The Situation

Subnational Governments in Myanmar have a number of revenue streams available to them to finance the expenditure for which they are responsible. The majority of resources are derived from intergovernmental fiscal transfers, predominantly via the general-purpose grant transfers and tax sharing. In addition, states and regions collect a host of their own small tax and non-tax revenue handles.

This note focuses on how subnational governments could increase the tax revenue they receive and improve the stability and predictability of tax-sharing. Revenue from four union taxes collected by the Internal Revenue Department (IRD) is shared with states and regions at various rates based on the location of collection. These include: Commercial Tax (15 percent shared); Special Commodity (Goods) Tax (15 percent); Individual Income Tax (5 percent); and Stamp Duty Tax (2 percent).

Along with grant transfers, shared taxes play an important role in addressing vertical fiscal imbalances, particularly in the growth centers of Yangon and Mandalay. While shared tax revenues accounted for only 12 percent of total resource transfers between levels of government in 2017/18, their small share belies the role they play. By their nature, transfers are a pro-cyclical revenue handle. They are therefore a key transfer mechanism for reinvesting in the sources of Myanmar’s growth rather than for achieving horizontal equity. Accordingly, most shared tax revenue accrues to more the urbanized and economically vibrant Yangon Region and to some extent the Mandalay Region.

At present, however, there are a number of key shortcomings in the way the shared tax system operates.

- States and regions have no autonomy over the tax handles that are shared, which limits their incentives to improve the base, rate, and administration. For instance, states and regions have no say in setting the tax base, the tax rate or in administering the

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1 A much smaller Constituency Development Fund (CDF) accounts for a small and declining share of total transfers.

2 Separate and complementary notes propose reforms to the intergovernmental transfer system and own-source revenues of subnational governments. See “Suggestions to Improve Intergovernmental Fiscal Transfers”, “The Potential of Land Value Capture Tools in Yangon” and “Realising the Potential of the Property Tax in Yangon”.

3 Yangon Region previously received as much as 87 percent of total shared tax revenue in 2016/17. However, this share has since fallen as a result of some adjustments made to the derivation rules.
shared tax handles. There are no options for “piggybacking” (that is, the potential for states and regions to add additional tax rates to shared taxes to reflect local economic conditions). Moreover, states and regions have no input in setting the percentage split of the shared revenues, this is decided by the union.

- Figure 1: Volatilities in union tax sharing - In-year variations in shared taxes weakens planning and execution of subnational budgets. The tax sharing mechanism is based on tax collections in the current fiscal year. States and regions therefore rely on revenue forecasts for their planning and budgeting at the beginning of the fiscal year. However, weaknesses in the forecasting system mean that the amount of shared tax revenues received by subnational governments often differs from the forecast amount (Figure 1). This undermines the ability of subnational governments to effectively plan their expenditure.

**Figure 1 : Volatilities in tax sharing**

2017 -18, Million Kyat

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**Strengthening the Shared Tax System**

This note provides a suite of potential reforms for increasing the shared tax revenues available, provide for states and regions with greater revenue autonomy and improve predictability and stability of the shared tax system. The primary focus (at least initially) is on Yangon and Mandalay Regions. These are the largest beneficiaries of shared tax revenue, and the location of the two largest cities, they offer the greatest prospect for reinvesting in sources of growth. All states and regions are likely to benefit, directly and indirectly.

A stronger shared tax revenue system would have a number of clear benefits:

- **Improvements in tax efficiency.** Offering subnational governments increased authority over certain shared tax handles would adhere to the benefit principle of taxation, which states that taxpayers are willing to pay in order to benefit directly from certain public goods (e.g., for public transport, toll roads, etc.). Lower levels of government are best placed to levy these “benefit taxes” as it helps reinforce the direct accountability relationship between the citizen and the state.

- **Improved accountability.** Strengthening the nexus between spending and revenue will improve downward accountability and may impose greater fiscal discipline on subnational governments.

- **Improvements in allocative efficiency of intergovernmental transfers.** Increasing the revenue generated by Yangon and Mandalay Regions from shared tax handles, would allow the union government to use its available resources under the general grant transfer to better target horizontal inequities rather than fund service provision in two of the wealthiest regions.

- **Support decentralization.** Reforms to tax sharing can increase revenue to states and regions while remaining fiscally neutral for the union government. It creates an important win-win in Myanmar’s transition towards increased decentralization:
equipping subnational Governments with greater fiscal autonomy without doing so at the expense of the fiscal position of the union.

- The tax system is no stranger to reform. 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.

Enhanced Tax Authority for Yangon and Mandalay Regions

A sequential two-step approach is proposed:

In the short term, states and regions could be given the right to “piggyback” additional tax on top of certain shared tax handles. Any reassignment of rights to set tax rates and base should be limited to immobile economic factors of production and immobile economic units so as to avoid any inter-subnational government trade implications and tax exporting. It should therefore be limited to the services components of the commercial tax (such as restaurants, hotels, sale of buildings and jewellery) and the stamp duty base. Such an approach would not have any implications for union tax collections.

For example, the Yangon Region Government may wish to capitalize on its established position as the country’s economic hub by piggybacking an additional 1 percentage point onto the current 5 percent commercial tax rate. In Yangon Region the IRD would continue to collect commercial tax, but would do so at the higher rate of 6 percent.

Yangon Region could continue to keep 15 percent share of the baseline commercial tax (i.e. the taxes collected on the first 5 percent rate), as per the existing shared tax arrangement. The piggybacked amount (i.e. the extra 1 percent in tax rate) could then accrue mainly to Yangon Region – with a small share of this piggybacked amount (say, 15 percent) retained by the Union Government to cover the additional costs associated with tax collection (Figure 2).

Piggybacking is a particularly attractive option as it raises additional revenue for subnational governments but is fiscally neutral for the union government. Piggybacking incentivizes subnational governments to utilize policy instruments that have the least administrative difficulty and that avoid any duplication of tax administration.

The increased revenue available to subnational governments from applying a ‘piggyback tax’ is potentially significant. A one percent increase on the commercial tax rate on restaurants in Yangon would generate an additional 1.2 Million USD above the current baseline. This is equivalent to more than three times the land tax collected by Yangon Region Government in 2018/19.

In the medium term, for taxes with immobile base the right to expand the tax base could also be devolved to states and regions. This builds on the previous step by devolving the right to expand the tax base to states/
regions in addition to the rate-setting. As with the previous step, collection would remain the responsibility of the union government and the baseline amount of shared taxes would continue to be shared between the union and the relevant state/region according to existing ratios (thus remaining fiscally neutral for the union government). Devolution of certain taxes would also incentivize states and regions to increase the base as well as the rate. Marginal increases in revenue above the baseline (or the agreed trendline) that would come from enhancing the rate or base would predominantly accrue to the relevant state/region and compensate for any added effort and/or political cost from the changes.

Stamp taxes are arguably the best candidates for full devolution of rate and base setting with maximum retention of the marginal gains by the respective states/regions. Stamp taxes are assigned to subnational governments in many federal countries (Australia, India, and Pakistan, for example) because their tax base is immobile.

However, reassigning a substantially larger share of defined commercial taxes collected from an immobile base would also help cities such as Yangon better capture a slice of the growth in economic activity and/or reap the rewards from improved compliance and changes of policy, like the expansion of the base. For example, in Yangon, the baseline collection of commercial taxes from a subset of restaurants is US $7.2 Million. An increase of 10 percent in the number of restaurants paying tax and a 10 percent increase in average turnover would result in a marginal increase of US $1 million, of which the majority would be returned to Yangon Region Government.

**Improving the Stability and Predictability of Shared Taxes Through a Balancing Fund**

Establish a balancing fund would allow the union government to guarantee a certain amount of general purpose and revenue sharing transfers. In years when revenue is higher than forecast it will be transferred to the balancing fund. These reserves can then be drawn down in years when revenue is lower than forecast. The result is a more stable and predictable system of tax sharing with no in-year variations. An initial allocation from the union budget would ensure that there are balancing funds available from the outset. This design is consistent with existing financial rules and regulations in Myanmar, as it could be treated as a special contingency fund.
The Bigger Picture

The proposed recommendations do not exist in isolation and there are a number of important contextual issues that need to be considered.

Increasing tax bases and tax rates is never politically easy though there are advantages for states and regions. The proposed recommendations will increase revenue and reduce spending volatility at the subnational level. This, in turn, will help states and regions increase the quantum and quality of public investments and services.

Creating a differentiated system of taxes between states and regions can create economic distortions. Misalignments between the sources of revenue and the benefits of spending can heighten risks of distortions such as cost shifting (known as tax exporting) and harmful tax competition between jurisdictions. However, this risk should be mitigated by only offering subnational governments authority over the taxation of immobile bases.

There is considerable variation in administrative capacity across subnational governments. Less able administrations risk being overwhelmed by local revenue collection while more competent administrations will thrive, which will exacerbate subnational inequalities. The proposed reforms are therefore deliberately modest, administratively straightforward and focused initially on the two most administratively capable regions, Yangon and Mandalay.

The administration of commercial and stamp taxes is also in need of reform. Better surveys of tax bases, improved compliance, risk-based audits, tax facilitation measures, performance monitoring and use of information and communications technology will benefit the union and subnational governments as well as citizens.4

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4 Separate but complementary policy notes focus on reforms to subnational own-source revenues and e-Governance. See "Realising the Potential of the Property Tax in Yangon", "The Potential of Land Value Capture Tools in Yangon" and "Unlocking the Potential of Digital Governance of the Subnational Level".
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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