sales tax in this document (but I would be happy to supply such an analysis if desired at a later date). Regardless of choice, a properly designed and administered indirect tax system is the most significant revenue source for many countries (accruing more than 40% of total revenue in some cases).

[9] A fly-by-night firm is an entity that is created to make one (or a few) transactions, collect VAT on output, not pay VAT on inputs, close operations, and steal the VAT. Such schemes are common throughout the world.

administrative misunderstanding and constraints on the government's ability to pay refunds can result in a VAT that is not able to function as designed.

The working group has completed an initial analysis of the Commercial Tax and drafting instructions have been developed. Administrative considerations for crediting capital goods and the efficiency of the export refund system still need to be examined. The rate will need to be increased in order to compensate for losses resulting from capital goods, credits and, perhaps, expanded returns. In addition, the rate should be increased in order to shift the relative burden from direct to indirect taxes.

b. An Excise Tax System Limited to a Few Selected Items

An excise tax can be an important revenue source for Myanmar. It is generally a tax imposed at the point of production or importation.[10] Thus, unlike the Commercial Tax, administrative emphasis is placed on physical control. For this reason, the number of commodities subject to excise taxes should be limited to a few categories, generally including:

i. Petroleum products,
ii. Tobacco products,
iii. Alcoholic beverages, and
iv. Motor vehicles (optional).[11]

Tax rates can be either per unit or ad valorem, as they are now. Per unit taxes should be adjusted for inflation, automatically, to ensure that real revenues are not affected. That is, inflation erodes the real value of a tax measured in terms of nominal domestic currency. Automatic indexing for inflation preserves the real value of the per unit tax.

As a technical issue, ad valorem rates might be preferred as a methodological matter, but a tradeoff exists between valuation and administration at the point of collection. Administration is simplified if the tax is collected at the initial point of production, importation, or distribution. Valuation and transfer pricing difficulties are created if an ad valorem tax is used at the collection point because the distribution may not be an actual final sale. Alternatively, sales, if they occur, may be between related parties. Tax administrators can address this problem by using ad valorem rates on a sample of market values (to determine the tax on a quarterly basis), and then transforming that market-determined tax to a specific per unit rate to be applied at the point of initial distribution.

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[10] Excises for commodities like gasoline are sometimes collected at the retail level in more developed economies. Such practices are more difficult in developing and emerging economies for administrative and compliance reasons.

[11] Motor vehicles may be included to add progressivity to the overall tax system. This tax can be collected at the time of importation in most countries. Revenues are not significant, however.

The excise tax needs to be discussed in the working group and will be addressed during my March visit.

c. An Enterprise Income Tax (EIT)

The enterprise income tax is usually the second largest revenue source (adjusting for mineral payments) for economies undergoing transitions. This relative significance arises from the historical dependence on enterprise taxation, the importance of the modern sector within the tax system, and the emerging importance of foreign investors to tax compliance.

Notwithstanding the importance of enterprise taxes, the share that these taxes contribute to total tax revenue should fall as reform proceeds. In most cases, one objective is to reduce taxes on enterprises that are in full compliance with the law and that do not benefit from special exemptions. Such changes are achieved through a combination of base-broadening initiatives alongside expanded use of market-oriented accounting for the derivation of income.

Changes to enterprise taxes should include:

i. Elimination of all, or a significant reduction in, tax incentives such as tax holidays, export allowances, investment credits, asset expensing (or rapid depreciation), and export zones;

ii. Use of a single tax rate that is equal to the maximum individual tax rate (to reduce tax avoidance schemes);

iii. Recognition of reasonable expenses in the derivation of income, including interest (although limited by a thin capitalization rule), advertising, overheads, indirect costs, and other costs generally considered ordinary and necessary expenses;

iv. Development of simplified administrative rules for transfer pricing, tax years, reorganizations, and liquidations;

v. Development of source and residence rules consistent with international standards so that all investors have a consistent set of cross-border rules for income attribution;

vi. Use of simplified depreciation such as pooled accounts combined with declining balance depreciation[12];

vii. Development of a means to account for inflation for at least some aspects of the enterprise tax, if it is deemed impossible to fully inflation-index the tax system as a whole; and

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[12] I made this proposal in Myanmar a number of years ago and the IMF recently advocated the adoption of such depreciation methods. I will again supply the specific proposal I made as part of the March visit.

viii. Use of a method to integrate the enterprise tax with the personal income tax in order to eliminate double taxation of capital income.

d. A Personal Income Tax (PIT)[13]

Typically, the PIT will not be a significant revenue source in either the near or intermediate terms. Per capita income is generally too low, and participation in the modern sector by a significant proportion of the population too small, to justify more extensive reliance on the PIT. One strategy is to use the PIT to provide additional progressivity to the tax system in the near term and to expand the base to increase the probability that high-income individuals will pay tax.

The tax should also be designed to enable the economy to "grow into" the PIT. The PIT should be revenue elastic so that the proportion of PIT revenue to total tax revenue increases as growth resumes. In addition, as per capita income grows, more individuals participate in the modern sector and the aggregate tax base expands. Such a strategy can be pursued by incorporating the following elements into the PIT:

i. A combination of a flat rate with a relatively high exemption level (in some cases, 75% (or more) of the population can be eliminated from the system by setting the exemption threshold at a high level);

ii. If a flat rate is not acceptable, then the number of rates in the PIT should be reduced to either two or three;

iii. An expansive definition of income that includes all income for domestic residents (regardless of source), fringe benefits (except perhaps for pension contributions),[14] interest, dividends (with appropriate integration), capital gains, honoraria, and professional income; and

iv. Extensive use of withholding on wages, fringe benefits, interest income, and other payments (including withholding on gross payments for services).

There is a draft income tax law prepared by the Legal Department of the IMF that might be used as the basis for the reform. The importance of the policies and their clear elucidation should be emphasized in preparation for the post-election period. A recent IMF mission provided useful recommendations for income tax reform, many of which should be adopted once technical issues are discussed. In addition, I believe it may be possible to expand the number of changes that are feasible during the post-election period.

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[13] Social taxes may also be an important element of the revenue system. Reform of the social tax system should be coordinated with reform of the benefits provided by the system (pensions, health, unemployment, and other benefits). Until that time, it is generally recommended that the tax be uniform and applied to a base essentially the same as the PIT base to ease administration.

[14] Sometimes fringe benefits are taxed via a fringe benefit tax imposed at the employer level with an exemption at the personal level.

e. Uniform Tariff

Free trade is generally the preferred strategy with respect to trade taxes. Such a policy may not be efficient during early stages of reform, however. As a practical matter, trade taxes can be a reasonable revenue source during a transition phase and are relatively easy to administer given limited collection points. A uniform tariff may be a reasonable option in such circumstances.[15] The clear function of a uniform tariff is to collect revenue, and a well-designed instrument generally results in uniform effective (as well as nominal) protection for domestic industries.

One strategy used to reduce the variance of trade distortions is to first convert quotas and import bans (to the extent any exist in Myanmar) into tariffs (so the government obtains some revenue), and to then engage in what has been termed a "radical reduction" of the tariff structure. A target uniform rate (5-8% for instance) is chosen and achieved by systematically reducing the high tariffs and increasing the low tariffs in two or three stages (over a period of up to three years). This method provides time for domestic producers to plan and to adjust to a new international trade environment.

f. Property Tax (attributed to and administered by local governments)

A tax on real property can provide the basis for local government finance. However, implementation of this tax can be complicated for a local government in an emerging/developing economy because of lack of clear land tenure and the complications of using market-based valuation methods. Like the PIT, one strategy is to develop a structure that is compliance driven in order to allow the economy and tax administration to grow into the tax system.

A number of steps are needed to develop such a system:

i. Develop a reasonable tax cadastre;
ii. Use mass valuation techniques;
iii. Impose the tax on the real property and not on the owner of the real property -- tangible personal property (such as autos, boats, and items other than land or buildings) should not be part of the base;
iv. Impose a uniform rate;
v. Keep exemptions to a minimum; and
vi. Develop methods of local administration and enforcement.

Work on the property tax is ongoing by RI and the Asia Foundation, among others. I believe it has been agreed that no action by the national government is needed at this time. There might be the possibility of drafting a model property tax law that can be provided to local governments for consideration. Such an effort, however, should be deferred until there is more experience with property tax reform in Myanmar.

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[15] Chile's successful economic reform demonstrated the potential for a uniform tariff.

g. Other Issues

i. Small Business Taxation

Small- and medium-sized business is a difficult sector to tax and so special taxes are sometimes employed. If employed, such taxes need to be carefully designed in order to enhance compliance and to avoid creating adverse incentives that deter the growth of the business.[16]

A useful small business tax might include the following elements:

1. The definition of small business should be based only on gross revenue (not on employment, capital, or other factors) and the tax should be restricted to non-legal entities such as sole proprietorships and simple partnerships.

2. The small business tax should replace the EIT, VAT, and perhaps the PIT (in the case of entrepreneur income).

3. It can be useful to impose a fixed fee for very small businesses.

4. Simplified accounts-based cash flow taxes can be used for businesses other than those charged a fixed fee. Under this system, assets are expensed and no deduction is allowed for interest payments.

ii. Natural Resource Taxation

Natural resource taxation will an important part of Myanmar's revenue system. A complete examination of natural resource fiscal revenue is beyond the scope of this note, but a few points are important. In addition, work has already begun on the technical analysis of the contracts by the Working Group and the NECC. Thus, the discussion here is to provide some additional context for that work. First, it is critical to differentiate taxes from resource factor payments. Royalties and risk-sharing payments need to be clearly defined for their economic functions and should not be considered taxes. The government owns a scarce factor of production (reserves) and those reserves have a marginal price (like other types of capital) on both a stock and a flow basis. Royalties then are a market signal of the owner's value of reserves at the margin. Risk-sharing payments (via equity participation, for instance) should reflect the cost of risk bearing to the people of the country, the relative ease with which those risks can be offset by other policies, and the opportunity cost of using scarce resources in other investments.

Second, the relationship between mineral contracts and taxation needs to be examined. It appears that contract policies differ by contract, and it is important to understand how contracts and taxation interact to affect the returns to the country and to the investor. Third, the mining sector should be subject to all generally applicable taxes (including enterprise taxes). Specific provisions of the

[16] A small business tax has been proposed by the IMF, and I have supplied a specific proposal in the past. I will supply a technical discussion of small business taxation prior to my next visit.

enterprise tax law should not be overridden by the mining contracts and mining enterprises should be subject to reasonable compliance activities of the tax administration.[17]

iii. Agricultural Taxation

Agriculture is a difficult sector to tax. In general, such difficulties are reduced by introducing a large exemption for the PIT and having a relatively large threshold for VAT. Small holders will generally be exempt from both taxes in this case. Agricultural taxation is then applied to legal entities such as corporations, state enterprises, and/or cooperatives. The generally applicable law, perhaps with some special provisions for cooperatives, should be imposed on such operations.

iv. Estate and Inheritance Taxation

Estate and inheritance taxes are relatively minor taxes in terms of revenue generated. Such taxes can be important for progressivity and perceptual purposes, however. A simple flat-rate tax with a large exemption (after accounting for spousal transfers) is one common approach.

h. Fiscal Decentralization

The new Constitution has provided added impetus to decentralize expenditure responsibilities, in keeping with the worldwide trend toward decentralization. This trend is based on an increasing body of evidence that economic growth is enhanced if the subnational governments control some public expenditure. Through time, public expenditures tend to be more transparent and more targeted to the population's needs because local decision makers can be better held accountable for their actions.

It appears that the fiscal resources necessary for the subnational governments to meet their expanded obligations is lacking. Revenue sharing, grants, equalization formulae, and other central-to-subnational transfers compose one set of tools to provide resources to subnational governments. These methods are mechanical, however, and do not take all local concerns into account even if distributions are transparent and well-funded. Thus, it is generally agreed that subnational governments need some types of own-source revenues at the margin in order to accrue resources sufficient for locally identified, publicly supplied goods and services.

Three types of taxes are generally preferred.

i. Property Taxes

Property taxes need to be administered locally, regardless of revenue assignment, because local markets vary, relative valuations vary, and cadastres can be more accurately maintained at the local level. There is the potential for local business and citizen interests to coincide with local government interests when the property tax is properly used. Efficient, and effective, provision of local goods and

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[17] Mining enterprises are often exempt from VAT because most capital is imported and output is exported, creating a possible perpetual excess credit for production activities. In addition, foreign investors are sometimes concerned about tax stability. Tax stability can be assured by including a contract provision that states that the firm will be subject to the generally applicable enterprise tax law at the time the contract is signed for the duration of the contract.

services can increase property values. Thus, taxpayers have a direct interest in service provision and can hold local officials more accountable for expenditures.

ii. Local Excise Taxes

Local excises can be used to fund a number of local public goods. The base is well defined because relatively few goods are subject to excise.

iii. Local Option Sales Tax

A selective local option sales tax can be an effective revenue tool within the competitive constraints that subnational governments operate. There are some justifications for imposing local sales and use taxes on an origin basis for administrative and economic reasons. Such benefits must be weighed against the inability of local government to export such taxes if factors are mobile and other subnational governments compete for resources. Thus, it is probably best to consider that the incidence of any local option sales tax will fall on residents.[18]

iv. Other Taxes

Other taxes are generally not effective subnational taxes unless some pre-conditions are satisfied. Personal income taxes might be collected by the national government and allocated to subnational governments. Alternatively, subnational governments might "piggy-back" on the national personal income tax.

Any personal tax, other than wage withholding, is generally too costly for subnational governments to administer. Significant fixed costs are incurred to establish any tax, and subnational governments may not have the infrastructure, skill base, or resources necessary to invest in complicated systems. Similar difficulties arise with respect to enterprise tax and VAT. All three taxes (enterprise tax, VAT, and PIT) are complicated by residence rules, source rules, attribution rules, and other issues regarding the derivation of the base. These factors, combined with the administrative complexity of these taxes, make all but the simplest withholding systems non-feasible for subnational governments.

IV. Sequencing the Tax Reform

There are two components to sequencing the tax reform.

a. Sequencing Tax Reform in Relation to Other Institutional Reforms

i. Tax Reform Should Lead Other Financial Reforms (to the extent other financial reforms have not been completed)

Taxes affect almost all aspects of economic life. Thus, tax reform might be used as a tool to lead other types of institutional reform. For instance, tax accounting can provide a model for the

[18] A means to coordinate a sales tax with a VAT or other national sales tax might be necessary. Canada and Australia have done this in reasonable manner, and Germany has used the VAT as a source of subnational revenues.

development of accounting standards and simplified bookkeeping. Reasonable settlement of tax disputes can create a demand for an impartial judiciary. Most importantly, tax reform can increase the overall efficiency of the economy. Thus, income increases can be used to create the demand for and implementation of transparency initiatives and other types of economic reforms.

Accordingly, I believe tax reform should be one of the primary elements of Myanmar's overall reform strategy and am pleased that tax changes are being given such a priority in planning for the post-election period.

ii. Tax Reform Should Be Coordinated with the Imposition of Expenditure Controls and Initial Budget Reform

Expenditure control and budgeting are essential elements of governmental reform. Taxpayers must have some assurance that government will use revenues in a responsible manner. Tax reform will fail otherwise because taxpayers will resist complying with a revenue system that is used to finance wasteful or corrupt spending. Efforts for controlling budgeting and expenditure are ongoing and there should be some discussion about coordinating tax changes with expenditure controls in the post-election period.

b. Sequencing the Tax Reform

Tax administration reform has made significant progress. In addition, I believe it is possible to lay the foundation for the tax system's evolution immediately after the election. The working group has made significant progress, and, in addition, I have included some initial actions in a separate memorandum.[19] Specific recommendations will be finalized by June. The objective is to move incrementally on as many issues as practical, build momentum for reform, gain experience, and be able to adjust considering experience as well as changes in economic circumstances.

Finally, I believe that now is the time to begin to move the tax policy function to the MOPFI. I appreciate the institutional constraints, but believe that appropriate oversight of tax policy development and tax analysis will be enhanced by transitioning now by taking the following actions:

1. Expand the current working group to include more MOPFI officials and charge a senior MOPFI official with supervising the working group's activities.

2. Institutional and skill constraints are apparent, so I recommend that the working group be supplemented with NECC staff, MDI staff, and RI staff. Two benefits accrue from this approach. First, the skill set is expanded at a crucial time. Second, using NECC, MDI, and RI staff will help fill needed manpower gaps in the short term while expanding the pool of individuals that can form the core of a tax analysis unit within the MOPFI.

3. To the extent necessary, use the resources of various donors to supplement the expanded working group. The World Bank has been performing an analysis of tax incentives. The IMF Fiscal Affairs Department has provided essential guidance, and their skills can be exploited to help with technical issues. The International Growth Center has already provided an

[19] Memorandum "Initial Recommendations for the Next Budget" dated June 1, 2019.

important study on effective tax rates, complete with a methodology that can be transferred to the working group. Other projects, such as the Robert Nathan project, have provided important resources for legal drafting and other efforts.

4. Begin to develop an organizational plan for a tax policy and analysis unit within the MOPFI. The expanded working group, supplemented by others, supervised directly by MOPFI is only a transition method, but time is provided to enable a reasonably expeditious organization of a formal unit as part of MOPFI's overall institutional development. I am willing to provide one suggested approach to organization if there is interest.

I hope this information is helpful.

Thank you.