Managing Subnational Finance

Suggestions to Improve Intergovernmental Fiscal Transfers

December 2019

This note is based on the World Bank Myanmar Subnational Public Expenditure Review 2019: Fostering Decentralization in Myanmar.

The Situation

Subnational financing has increased substantially in the five years to 2017/18, mostly driven by growth in transfers. The total resources available for spending by state and regions increased three-fold from 2012/13 to 2017/18 – from 1.7 percent of GDP to around 2.9 percent of GDP. Most states and regions, apart from Yangon and Mandalay, rely heavily on fiscal transfers from the union government – ranging from 71 percent of total financing in Ayeyarwady Region to 89 percent in Chin State in 2017/18.

Fiscal transfers are essential for subnational economic development because they support decentralized public service delivery and investment. Fiscal transfers play an important role in addressing two key fiscal imbalances: 1) between the union and subnational governments created by the fact that most major revenue sources are centralized (known as “vertical fiscal imbalance”); and 2) between states and regions created by differences in different revenue-raising capacity and expenditure needs (known as “horizontal fiscal imbalance”). A well-designed, fiscal transfer system is key to meeting local and higher-level union priorities and achieving equity objectives by directing funding to poorer areas.¹

The general-purpose grant is the most important mechanism through which resources are transferred between levels of government. The general-purpose grant accounted for 87 percent of all funds transferred to states and regions in 2017/18. The size and distribution of the general-purpose grant is determined by the Union Finance Commission. Funds are partially allocated to states and regions based on a formula that accounts for equity and fiscal capacity considerations. It is therefore an important mechanism available to government to support inclusive economic development.

Complementing the general-purpose grant is shared revenue from four union taxes collected by the Internal Revenue Department (IRD); these are particularly important in Yangon Region. Since 2016/17, a fixed small share of these taxes (Commercial Tax; Special Commodity (Goods) Tax; Individual Income Tax; and Stamp Duty Tax) has been shared with states and regions based on the location of collection. Shared tax revenues, accounted for only 12 percent of total transfers in 2017/18. However, they are a key mechanism for reinvesting in the sources of Myanmar’s growth; most shared tax revenue accrues to Yangon Region reflecting the geographical concentration

¹ Separate policy notes focus on other aspects of fiscal transfer system including reforms that improve the incentives for states and regions to further develop their own-source revenues. See “Improving Tax Sharing Arrangements”, “The Potential of Land Value Capture Tools in Yangon” and “Realising the Potential of the Property Tax in Yangon”. 
of economic activity. 2

The system of intergovernmental transfers in Myanmar has been considerably redesigned in recent years, with improvements in transparency, predictability, efficiency, and equity. In 2015/16 the previous deficit-based system of financing states and regions was replaced by a rules-based approach to determining the size and distribution of the general-purpose grant. In addition to improving transparency, predictability of transfers this also eliminated a raft of perverse incentives. A patchwork of smaller transfers was also replaced with the three main instruments used today, reducing the burden on administrative capacity and improving efficiency and transparency. In 2017/18, changes were made to the tax sharing arrangement to address a bias in the allocation in favour of Yangon as the location of the sole Large Taxpayers Office (LTO). Taxes collected from the largest State-Owned Enterprises (SOEs) at the Yangon LTO are now allocated across states/regions in accordance with the formula used for the general-purpose grant transfer.

Despite noticeable improvements, the transfer system still falls short of achieving some objectives:

- Transfers are not administered in a coordinated manner, which undermines predictability and transparency. Transfers should be designed in such a way that subnational entities have a clear mandate, are adequately resourced, have sufficient flexibility to make decisions and are accountable for results. Institutional fragmentation and weakness in forecasting union revenues results in frequent ad hoc in-year adjustments being made to the revenue shared with states and regions. This undermines the capacity of states and regions to adequately plan and budget each year by creating uncertainty regarding the size of the total resource envelope.

- The general-purpose transfer has only marginally impacted horizontal equity. The formula-based approach is only applied to the marginal addition to transfers each year after ensuring that states and regions receive at least as much as they did in the previous fiscal year. The result is that only 6 percent of the general-purpose transfer pool is allocated via the formula, with the remaining 94 percent reflecting historic distributions of about 1.5 trillion Kyat that were made before 2015/16. The result is that grant transfers are only weakly correlated with the indicators of deprivation.

## Improving Predictability and Transparency of the Transfer System

### Short term options:

**Reduce the volatility of transfers via a balancing fund.** At the start of the fiscal year, a certain amount of general-purpose and revenue-sharing transfers could be guaranteed to states and regions based on the Union revenue forecasts. If Union revenues exceed estimates, then the excess amount could be transferred to the balancing fund, which could be drawn down in years when the union revenues are lower than the forecast. This design is consistent with existing financial rules and regulations in Myanmar, as it could be treated as a special contingency fund. Introducing such a fund will enhance the predictability of transfers and remove the concern from in-year volatility.

**Create an inter-departmental group between the Budget Department, which administers the general-purpose transfers, and the Internal Revenue Department, which operates the shared revenues.** This group would ensure consolidated communication on overall transfer envelope to states and regions and that the different transfers are administered in a coordinated manner.

### Medium- to longer-term options:

**Establish a forum where the union and the states and regions governments regularly discuss the functioning of the intergovernmental transfer system.** The forum could discuss how the intergovernmental transfer system is doing and, if needed, update the transfer formula. It could provide a space for states and regions to express their concerns. Regular open dialogue is critical to

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2 A much smaller Constituency Development Fund (CDF) accounts for a small and declining share of total transfers and is not the focus of this brief. There are currently no conditional or performance-based grants in Myanmar’s intergovernmental transfer system.
ensuring the longer-term stability of the transfer system and to ensure that the size of the general-purpose transfers is safeguarded against competing budgetary priorities. The forum could be the existing Finance Commission but maintaining the voice of states and regions is critical.

**Improving Equity in the Transfer System**

The general-purpose grant could be further strengthened by gradually increasing the share of the pool allocated under the formula. Presently, most of the general-purpose transfer is blind to the fiscal capacity or development needs of states and regions. Without significant changes to the size of the divisible pool, any changes in the basis for allocation necessarily benefit one state or region at the cost of another. Moreover, sudden changes may also lead to further unwanted volatility. Consequently, any attempt to increase the share of the divisible pool allocated by the formula should proceed gradually and in consultation with the states and regions. One possible approach is to increase the formula-based share of the transfer by 8-10 percentage points each year with the ultimate aim of subsuming the full grant into the formula over ten years.

**Gradually adjust the formula to improve equity and reduce horizontal imbalances.** The current formula attempts to equalize receipts across states and regions based on six equally weighted variables related to development needs and fiscal constraints. However, the current weights downplay the importance of the population, which biases the allocation mechanism towards states/regions with smaller populations. The current formula may also be downplaying the importance of development needs. Further improvements and refinements could be made to the formula to address these concerns. However, it is important to note that no formula can adequately address all equity concerns as there is not a perfect formula that would satisfy all the needs of different states and regions.

Further, any changes to the formula will result in some states and regions benefitting while others will lose out. It is therefore essential that any changes to the formula are discussed and debated amongst all state, region and the union governments to ensure any proposed changes have broad approval and are politically viable.

**The Bigger Picture**

The simplest way to increase the general-purpose grant to states and regions is for the union government to improve revenue collection. Ultimately, the basis for determining the general-purpose grant amount in the union budget is discretionary, driven by the size of the union budget and the ceilings approved by the Union Finance Commission. To date, the union government has prioritized transfers, which have increased as a share of the union budget from 3 percent in 2013/14 to nearly 9 percent in 2017/18. Indeed, in 2017/18, transfers to states and regions were larger than union spending on agriculture and health, and almost as much as spending on education.

The effectiveness of transfers is also influenced by the pace of broader decentralization reforms. Currently, there is a lack of clarity of expenditure and revenue assignments between the subnational and union governments. Many core functions of government, except for municipal services, are shared between levels with no clear guidance on what, precisely, states and regions are responsible for. Without proper and detailed information about Subnational Government’s expenditure needs and revenue raising capacity, redesign of the intergovernmental transfer system may not adequately address the problems of horizontal and vertical inequities it intends to address.
Further Information

During 2018 and 2019, the World Bank and the Renaissance Institute jointly reviewed the governance, revenues, and expenditure arrangements in Yangon and Mandalay regions and cities, and Shan state. They also examined the status of digital infrastructure, the delivery of solid waste management and transport services. The findings and their discussion are detailed in the “Subnational Public Expenditure Review 2019: Fostering Decentralization in Myanmar”. The above advice is based on these findings.

For more information, including Myanmar versions of these notes, please visit www.rimyanmar.org or contact renaissance@rimyanmar.org.

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