Public Finance for a Genuine Federal Democratic Union

An Introduction into Public Spending and Taxation Issues for Myanmar

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Introduction

In March 2016, the new government led by the National League for Democracy (NLD) took office in Myanmar under the leadership of State Counsellor Aung San Suu Kyi and President Htin Kyaw. The NLD controls a majority of both upper and lower house parliamentary seats in the country's first democratically elected, civilian-led government since 1962. The new direction for the country was set out in the 2015 Election Manifesto, which stated that it will "strive for the establishment of *a genuine federal democratic union* based on the principles of freedom, equal rights and self-determination".[1]

Election manifestos indicate the objectives a government wishes to accomplish, but the ways to achieve them are often hard and complicated, especially in the context of a constitution that gives veto power to non-elected representatives from the Tamadaw. The people may easily become disappointed unless they see real progress. However, the challenge is not only to move from military dictatorship to a genuine federal democratic union, but also to move from a war economy to a genuine market economy. The two transitions are linked, but economic progress is crucial if Myanmar is to become a modern democracy.

The NLD manifesto clearly gave high priority to "*the freedom and security to prosper*" and declared as its first economic priority:

"*1. To enable the effective use of the public financial system and the full and systematic collection of financial revenues, we will establish a public financial management system that is transparent, ensures prudent expenditure, and is in line with financial standards.*

a. For the collection of tax revenues, we will develop a tax system that the public will actually want to support through tax payments. In order to broaden the tax base, we will reduce tax rates. We will collect, systematically and in line with the law, tax revenues from the profits made by the sale or transfer of immovable and other assets. We will ensure, through transparency, that the general public is able to see how these tax revenues are used.

b. In order to reduce centralized financial control, the authority and responsibility for financial matters will be divided appropriately between the Union and the State/Regional governments. At the same time, we will work through negotiations to ensure a fair financial distribution between States/Regions."

The reform of the public financial system is therefore a top priority of the government. It is also an indispensable element in the political dialogue based on the Panglong spirit that seeks to address the roots of the internal armed conflict, which has harmed the country for so long. The Manifesto clearly stated that the government will

- *Lay down transparent projects for the balanced development of all the States and Regions.*

[1] (NLD 2015)

- *Work to ensure a fair distribution across the country of the profits from natural resource extraction, in accordance with the principles of a federal union.*

These are great ambitions, which need a lot of technical knowledge and expertise. The purpose of this booklet is to give an overview of the public finance issues involved, so that policy makers from all sides can make informed choices that would help to accomplish the vision for a modern Myanmar. In this context it may be useful to refer also sometimes to the experience of other countries.

1. General Principles

Economic development is driven by markets. We distinguish between private goods, which are exchanged in markets, and public goods, which are supplied and consumed collectively. Public goods, such as roads, electricity, schools, etc., are necessary for markets to operate effectively. They contribute to the economic efficiency and the general well-being of the people living in Myanmar. Hence, public goods complement private goods. Without them economic development is not possible.

The provision of public goods to citizens is the purpose of government. Depending on the nature of the public goods, the government may operate on different institutional "levels": central, State or Region governments or local authorities. However, some public goods are also provided by religious organisations (monasteries, churches, mosques) or non-governmental organizations (NGOs) or even groups of engaged private citizens (clubs and associations). Ethnic Armed Organisations (EAOs) also provide a wide range of services such as health and education, etc. at their controlled areas. The United Nations Development Program defines NGOs as "any non-profit, voluntary citizens' group, which is organized on a local, national or international level. Task-oriented and driven by people with common interests, NGOs perform a variety of services and humanitarian functions, bring citizens' concerns to governments, monitor policies and encourage political participation at the community level."[2] Thus, NGOs can make an important contribution to the provision of public goods, but the role of government remains decisive. Furthermore, in Myanmar, the Tamadaw is a state within the state that supplies public goods to the members of the military and its members.

While the private sector relies on the market mechanism to provide incentives for mutually beneficial exchange, and NGOs rely on voluntary efforts to further common causes, governments often rely on authority and force to achieve their objectives. For this reason, governments must be legitimised by the democratic choices made by citizens. A democratic government is the agent that turns people's choices into reality and not an external power that imposes its will on citizens. A central question is how governments can mobilize resources and pay for the public goods people want. The theories of public finance give some answers. Governments also issue regulations and laws, which influence the provision of private and public goods, but do not necessarily require significant resources. In this booklet we shall concentrate on mobilizing and allocating public goods and services.

All public goods together constitute the public sector, and private goods define the private sector. We also call *the state* the set of functional rules to administer public goods. The *government* determines these rules through laws, regulations, and allocates resources for their provision through a variety of institutions and organisations. In Myanmar, the *state* consists of the central government with its ministerial organs, the state and region governments, as well as union territories, districts, townships, villages, and state-owned economic enterprises. However, it also consists of Parliaments, Courts of Justice, police and the Tatmadaw. In addition, there are subordinated institutions for specialized services, such as the Central bank, public utilities providing water, electricity and waste disposal, or general services such as hospitals, schools and universities. All these organisations need material resources and money for their work and public finance explains how to fund them efficiently. In developed OECD countries, social welfare transfers are a significant part of the public sector, but they are separate from the central and local government budgets.[3] In Myanmar, social security expenditure is negligible; the Union Government controls most of the subordinated administrations, but this

[2] UNDP *Human Development Report, 2003*; quoted by (Todaro, Michael P. and Stephen C. Smith 2015, p. 569)
[3] See below Figure 8, page 35.

centralization of power does not necessarily ensure the most efficient allocation of public goods and services. This is why the issue of a genuine federal constitution remains a burning priority for public sector reform.

Modern economies are monetary economies, where goods and services are bought and sold in markets for money. Markets provide freedom for consumers and producers, although they require a strong institutional framework that constrains undesirable consequences.[4] Traditional economies were based on the barter of physical goods and on the appropriation of resources by tribute and command. Burma had inherited a monetary economy from colonialism, but under General Ne Win's *Burmese Way to Socialism* the economy was increasingly de-monetized, markets repressed and abolished, private companies nationalized. This planned, government-directed economy turned the former "rice bowl" of Southeast Asia into one of the poorest countries in the world. It often returned to the traditional pre-monetary economy of barter and tribute.[5] A strict quota system based on the size of households and the age and gender of its members was imposed on consumers and producers and the Central Bank was part of the Ministry of Finance, while banking activities were tightly controlled and circumscribed.[6]

The military government after 1988 started to re-privatize some parts of the economy by giving preferential concessions to its supporters, but only in 2012 did economic reforms like the integration of the foreign exchange management start to the restore the monetary economy. However, the burden of the past is heavy; in a transition economy like Myanmar, the public sector is still highly inefficient. Electricity supply is irregular, roads and train trucks are in bad shape, the education system is far below world standards, and health care in the rural areas is insufficient. Red tape impedes individual and entrepreneurial initiatives. While the officially recorded public sector represents close to 20% of GDP, it is in reality larger because these data do not take into account the spending and revenue of Border Guards, the Ethnic Armed Organisations (EAO) or the work of local and international NGOs. Some these alternative organisations may fulfil useful and important functions in the provision of public goods, but they can also be harmful when they substitute themselves for markets or democratic governments.

Setting up efficient market mechanisms is a necessary precondition for fostering wealth creation and economic development. This transition requires profound reforms of the state and the transformation of the public sector by creating institutions for the transparent democratic articulation of public preferences and by strengthening the federalist content of the Myanmar constitution. These structural changes must be consistent with the functions of public finance. Form follows function. A movement to a more decentralised fiscal system requires that the public, officials and the business sector understand the functions of public goods and how they are best financed, so that discussions about the use of public resources is fully informed.[7]

Private and Public Goods.

Before taking a closer look at the finance of the public sector, it is useful to clarify the concept of public goods because taxes finance the provision of public goods. The distinction between private and public

[4] This is the idea behind the concept of "ordoliberalism", which has laid the foundation for the German economic miracle after World War II: combine free markets with a strong government to protect the freedom of markets. See (Nicholls 1994).

[5] For a discussion of the Burmese ideals of the state and its implications for the economy, see (Taylor 1987)

[6] (IMF, Myanmar Country Report 17/31. Selected Issues (Financial Sector Reform). February 2017, p. 4)

[7] (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, p. x.)

goods is of great importance in this context. Economic theory has established for a long time that the market place is the most efficient way for producing and distributing private goods. The market mechanism ensures that, at a given price, consumers purchase what they prefer most and suppliers deliver goods and services to those, and only those, who pay them the market price. This allows consumers to choose freely which goods they wish to purchase and producers to compete for their custom. Therefore, the market economy fosters innovation, higher productivity and general welfare. It anchors a culture of modern liberty.

The efficiency of the market mechanism is the driver of economic development. However, there is also the well-known problem of *market failure*. There exists a large set of public goods and services, which cannot be supplied efficiently by markets alone and it is important to find the right balance between the two. The concept of externalities is helpful in this respect.

Externalities

"External effects" characterize all public goods, and such externalities can cause market failure. Externalities occur when the production or consumption of a good or service affects not only the producer or consumer, but also other people.[8] Externalities are "extra" costs and benefits that arise when an individual or firm or government takes an action, but does not bear all the cost (negative externality) or enjoys extra benefits (positive externality). Such an action affects other parties without being reflected in the market price or the cost of production. Without a mechanism that re-assigns these costs to the originator (which is called internalising the externalities), market prices do not reflect all the costs correctly. The same is true for positive externalities, which are a benefit for which users do not have to pay and this can generate free-riding and the overuse of resources.

When externalities are positive, we call them public goods. For example, the more children get good education, the higher will be their productivity and capacity to contribute to the growth and welfare of the society when they enter the labour force. Clean rivers, clean air, good health care, an educated labour force, well-maintained roads, electrification, etc. are all public goods. They are good for everyone. Some externalities, such as pollution, are negative and they are sometimes called "public bads". A firm may find it to be the cheapest solution to drain its sewage in a nearby river, but this will cause negative external effects for the people who live further down by the river. These externalities reduce the cost for the firm, but generate negative effects and costs for others. The negative externalities of pollution, for example, could be remedied by forcing the factory to set up a clearing system, but that would increase the cost and prices of the goods produced. Avoiding a public bad is a public good.

The distinction between private and public goods is important for the development of an economy. Public goods often provide the infrastructure, which allows the production of private goods, but excessive public control can also stifle private initiative in markets and therefore hamper long run development.

Problems with the provision of public goods

Like anything in life, the provision of public goods is costly. As economists often say: "There is no free lunch". Time must be spent, resources must be bought, and skills are needed to produce public goods. Unfortunately, markets cannot produce public goods efficiently. The reason is that private goods are "rivalrous" and public goods are not. When goods are rivalrous, one can exclude someone from using

[8] (Minoletti 2016, p. 14)

and producing them unless the users pay or producers receive the market price. For example, an apple is rivalrous in consumption because only you *or* I can eat it. We are rivals for its consumption. If you want it, you have to compensate me for my loss of utility. However, because of the externality, this is not possible for public goods.

When consumers of public goods, i.e. those who enjoy the benefits, cannot be excluded from using them, the market does not provide the mechanism that ensures that the costs of providing them are covered. Such goods are "non-rivalrous" and it is impossible to charge a market price, which pays for the cost of producing them. Some consumers of public goods can therefore "free-ride" on the contribution made by others who have paid the price. The streetlight is non-rivalrous because if the street is lit at night, you *and* I can use it and it is impossible to exclude a person who has not paid his taxes. Hence, the market price will determine who will eat how many apples, but it is impossible to prevent someone from walking on a well-lit street if he has not contributed to their maintenance. However, if the tax payments are insufficient to cover the cost of production, the public goods will not be supplied in sufficient amounts.

For this reason, markets will fail to supply the optimal amount of public goods and at least some government regulation is necessary. In certain cases, however, the government itself must ensure that the public goods are forthcoming.[9] It must impose taxes, which ensure that a sufficient amount of money is mobilised to satisfy people's desired preferences for public goods. In other words, without taxes, there are no public goods; and without public goods, there will be no development.

Pure public goods are non-rivalrous with respect to supply and demand. However, there are also impure public goods, which allow some exclusion.

- *Club goods* allow restricting the access for members who are willing and able to pay the fee necessary for providing the good. The club members then jointly share the benefits and pay for them by their entrance fee. In this sense, even highways or bridges that charge a toll are club goods. The question is whether one can charge a fee for providing the public service rather than having to impose a tax on everyone.
- *Common resource goods* are goods where it is impossible to restrict access to resources, which are limited in supply, but there is rivalrous competition for the benefits. Fishing grounds or natural resources like oil, gas, or precious minerals are common resource goods, because the supply is limited while access is naturally free. However, because every "consumer" exploiting these resources will seek to get as much benefit as possible, there is a danger of overexploiting such common resource goods with negative consequences for everyone.[10] This is a particular predicament for natural resources like fishing grounds, forests, and precious minerals. Governments must prevent such negative externalities by defining clear and equitable property rights, and such rights can be traded in efficiently organized markets.

[9] Ronald Coase (1960) obtained the Nobel Prize in Economics for arguing that social costs could become negotiated compensations between those who cause and those who endure the externality. However, while this is true in the case of small groups of people, it becomes impossible when the group of people affected by the externality becomes very large. See (Collignon 2003, Annex). The Scottish Philosopher David Hume therefore pointed out already nearly 300 years ago that people invented government to ensure the provision of public goods. See (Hume 1978 [1739], p. 534-539).

[10] This was first explained by a ground-breaking paper by (Hardin 1969).

Private goods and services dominate the market economy. In the case of private goods, those who use them and those who pay for them are usually identical. If I buy a lungyi in the market, I will chose the colours I like, pay the market price, and I shall wear it myself and no one else. Thus, private goods are bought and sold in markets, where individuals freely exercise their choices over how they wish to spend and allocate their wealth. For public goods, this is not so, because the decision to produce and allocate public goods is a collective decision that binds everyone.

Hence, the distinction between private and public goods is clear in principle. However, there often exist overlaps between the two concepts that will render their practical implementation complex. For example, the government may run hospitals or schools with open access as a general service for everyone, or private organizations may offer health care and education for those who have the money to pay for it. Thus, the government can offer healthcare as a pure public good for which people pay out of their taxes, or it can turn it into a club good by allowing private doctors to charge a fee. Such private institutions may increase the quality of service, but by preventing the open access to a public good, the negative externality of insufficient healthcare may hamper economic capacities.

The key to the efficient supply of public goods is to ensure that people pay their taxes. However, even if paying taxes is a civic obligation that the government can enforce, nothing is more common than tax evasion. Ultimately, the morality of taxpayers depends on their "willingness to pay", and to a large degree that depends on the legitimacy of the government, which must respond to the collective preferences for public goods. This implies that people should pay for the public goods they could possibly enjoy, but not for those outside their reach. Fiscal federalism is a normative theory that articulates guidelines for how to match public goods with the desires and preferences of people living in different geographic and cultural areas.

To grasp the issue of matching the desired use and the available resources for public goods, we may say that the group of people who use these goods define the *range* or *reach* of public goods. Thus, we have local, regional, national and global public goods. For example, a highway that links the north and the south of the country and thereby contributes to the integration of the nation is a national public good; but the road, whichlinks a village to this national road and is primarily used by the villagers concerned, is a local public good. However, the local public good may also generate external effects for the nation, when the local road allows local farmers to sell their goods in the next big city and thereby contributes to the creation of wealth and income for everyone. Finally, there are also global public goods, such as preventing climate change, that require coordinated action on the global scale.

The problem of public goods is to match the group of people who *use* them to the group of people who *pay for* them. This implies allocating public expenditure to the tasks, functions and objectives of the government and mobilizing the resources required to attain the objectives. This is a tougher problem than it sounds. Ultimately, it relates to the issue of democracy and federalism.

The Functions of Public Finance

Public finance is the branch of economics that deals with the mobilization of resources for the provision of public goods and the consequences for economic welfare and development. This means the government must set priorities for public spending, decide how it can pay for them, and consider the effects it may have for the development of the private sector. However, the government operates through its institutions at different levels. Public sector reform seeks to assign clear purposes to these institutions so that they can fulfil their functions and to allocate the appropriate amount of resources for their purposes, and so that the public goods are supplied efficiently without taxpayers paying too much. Hence, an efficient system of public finances will avoid waste and corruption. Economic theory assigns three distinct functions to public finance: the allocation function, the distribution function and the stabilization function. The issue of public debt covers all three of these functions.

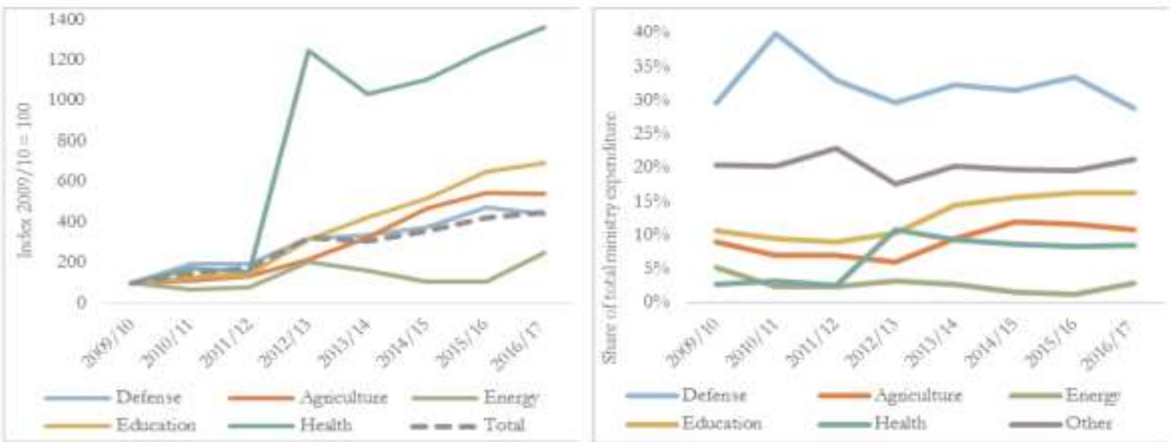
The allocation function

The Government's budget allocates public funds to specific tasks, such as improving energy and electricity supply, education, health, transport, agriculture and forest conservation, defence or supporting industry and construction. According to the World Bank, the share of public expenditure in GDP has varied word-wide between 25 and 30 percent over the last decade, but in Myanmar it is below 22 percent. These allocations reflect the political and social priorities of given governments; in Myanmar, budget priorities are now changing from previous military rule towards a democratic government.

The instrument by which the government implements the allocation of funds to specific tasks is the government budget, an annual financial statement presenting the government's proposed revenues and spending for a financial year. The Finance Minister presents the budget, Parliament votes it into law, and the President approves it. The presentation of the Myanmar government budget is not yet fully compatible with international standards, such as the International Monetary Fund's (IMF) Government Financial Statistics framework,[11] but here are some data. Health Ministry spending has seen the biggest increase over the last decade, followed by Education and Agriculture. Between 2009-2010 and the 2016-2017 approved budget, spending for these ministries grew at a faster pace than spending for ministries as a whole. As a result, their overall share has increased. See Figure 1.

Figure 1.

Spending growth (Index, 2009/10 = 100) Spending share (% of total ministry)



Source: (World Bank Group 2017)

Compared to countries at similar levels of income, Myanmar spends a larger share of GDP on defence and a smaller share on health, education, social protection and economic services. This is due to a combination of a relatively small General Government and the crowding out of nondefense priorities in the Union Budget. The World Bank has argued that Myanmar could benefit by a gradual rebalancing

[11] For example, the budget should accurately report both the 'stock' and 'flow' of a government's economic resources and activities by entity and type so as to allow analysis of government activity, fiscal sustainability and liquidity. See (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, pp. 17-18). Annex I reproduces the explanations by the (World Bank Group 2017)

towards nondefense priorities: an extra Kyat allocated to economic or social functions could have a higher marginal impact on citizen's welfare, than an extra Kyat added to an already large defence allocation.[12] This advice has apparently found its way into the budget priorities of the NLD-led government that took over in 2016.

Another aspect of the allocation function is how much of public resources are used to keep *recurring* expenditures going and how much is spent on public *investment*. Recurring expenditure, largely for wages and salaries and the consumption of public goods, represents by far the largest share. Public investment is necessary to build up the infra structure that the private and public sector require for their efficient functioning. In Myanmar, this is largely done by the Ministry of Construction and Public Works department. Yet, despite significant public investment needs, capital spending in Myanmar is low and falling. During the recent fiscal adjustment, which wasaimed at reducing inflation, public investment has declined from 7.6 percent of GDP in 2013/4 to 4.7 percent planned in 2017/18. The efficiency, i.e. the marginal product, of capital spending in Myanmar could be high given existing low levels of public infrastructure.[13]

As an inheritance from the socialist and military rule, State-owned Economic Enterprises (SEEs) are implementing an important part of the allocation function in Myanmar’s public sector. While the total public sector covered 20.2% in the fiscal year 2014/5, SEEs used to provide half of it, although their share is diminishing and now only one third. This shift has negatively affected spending on capital and has, therefore, lowered the long run growth capacities of Myanmar. Higher investment by the Union government could remedy this development, but this requires higher tax income and improved fiscal management. As we shall see, the narrow fiscal space, i.e. the limited capacity of the government to allocate public goods, is a consequence of the need to keep the overall economy stable and reduce inflation, but a reform of the tax system could help to overcome some of these problems.

The distribution function

Public finances have a *distribution function*, both in terms of how big the public sector ought to be in relation to the private economy and in terms of “who pays for what?”. In a market economy, the distribution of private goods follows the incentives of prices and costs that ensures that resources are efficiently used and consumers can satisfy their preferences subject to their budget constraints. However, as we saw, the market mechanism may not work optimally. On the one hand, the existence of externalities can cause market failure. On the other hand, the growth dynamics between different regions and sectors of the economy and the resulting distribution of ownership in resources, money, income and wealth may be unacceptable when it violates basic notions of social justice. This can lead to social unrest, which cannot be contained by military force and has damaging effects for economic development. For this reason, governments must support the poor and redistribute resources in order to create equitable social conditions in the economy. This is the purpose of a social market economy.

The classic instruments for redistribution policies are progressive taxation and regional transfers. While progressive taxation and social security insurance are mechanisms for individual income redistribution and risk sharing, regional transfers through the government’s budget as proposed by fiscal federalism are mechanisms for the collective redistribution between regions and groups of

[12] (World Bank Group 2017, p. 34)
[13] (World Bank Group 2017, p. 43)

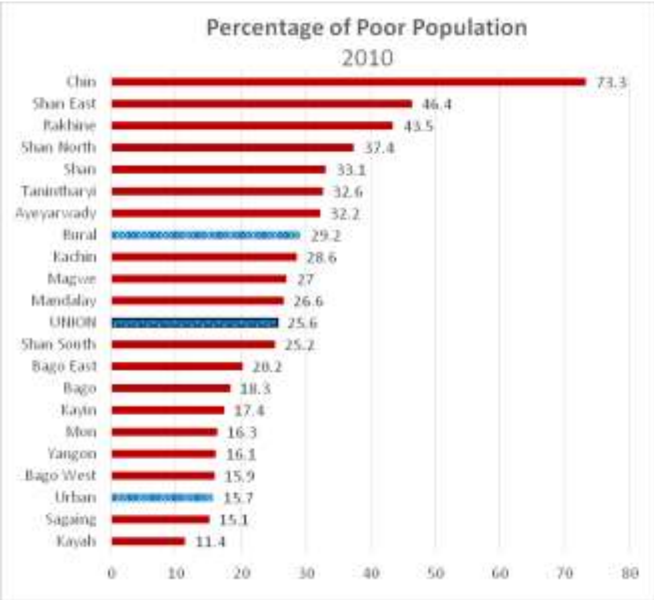
populations. They will be discussed below, but in essence they imply that richer regions and states help poorer regions to develop more rapidly.

- *Progressive taxation* means that people in higher income groups will pay higher rates of taxes on their income than poor people. The argument is that an additional 1000 kyat of income has a higher utility for someone who only earns one lakh (MMK 10,000) than for someone who earns a crore (MMK 10 million).
- The 2017 Union Tax Law has confirmed progressive taxation of personal income with the lowest bracket of 0% for incomes between zero and MMK 2 million (USD 1666) per annum and a top rate of 25% for any income above MMK 30 million (USD 25,000). With that, Myanmar lies in the lower middle tier of tax rates in the world.
- Other instruments to reduce social inequality are social security contribution and the allocation of public goods for specific groups of the population, for example public housing available only for low income groups. The rates of the monthly contributions by the employer and employees are 3% and 2%, respectively, of an employee's total salary including benefits (capped at a maximum monthly salary of MMK 300,000). In many industrialized countries, redistribution is ensured by the collective insurance system of the social welfare state, but due to the scarcity of resources in developing countries, governments more frequently focus on anti-poverty programs that improve the skills and capacities of low-income groups.

An important aspect of public finance is people's *ability to pay*. When household income is close to the subsistence level, the fiscal space for taxing people is limited. As the economy prospers and a vibrant middle class and rich entrepreneurs emerge, the capacity of the government to raise money for public goods increases. In Myanmar, urban areas, especially Yangon and Mandalay, are more prosperous; only 15% of the urban population is considered poor. Poverty is concentrated in the rural areas, where 70% of the population live, of which 29.2% are poor. This means that one quarter of the population in Myanmar would be too poor to pay taxes of any significant amount.[14] However, in some States and Regions the levels of poverty are far higher. See Figure 2. In these parts of the country, the tax base, which could be tapped for local development, is extremely limited, and therefore the central government must transfer resources for the provision of public goods. Thus, transfers are a method for regional redistribution through the budget.

[14] The data quoted here are based on (UNDP June 2011). They give a broader assessment of poverty criteria than the World Bank's Poverty headcount ratio at $1.90 a day (2011 PPP), which claims that only 6.5% of the population were (extremely) poor in 2015.

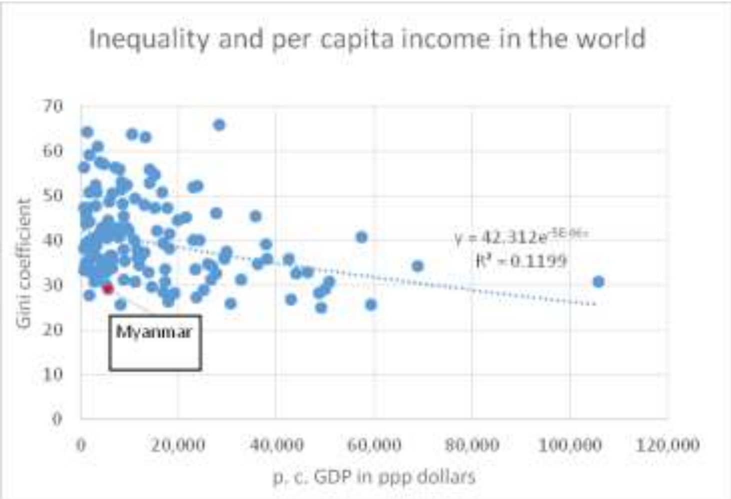
Figure 2.



There exists a general tendency for income inequality to fall as countries become more prosperous, as Figure 3a shows.[15] It is a weak tendency, because there is a wide variety of country experiences, which reflect the endowment of resources and skills as well as political will to rebalance income and wealth. Income inequality in Myanmar is relatively low, although the degree of poverty in Myanmar is the highest in Southeast Asia (see Figure 3b).This implies not only that poverty is a problem that needs to be addresses urgently, but also that there are less rich people who can be taxed to provide services for the poor. This is a major obstacle for the reform of public finance.

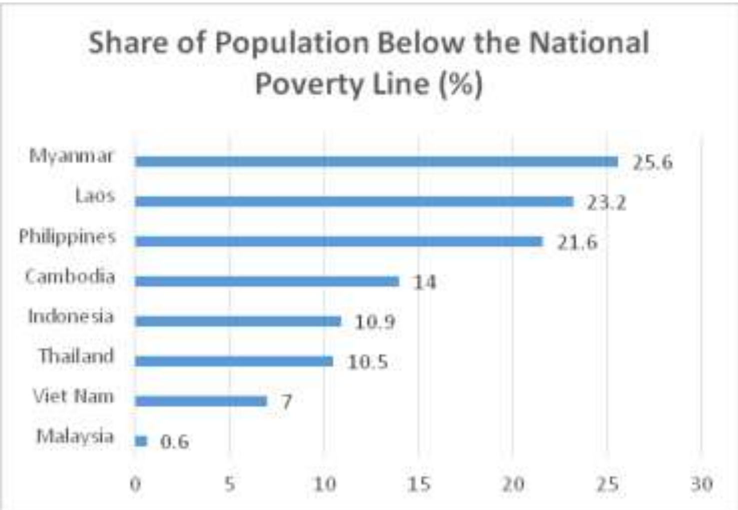
[15] Income inequality can be measured by the he Gini coefficients the most commonly used measure. A Gini coefficient of zero expresses perfect equality, where all values are the same (for example, where everyone has the same income). A Gini coefficient of 100% expresses maximal inequality among values (e.g., for a large number of people, where only one person has all the income or consumption, and all others have none, the Gini coefficient will be very nearly one).

Figure 3a.



Source: own presentation with World Bank data

Figure 3b.



Source: Asia Development Bank

The stabilization function

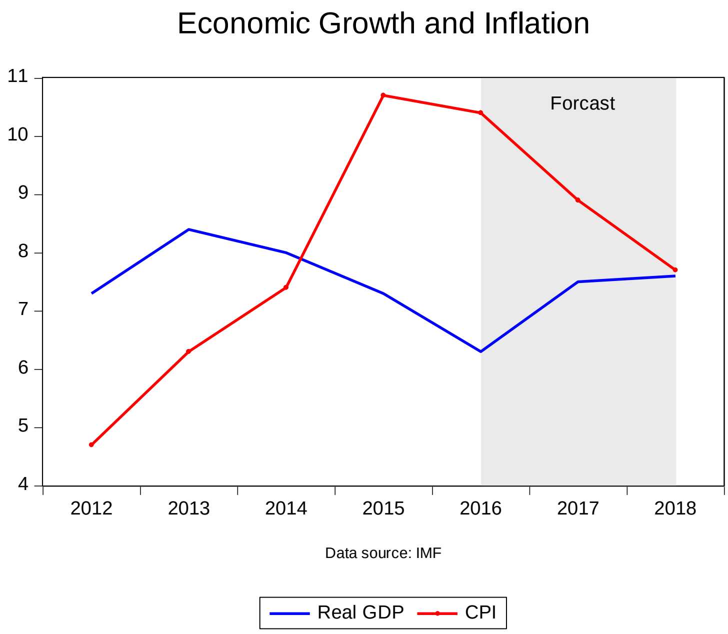
Because spending by governments is a significant proportion of economic activity, fiscal policy has often far-reaching effects for the stability of an economy. Stability is important for it provides the necessary framework for the development of the financial sector, but also in the "real" economy with respect to employment, income, trade and growth. There is no economic development without stable money. In Europe, monetary instability has laid the ground for the rise of fascism in the last century, but Latin America had to learn similar lessons in the 1970s. Inflation is the most evident sign for monetary instability.

High inflation undermines the value of money and deters investment. It also causes losses of competitiveness and an overvalued currency, which will then lead to nominal exchange rate devaluations with high volatility. This is also damaging for domestic and foreign investment. If external borrowing is financing public deficits, foreign debt could become unsustainable and ultimately a debt crisis would destroy a large part of the wealth of the nation. High unemployment is a waste of human capacities and reduces the country's growth capacities.

Excessive money creation causes inflation, and excessive public debt undermines the development of financial markets. Thus, without sound public finance, the government cannot meet the needs of its citizens, but without a stable constitutional state, public finances cannot be sound. Hence, economic and political stability reinforce each other mutually and thereby ensure the long run development and the sustainability of democracy. Knowing how to manage public finance is an indispensable condition for a democratic state.

In Myanmar, inflation is high and public deficits are the main cause for its persistence. At the beginning of 2016, inflation reached 16%, and the government aimed to bring it down to around 7.8% by the end of 2017.[16] The country's fiscal deficit was expected to hit 4.8% of GDP by the end of 2017 and the government sought to ensure that the deficit would not exceed the 5% threshold set by the IMF, under which governments are better positioned to guarantee the fiscal sustainability of their national budgets.[17] Thus, the Myanmar economy seemed overheated and the government used fiscal policy to address macroeconomic imbalances. Such imbalances are damaging economic growth. Hence, together with monetary policy, fiscal policy must aim for price stability, high employment, balanced external accounts and sustainable economic growth. Figure 4 shows the inverse dynamics of inflation and real economic growth in Myanmar.

Figure 4.



Economic stability is a necessary condition for economic growth, but it is not sufficient. Private investment is the driver of growth. Instability and uncertainty are reasons why people keep their assets in liquid cash or in banks abroad, rather than putting their money into the creation of firms, jobs, innovation and the creation of wealth. However, public investment can support and create the infrastructure for private investment. In order to accelerate growth and development, the priorities

[16] The graph in Figure 4 represents annual averages, which hide some of the peeks.
[17] (Turnell 2017)

in the public budget for allocating public goods are crucial, but the ways of financing this expenditure play an important role as well. Ethiopia is the successful case of a country with similar starting conditions as Myanmar that has achieved one of the highest growth rates in Africa. It has significantly reduced poverty by keeping government consumption low in order to finance investment in the public infrastructure.[18] Thus, getting the priorities for public expenditure right is key for economic progress.

In the long run, public investment must be financed by taxes. However, taxation is a burden on investors, consumers and households; it affects investors' return on capital, and changes the distribution of purchasing power and wealth. These effects cause economic agents to abstain from producing or consuming goods and services, and that will affect economic growth and development. All the major international donor institutions have always insisted that economic reforms must improve the efficiency and legitimacy of the public administration of the state and make sure that the government has the resources necessary to service the tasks citizens require.

Besides having long run consequences for economic development, fiscal policy can also be an important tool for stabilizing the economy after sudden shocks. For Myanmar this is particularly important as it is among the countries which are world-wide most exposed to disaster risks such as earthquakes and climate-related hazards.[19] The IMF has found that climate-related natural catastrophes pose major macroeconomic challenges, because loss of life and physical assets affect production negatively and the immediate cash demands after the disaster will strain the fiscal and external position of public finances. Often public funds for reconstruction only become available in the second year after the event. According to UN and IMF estimates such emergencies cause on average material damage in the order of 1 to 2.5 percent of GDP, and Myanmar has been hit by disasters four times since 1991 causing even greater damage. Nargis was by far the worst experience, but the Cyclone Komen in 2015 and the floods in 2016 also slowed down economic growth. Furthermore, the UNDP study[20] shows that one of the major reasons in Myanmar for people falling into transitory poverty are natural calamities. For this reason the government must improve fiscal risk management and provide public finance assistance. This requires well-established rules for *ex-ante*, i.e. planned, flexibility in the budget process and the creation of "fiscal space" by improving the effectiveness of resource mobilisation through a combination of government emergency aid, private sector (especially NGO) support and external aid.

Finally, another aspect of the stabilisation function is anticyclical demand management. It is well-known that in market economies there are periods when the private sector is buoyant and seeks to invest more than is compatible with long run capacities and inflation picks up; there are other periods when demand is insufficient and the economy enters into recession. In those cases, fiscal policy - in interaction with monetary policy - can help to stabilize the economy by closing the demand gap of the private sector. The need of such government intervention was proven during the Global Financial

[18] (World Bank, November 24, 2015)

[19] "Myanmar is exposed to a number of natural hazards, some of which have caused devastating damage in the recent past. According to the UN Risk Model, Myanmar ranks as the 'most at risk' country for natural disasters. Coastal regions, particularly Rakhine State and the Ayeyarwady Delta Region, are at high risk for cyclones, storm surges and tsunamis. Much of the country is also exposed to flooding and landslides during rainy season in addition to drought and fire during dry season. As Myanmar falls on one of the two main earthquake belts in the world, much of the country is prone to earthquake." (http://www.give2asia.org/disaster-preparedness-and-resilience-myanmar-1/). For an in-depth discussion, see (IMF, Myanmar Country Report 17/31. Selected Issues (Financial Sector Reform). February 2017, p. 28-43)

[20] (UNDP June 2011)

Crisis, when countries used fiscal policy together with low interest rates which moved them quickly and successfully out of the crisis.

Deficits, Public Debt, Financial Markets and Economic Stability

When the government's revenue is insufficient to cover the expenditure, it has a deficit and must go into debt. There is nothing wrong in borrowing money to finance public goods or stabilize the economy in the short run. However, what matters is that the deficit remains manageable and public debt remains sustainable. This means that the debt level has to be compatible with economic stability. The key is how the debt is managed. There are three possible sources for public borrowing: savings from domestic households, savings from foreign lenders, and the central bank. The government could also obtain grants from foreign donors.

Due to Myanmar's human rights records and the related international sanctions, foreign aid and grants have been historically low for Myanmar. The country has only opened to international donor institutions since the economic and democratic reform process started in in 2013.[21] However, the volumes are still low. Between 2000 and 2012, the ratio of Overseas Development Aid was in the order of 1-2 percent of gross national income; it jumped up to 6.7 percent in 2013, but has since fallen back to 2 percent. In Cambodia, the ratio is double or triple this amount. This situation could improve if the political situation improved, human rights were respected, and the Peace Process came to a positive conclusion.

The main purpose of government borrowing is to smoothen public income and expenditure, because the timing when tax revenue is collected and when it is spent may not coincide. For example, an improvement of the railway system requires high investment spending now, but the economic consequences for growth and fiscal revenue will only materialize in the future. However, in the long run, income and expenses must balance, for otherwise the debt becomes unsustainable. When the government can no longer service its debt and lenders no longer trust that the government deserves credit, the state will default on its obligations, which means lenders do not get back what they have been promised and the government can no longer provide the services it is supposed to provide to its citizens.

Usually, when a government borrows money, it issues Treasury bonds or Treasury bills, which is a promise to pay back the debt plus interest out of future tax revenue. In emerging or developed economies, such treasury bills (short term) and government bonds (long term) are traded in financial markets. Banks underwrite (guarantee) these securities and then sell them to private or institutional investors (such as pension funds). However, investors will only buy them if they can obtain an attractive return. If the rate of inflation is higher than the interest rate, this is not the case. With high inflation and interest rates repressed by the government it is therefore impossible to develop a properly functioning financial market. Unfortunately, in Myanmar treasury bills are not issued in sufficient volume, as the Ministry of Planning and Finance (MoPF) seems reluctant to pay the T-bill interest rates required to induce larger purchases by banks.[22] Hence, the government remains heavily reliant upon monetary financing from the Myanmar Central Bank.

[21] The World Bank has resumed normal lending relations with Myanmar and the International Finance Corporation (IFC) commenced its investment and advisory activities following the clearance of arrears to the International Development Association (IDA) in January 2013.

[22] (IMF, Myanmar Country Report 17/31. Selected Issues (Financial Sector Reform). February 2017, p. 7)

If private investors do not wish to purchase such government bonds, the central bank can buy them and issue money directly to the government. This is called *monetary financing of the budget deficit*. The monetization of public deficits is the main cause for Myanmar' high inflation. As the IMF explained: "The fiscal deficit widened sharply in FY 2015/16, reaching 4.1 percent of GDP. This increase resulted mainly from a decline in revenues from underperforming State-owned Economic Enterprises (SEEs), on the back of lower energy prices and inefficiencies, as well as a rise in public sector wages. In net terms the deficit was entirely financed by the Central Bank of Myanmar (CBM) through automatic purchases of treasury bills".[23] According to the IMF, the monetization of public debt explains 25% of all inflation shocks, including food prices, exchange rate variations and inertia from the past.

The distorted banking system

The appropriate strategy for reducing the dependency on monetized public debt is to develop financial markets. However, the banking system offers an alternative. In Myanmar, banks have been a major vehicle for governments to close the financing gap between expenditure and public revenue. As long as financial markets remain underdeveloped, banks serve as the main intermediary by which savings are channelled to investors or governments. State-owned banks provide loans to State-owned Economic Enterprises and thereby finance the budget indirectly. The four state-owned banks still account for nearly half of the banking sectors assets, with their lending largely targeting the state sector and large firms. As a consequence, a large share, 49% in 2015/16, is lent to the government, with 80 % coming from the Central Bank of Myanmar and the remainder mainly from the state-owned banks. This has created important distortions between the urban and rural economy and large and small enterprises.

Because financial institutions are lending to thee government, they do not help with the development of the economy. Despite the rapid expansion of the financial sector in recent years, current levels of savings remain low in Myanmar with nearly two thirds of the population reporting no savings at all.[24] Partly this can be explained by the high poverty levels discussed above (see Figure 2), but because inflation has always been high, and real interest rates were repressed to low levels, but incentives to save have been weak, too. More than 3.5 million farmers have no access to credit, which they would require for seeds and fertilizers. As a consequence, rural households and small and medium enterprises have very low access to credit, which hinders economic growth. While the agricultural sector represents 30 percent of GDP and employs 54 percent of the population, only about 2.5 percent of all outstanding loans are made to this sector.[25] Hence, an efficient and equitable system of taxation would liberate financial resources for the development of the economy and reduction of poverty. This is problematic not only because it fuels inflation, but also because it prevents the development of a growing middle class that could become the source for a larger fiscal space. Thus, the way the budget deficit is financed is crowding out private investment. The remedy would be to reduce the dependency of the Union Government on the banks.

[23] (IMF, Myanmar 2016 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Myanmar February 2017, p. 5) See also below, Table 2, Overview.
[24] (IMF, Myanmar Country Report 17/31. Selected Issues (Financial Sector Reform). February 2017)
[25] These data are from (IMF, Myanmar Country Report 17/31. Selected Issues (Financial Sector Reform). February 2017, p. 16). Other sources say agriculture represents 38 or even 45 percent of GDP and over 60 or 70 percent of the population are employed in agriculture. See: (Zorya 2016) and http://www.oxfordbusinessgroup.com/news/agriculture-myanmar-struggles-grow-its-potential

While it is true that the monetization of the deficit creates inflation, there is a trade-off for high inflation insofar it keeps interest-bearing public debt relatively low and sustainable.[26] The public debt to GDP ratio is close to 20% in Myanmar, compared to an average of 55% for South Asia, 29.3% in Thailand and 187% for Japan. In the Euro Area, fiscal rules set a debt/GDP ratio of 60% as the upper limit. As economic reforms take place in Myanmar, and the economy moves into an environment with stable money and sound fiscal policy, considerations of public debt management will become more salient and the debt ratio is likely to increase. Hence, the reform of public finance is an indispensable element in the strategy for economic growth, development and the transition to a modern economy.

Issuing public debt to private investors and accepting to remunerate them by market-determined interest rates would impose new constraints on fiscal policy. For it implies that the future interest burden and the debt service must be financed by higher tax revenue. Borrowing in order to pay back debt and interest is an unsustainable "Ponzi scheme".[27] Public debt is only sustainable when the government budget net of interest payments covers the difference between the debt service and the additional income growth generated by the economy.[28] For this reason, it is of great importance that fiscal policy contributes to the general economic balance and supports economic growth.

While monetary financing has effectively allowed previous governments in Myanmar to spend more than it was able or willing to collect in taxes for decades, the new government has indicated that it intends to phase out monetary financing and wishes public debt be ruled by market-determined interest rates in order to attract investors to Treasury bills and bond auctions. This would be a step forward towards the emergence of genuine financial markets as they exist in the more advanced neighbouring ASEAN countries.

With a growing economy, the share of poor people would fall and a more prosperous middle class would emerge. This would start a virtuous circle, whereby the middle class would be able to pay more (not necessarily higher!) taxes, thereby reducing the dependency on monetary financing, which would re-inforce the positive conditions for growth. Furthermore, a strong middle class is the sociological foundation of a modern democracy.

Democracy and Public Preferences

Parliament authorises the allocation of public funds to the supply of public goods in the Budget Law, which determines how much money is to be spent on different goods and how this is to be financed. The budget therefore reflects a choice between whether the government ought to produce public goods, or buy them from private suppliers, or even buy them abroad. For example, the government may set up public hospitals by a system of national health care, or it may subsidize hospitals run by NGOs, and it may import the necessary medicine. Yet, it is the purposes and ends of government objectives which must drive the allocation of public funds. Given that all citizens collectively contribute to their financing within the limits of their capacity, the objectives are the result of the democratic

[26] See (IMF, Myanmar Staff Report 17/30 for the 2016 Article IV Consultation—Debt Sustainability Analysis December 2016)

[27] A Ponzi scheme is a fraudulent investment operation where the operator generates returns for older investors through revenue paid by new investors, rather than from legitimate business activities or profit of financial trading. The scheme is named after Charles Ponzi, who became notorious for using the technique in Boston in the 1920s.

[28] The formula for sustainable debt is: $s > (i - g)$, where s is the budget position net of interest (also called primary surplus), i is the effective interest rate paid on government debt and g is the growth rate of the economy. For details, see (Collignon, Fiscal Policy Rules and the Sustainability of Public Debt in Europe 2012).

choices of what citizens want. The American Revolution put this idea into the slogan: “No taxation without representation”. Without the democratic foundation of collective choices, citizens are forced to pay taxes to which they have not agreed. This is not sustainable because this is a tyrannical state, which will be continuously challenged by discriminated minorities and disrespected citizens.

A dictatorial regime sets the objectives for the government in such a way that it serves the narrow interests of a small elite or a group of oligarchs. Democracy is a mechanism to establish which public goods and how many of them are desirable for the community. The transition from an authoritarian state to a modern democracy, in which Myanmar is presently engaged, requires a reform of the public sector as well as an efficient system of public finance.

Modern democracies are representative democracies, where parliaments vote on the budget proposed by the government. The government has the administrative insight to judge how much money is necessary to accomplish its tasks. However, before the budget is turned into law, the parliament can still make changes to the proposal of the government, if the public and citizens concerned request that from their representative. Hence, the vote of the budget is the most important act of a democracy, because it will reflect the collective preferences that emerge from public debates.

The rationality of fiscal policy

The allocation of resources to public goods must be rational and efficient. This means, it must follow simple rules that are easily understood by all citizens and can be implemented without ambiguity. All public choices require clear criteria for delimiting the competences of government levels and the areas of application of resource use. This requires key planning tools like strategic planning, a medium term budget framework, and multiannual budgets. To the degree that State and Regional governments have budget autonomy, these instruments must also be available for them at the sub-national level. Myanmar has embarked on a path to achieve greater effectiveness in the allocation of public goods, but there is still a need to improve them more – especially at the level of State and regional governments.

Costs and benefits ought to be evaluated and publically debated in order to reflect the preferences of citizens and of groups of citizens. In a democracy, this evaluation takes place through free public debates among citizens, to which NGOs, interest groups and political parties contribute. Public debates and, ultimately Parliament as the representation of all citizens, will define what the government’s objectives are, but even in democracies it is not always obvious, which goods are collectively desirable. Conflicts are inevitable. For example, a young family may prefer education for their children, but a retired person may wish for better health care. Supplying both public goods may overstrain the fiscal capacity of the state to tax citizens, so that the government must set priorities and make choices. The political process enshrined in the constitution, such as majority voting, will then decide what the government ought to do. However, as John Stuart Mill pointed out more than 150 years ago, in proper, liberal democracies human rights must protect individuals against the “tyranny of majority”. Markets and the private sector ensure that individuals can exercise their preferences and choices freely.

Assuming that the objectives for government actions reflect the democratic preferences of the people, the fundamental question remains who should spend the money and how much. The “who-question” is at the core of so-called fiscal federalism. The how-much question determines the balance between private and public sectors. However, this balance varies over times. It is not permanently fixed, but subject to political debates and preferences. Economically right wing liberal parties usually seek lower public sectors, left wing political parties often demand more public goods. These cleavages also show up in the debates about federalism.

Free markets for private goods are often criticized when the provision of private goods is violating the fundamental sense of social justice. Because the market mechanism excludes the poor who are not able to pay (because they have no money), market economies are often haunted by considerations of social justice. This is particularly problematic when it concerns a large population of poor people. In developed economies, especially in Europe, the concept of a *social market economy* and the emergence of the welfare state have been the answer to correct growing inequalities, but, as an unintended consequence, this has significantly enlarged the public sector. The average net total social expenditure in the OECD countries is 21% of GDP, equivalent to the total public spending in Myanmar, whereaccording to the 2016 Budget Law, spending on social welfare, including pensions, is less than 0.2 percent of the budget and 0.04 percent of GDP.

Social justice and fairness have always been important in Myanmar's history. Hence, the fair distribution of wealth is a public good in itself. Equity and fairness contribute to social harmony, peace and welfare. They are the foundation of the Union. The anti-colonial movement in Burma and Southeast Asia was driven by the growing inequalities and injustices generated by the colonial monetary economy and the opposition to the "Western" colonial system.[29] Yet, the *Burmese Way to Socialism*, which was the alternative to the market economy, has failed. In order to ensure the success of the now newly emerging monetary economy and to preserve its sustainability in the long run, social policies must ensure that wealth is fairly distributed. Such redistribution is the task of a democratic government, too.

Federalism

If democracy generates collective preferences, the process is fragile and the outcome is not always free of tensions. Federalism is a mechanism to make democracies more robust. It maintains unity in diversity. Political federalism recognizes that the preferences for some public goods are dependent on cultural and geographic factors that change only slowly and only conflict with the beliefs and preferences of the other groups. For this reason, federalism has been called "the best system for integrating diverse nations, ethnic groups, or combatant parties, all of whom may have cause to fear control by an overly powerful centre."[30]

Federalism is a mixed mode of government, combining the central government with regional and local governments (provincial, state, cantonal, territorial or other sub-unit governments) into a single political system. It is a normative theory for allocating the division of responsibilities between different levels or bodies of government. The constitution assigns competences and political power mechanisms to the centre and to regions and states. Fiscal federalism is the economic realisation of political federalism.

Federalism is associated with decentralization. The literature distinguishes different forms of transferring responsibilities between levels of government.[31]

- *Decentralization* is the process when the central government loses power and competences in favour of local administrations; when it gains competences, it is *centralization*.

[29] See (Scott 1976).
[30] (Meyer-Resende 2017)
[31] See (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015)

- *Delegation* is the shifting of functions to semi- or wholly-independent organizations outside the core government sector (for example, to independent authorities like the central bank, or in privatization to private firms). Transnational cooperation like in the European Union or in ASEAN uses delegation to transnational institutions to accomplish specific tasks.
- *Devolution* is a situation in which local government has autonomy over decisions and functions and is held accountable for those decisions by local people through elections, although the central government remains formally in charge and can take powers away from local authorities at any time.
- *Deconcentration*, or vertical decentralization, is the assignment of functions and resources to lower administrative levels of a central organization (typically a ministry), with accountability for these functions still being to the central authority. The relation between some Union Government ministries and Regional or State government ministries are manifestations of deconcentration. Some studies argue convincingly that the so-called decentralisation of the Myanmar 2008 Constitution has effectively been a form of deconcentration.[32]

In the United Kingdom, which does not have a written constitution and is formally a unitary state, *home rule* for Northern Ireland or the creation of Scottish and Welsh parliaments were acts of devolution and are not manifestations of federalism. This has created the haphazard system, where England is represented by the Westminster Parliament alone, which has members of parliament from England, Northern Ireland, Scotland and Wales and legislates simultaneously for national public goods and for purely local English goods.

Unfortunately, the British system, which gave England as special status at the centre, was reproduced by Burma's first constitution in 1947. General Aung San reflected on the issue: "When we build our new Burma, shall we build it as a Union or as a Unitary State? In my opinion, it will not be feasible to set up a Unitary State. We must set up a Union with properly regulated provisions to safeguard the rights of the national minorities". In his classic work *Burma's Constitution*, Dr. Maung Maung mentioned that the intention of General Aung San and the Founding Fathers of the Union at Panglong, was as follows: the Union States, i.e. Chin, Kachin, Karen, Karenni, Mon, Rakhine and Shan States, should have their own constitutions, their own organs of state, viz. Parliament, Government and Judiciary.[33] "Burma proper" was not a state under a federal government, so that – like in England – the central government was simultaneously the government for Burmans and for the nation. This confusion has undermined the loyalty to the state in post-independence Burma and contributed to the disintegration of the Union. In reaction to this process, the 1974 constitution set up a unitary state, which did not accommodate the ethnic groups and generated civil war.

The 2008 Constitution has set up 7 States for ethnic territories and 7 Regions for Burma proper. This is a step in the right direction, but in reality, the degree of autonomy is extremely reduced for these sub-national administrations and is best described as deconcentration. Deconcentration is the weakest form of decentralization. To see in which way this system could evolve into a genuine federal constitution, we may look at the American and German benchmark models of federalism. The American system of vertical federalism is based on the oldest still valid written constitution in the world; the German system is grounded in ideas of decentralisation that go back to the 16th century. This shows the robustness of these federalist constitutions.

[32] See (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, pp. 46-47)
[33] Quoted from (Williams, David C. and Sakhong, Lian H. 2005, p. 40)

Models of federalism

Federalism describes a clear hierarchy: the Union or central government is responsible for the nation as a whole; the subnational bodies administer specific tasks with respect to geographic territories. The legislation regulates the administration and allocation of national and regional pubic goods. When it is possible to separate these responsibilities, each level of government can act autonomously. In a federal state, the subnational governments have the right to legislate unless their laws are in contradiction with the national laws.[34] However, in reality, there are many overlaps due to different externalities from different public goods and this requires institutional forms of cooperation between government levels.

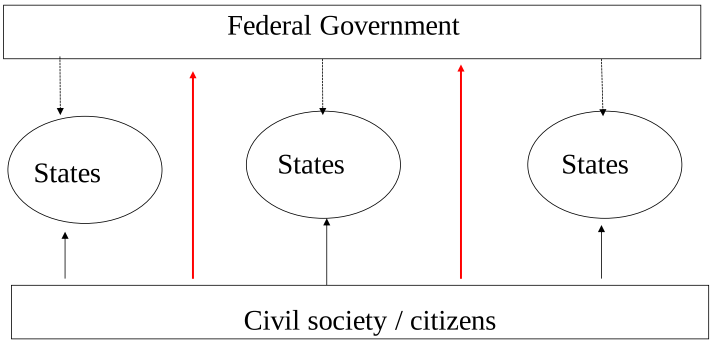
The United States of America and the Federal Republic of Germany represent two opposite forms of federalism. In the USA, federal and State competences are clearly distinct. For example, the FBI is a police force that enforces federal laws all over the territory of the USA, while state police can only operate within a given State. Citizens separately elect representatives for the Federal, State and municipal governments, each of which has clearly distinct responsibilities. Thus, citizens, as the owner of public goods, exercise their power over the allocation of these public goods directly through their representatives.

The US model is vertical federalism, because the competences are hierarchically ordered in accordance with the reach of public goods. It corresponds to vertical fiscal symmetry with respect to the financing of public goods, as we shall discuss below. At the top are those national public goods, which reach all American citizens, such as defence, foreign policy or interstate highways and trade; at the bottom are those, which are confined to some specific locality, like schools hospitals, bridges, etc. The federal government administrates national public goods, States and municipalities take care of local public goods. Federal law breaks state law. See figure 5.

Figure 5.

[34] For example, the German constitution stipulates in Article 70 [Division of powers between the Federation and the Länder (states)]: “(1) The Länder shall have the right to legislate insofar as this Basic Law does not confer legislative power on the Federation. (2) The division of authority between the Federation and the Länder shall be governed by the provisions of this Basic Law concerning exclusive and concurrent legislative powers.” And Article 72 [Concurrent legislative powers] says: “(1) On matters within the concurrent legislative power, the Länder shall have power to legislate so long as and to the extent that the Federation has not exercised its legislative power by enacting a law. (2) The Federation shall have the right to legislate on matters falling within clauses 4, 7, 11, 13, 15, 19a, 20, 22, 25 and 26 of paragraph (1) of Article 74, if and to the extent that the establishment of *equivalent living conditions throughout the federal territory* or the maintenance of *legal or economic unity* renders federal regulation necessary in the national interest.” See https://www.gesetze-im-internet.de/englisch_gg/englisch_gg.html#p0367

The US Model of Vertical Federalism



This is different in Germany, where the federation is more integrated. The whole state of Germany (*Gesamtstaat*) represents the nation and consists of the federal government and the local States (*Länder*). In Figure 6 this is represented by the red triangle. For some public goods, policy competences are clearly assigned to either the Federal or the State level, but often they are mixed. Citizen elect the federal and State governments, but national legislation is the outcome of a cooperative process between the *Länder* and the federal government. The German federal government is elected by the federal parliament, the *Bundestag,* but State governments have their own national parliamentary chamber, the *Bundesrat*, and they must cooperate with the Federal Government.[35] This implies that State governments assume responsibilities for the whole of Germany. Their competences are shared in many areas and not separated by the functions of externalities as in the USA. This system is also different from Myanmar, which is closer to a unitary state where the Union government takes full responsibility for all levels of government, including States and Regions.

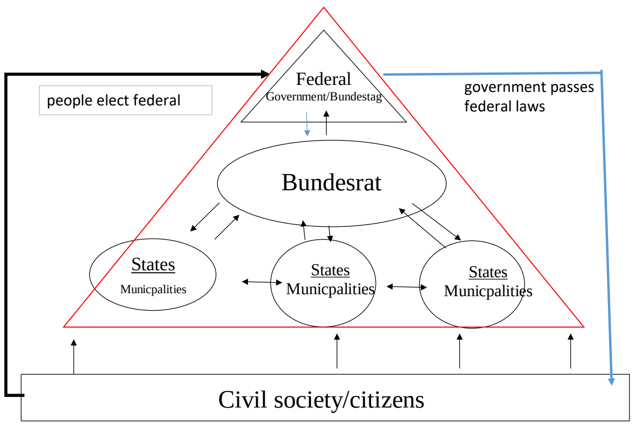
As in the American case, there are some areas where only the federal government or only State governments have exclusive responsibilities. For example, only the federal government can represent the Federal Republic internationally, but education is under the authority of the State governments. Nevertheless, at least two thirds of national legislation and all legislation that affects the finances of the States must be approved by the Upper House (the *Bundesrat*). This chamber can block laws passed by the national parliament (the Bundestag). However, the States must also cooperate among each other horizontally. As we have discussed above, local policy decision can generate externalities, which are causing inefficiencies. In the German federal system, they are overcome by horizontal cooperation between the *Länder*. Within the upper House of the Bundesrat, State governments negotiate consensual solutions – often in compromises with the federal government - that then apply to the nation as a whole. For example, while States have the power to organise school and educational

[35] The *Bundesrat* ("Federal Council") is the legislative body upper chamber that represents the sixteen *Länder* (federated states) at the national level. The Bundesrat participates in legislation, alongside the *Bundestag*, the directly elected representation of the people of Germany, with laws affecting state. The legislative authority of the *Bundesrat* is subordinate to that of the *Bundestag*, but it nonetheless plays a vital legislative role. The federal government must present all its legislative initiatives first to the Bundesrat; only thereafter can a proposal be passed to the Bundestag. Further, the Bundesrat must approve all legislation affecting policy areas for which the Basic Law grants the *Länder* concurrent powers and for which the *Länder* must administer federal regulations. The Bundesrat has increased its legislative responsibilities over time by successfully arguing for a broad, rather than a narrow, interpretation of what constitutes the range of legislation affecting Land interests. Constitutional changes require an approval with majority of two thirds of all votes in Bundestag and Bundesrat, thus giving the Bundesrat an absolute veto against constitutional change of competences. See: https://en.wikipedia.org/wiki/Bundesrat_of_Germany

facilities and curricula, the jointly determined educational standards which establish a level playing field for the highly productive German skill machine. This system has its historic roots in the process of German unification in the 19th century, when local states created the German Reich by funding the central government out of their own resource.[36] The advantage of this system is that regional identities strongly influence the German state as a whole; the drawback is a bureaucratic bias in favour of government administration, while citizens' control of policies is less influential than in the USA. As we shall see below, this structure of horizontal cooperation has also consequences for the transfer system under fiscal federalism.

Figure 6.

The German Model of Horizontally Decentralizing Federalism



Source: Own elaboration based on (Jeffrey 1998)

In all federal systems, the constitution assigns competences to the different levels of government and determines their fiscal responsibilities. The 2007 Myanmar constitution does so in Schedules I, II and V, which are reproduced here in Annex II. It established the framework for administration and representation at one subnational level only—that of the 14 States and Regions (plus the Union territory of Nay Pyi Taw) — although it does mention smaller subnational groupings. See Table 1. However, in reality the Districts, which combine collections of townships and villages, are probably more important for the provision of local public goods in Myanmar.[37] Table 1 shows the distribution of administrative units.

[36] This was not an entirely peaceful process, for the states were conquered by Prussia and forced to comply. Nevertheless, the system was set up as a central government financed by the states. The expression was that the Reich (centre) was living at the expense (it was the *Kostgänger*) of the Länder.
[37] (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, p. 10)

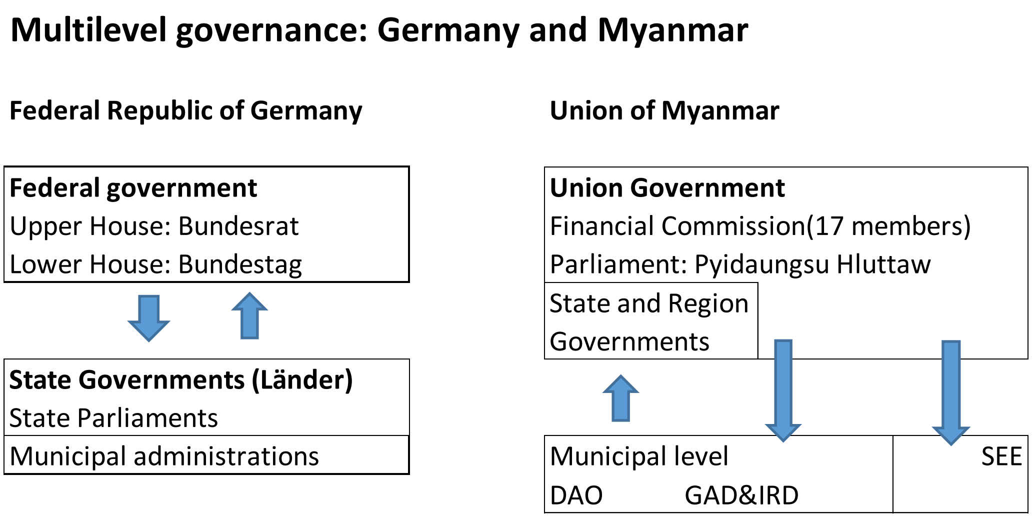
Table 1. Area and Administrative Units by Region and State

	AREA (km^2)	DISTRICT	TOWNSHIP	TOWN	WARD	VILLAGE TRACT	VILLAGES
UNION OF MYANMAR	676,552.70	74	330	442	3,301	13,588	63,798
KACHIN STATE	89,038.58	4	18	30	160	596	2,547
KAYAH STATE	11,731.10	2	7	8	37	74	56
KAYIN STATE	30,381.67	4	7	18	86	376	2,097
CHIN STATE	36,017.58	3	9	15	46	469	1,363
SAGAING REGION	94,621.07	10	37	46	238	1,754	6,000
TANINTHARYI REGION	43,343.34	3	10	17	87	264	1,228
BAGO REGION	39,403.00	4	28	51	325	1,410	6,441
MAGWAY REGION	44,818.96	5	25	30	184	1,535	4,781
MANDALAY REGION	29,954.33	7	28	28	271	1,415	4,779
MON STATE	12,296.19	2	10	16	100	368	1,153
RAKHINE STATE	36,776.72	5	17	26	170	1,035	3,738
YANGON REGION	10,170.89	4	45	21	743	619	2,126
SHAN STATE	155,795.72	13	55	85	505	1,566	14,334
AYEYARWADY REGION	35,136.05	6	26	43	292	1,920	11,910
NAY PYI TAW	7,067.50	2	8	8	57	187	795

Source: Kraas, Frauke; Regine Spohner; Aye Aye Myint 2017

One important difference between the subnational relations in a genuine federal model like Germany and the practices in Myanmar are the relations between the three levels of Centre-State-Municipality. In Germany, States are autonomous within the constitutionally assigned framework of responsibilities. Municipalities, which are the third administrative level, are considered to be fully integrated parts of the States (*Länder*), and the Länder contribute to their financial funding – not the federal government. By contrast, in Myanmar the States and Regions are essentially part of the Union Government, while the districts are often the organs to implement the Union Government's decisions. However, DAOs operate at township-level. They can levy taxes and have a great discretion over the use of revenues they collect. Although they are not autonomous, they are the foundation from where citizens' preferences are moving bottom-up to the Union Government. Moreover, the State-owned Economic Enterprises are effectively a bridge over and above the State and Region, because they provide direct access for Districts and Townships to the resources from the Union Government. This structural difference is drawn by the charts in Figure 7.

Figure 7.



However, while the Myanmar Constitution defines administrative responsibilities and tax competences in its Schedules I and II and V, the actual responsibilities for using and mobilizing resources at the different government levels remain unclear. No further legislation has been formulated or approved how to translate the constitutional provisions into greater detail, and by default, subnational responsibilities and arrangements are mainly governed by a range of pre-existing regulations and by established practices, which have not been fully documented.[38] These practices resemble the ancient patron-client relationships with little transparency and dark areas for corruption. Power remains essentially with the Union government.[39] This lack of clear competences generates a climate of insecurity which is a major obstacle for private investment and therefore for economic growth.

Due to the highly centralized economic policy in Myanmar, an inheritance from the *Burmese Way to Socialism* and military rule, many observers have emphasized the need to decentralise decision-making. Furthermore, if the Peace process is to be brought to a successful conclusion, it will be necessary to transform the present constitution into a genuine Federal Union, which would give States and Regions greater economic power and satisfy the needs of ethnic minorities. A properly working system of federalism will overcome the temptation of regional secession and allows satisfaction of the collective preferences in a region. Such a system must follow appropriate rules for allocating resources and public goods. Kenya is a successful example for how decentralization has lowered the level of social and political tensions, because opposing political parties have gained influence at different administrative levels.

Box 1. Devolution in Kenya

According to the World Bank,[40] "Kenya's decentralization is among the most rapid and ambitious devolution processes going on in the world, with new governance challenges and opportunities as the country builds a new set of county governments from scratch.

Promulgation of the Constitution of Kenya 2010 marked a momentous point in the country's history. The Constitution provided for, among others, enhanced checks and balances within the government, an enhanced role of Parliament and citizens, an independent judiciary, and a most progressive Bill of Rights. Notably, the Constitution provided for a major devolution—not only of resources and functions, but also creating a whole new layer of county government.

The sweeping changes in Kenya's policy and institutional framework have brought about a new regime of governance. Multiple new laws have been put in place—including new legislation on county government, urban areas, public financial management, and the transition to devolved government—as well as multiple national bodies and commissions with responsibility for devolution".

Decentralization and subsidiarity

In Myanmar, the debates around federalism often focus on cultural and ethnic identities. While this has a long history and is justified by leftovers from the colonial times, unfortunately this rarely coincides with the functional criteria for economic rationality or efficiency. This is most evident in the

[38] (Shotton, Roger; Zin Wint Yee; Khin Pwint Oo 2016, p. ii)
[39] See Schedule I and II of the Constitution.
[40] *Source:* (The World Bank (Website) [2017]) *See also the in-depth studies mentioned on this website*.

case of ethnic minorities, which have different traditions, languages and religions. These identities deserve protection, for they can contribute to the pluralism of a vibrant and innovative society. A successful political Union is a society where individuals and different groups are confident that they can participate fully to advance living conditions for themselves and everyone else. The West has become rich and remains powerful, because it values and protects pluralism. Markets offer entrepreneurial individuals the best opportunity to make a difference, and governments do not exist in order to "rule", but to empower people who affirm their individual identities.[41]

Theories of decentralizing federalism have followed this logic arguing that decentralisation will achieve higher welfare when people's preferences are heterogeneous in different jurisdictions, so that decentralised governments in different jurisdictions can accommodate different local preferences for the provision of public goods.[42] However, cultural identities may conflict with the functional efficiency of providing public goods. An autonomous sub-national government may take actions, which carry significant external effects for the neighbouring states and citizens. Efficiency would then require more centralization aimed at reducing these externalities, but this could generate discontent among groups whose preferences are ignored, so that they wish to become independent. A federalist system must strike a balance between these considerations. Decentralization does not invariably improve welfare.

The drawback with a decentralised system is that local governments will necessarily neglect externalities because they look after their own preferences. Benefits going to other districts and thus local public goods will be underprovided in the presence of spillovers. The drawback with a centralized system is that it produces a 'one size fits all' outcome that does not reflect local needs. The Decentralization Theorem states that, without externalities, a decentralised system is preferable. Without externalities, there will be a trade-off between narrow local and wide national public goods, whose resolution depends on the extent of heterogeneity in tastes and the degree of externalities.[43]

In federal states, the balance of competences between the centre and the subnational bodies varies over time. All federal states redefine the relations between the centre and the subnational institutions from time to time. In the United States, the federal government became an important supplier of welfare and educational services under democratic Presidents from Franklin Roosevelt to Lyndon Johnson, but the republican Presidents since Ronald Reagan have transferred many competences back to the states. These shifts were motivated by the ideological desire for increasing or reducing the use of public goods in general. By contrast, Germany has gone through several reforms of its federal system since re-unification in 1990, but they were mainly concerned with the fair redistribution of tax burdens and the need to integrate East and West.

It would be convenient to have clear criteria for deciding which competences ought to be kept at the level of the Union government and which should be decentralised and how to pay for these tasks. The *principle of subsidiarity* is one attempt to provide such criteria. This principle holds that social and political issues should be dealt with at the most immediate (i.e. local) level that is consistent with their resolution. However, in practical terms it fails to give clear guidelines which functions ought to be decentralised and which should be kept at the centre. The *Oxford English Dictionary* defines subsidiarity as, "the principle that a central authority should have a subsidiary function, performing

[41] See the important study by (Acemoglu, D. and J. Robinson 2012).
[42] See (Gadenne, Lucie and Monica Singhal 2014); (Oates 1972)
[43] (Besley, Timothy and Stephen Coate 2003)

only those tasks, which cannot be performed at the local level." The latter definition is confusing, for it does not take into consideration efficiency and externality effects; it does not clarify which tasks can or cannot be performed locally, because it ignores the externality effects that may be generated by local performances. By contrast, if we take the definition of public goods in terms of their externalities, it is easier to see which government level is consistent with their resolution. The proper criterion for defining the competences of different government levels is therefore the reach of public goods.

Fiscal Federalism

Fiscal federalism organizes the economic side of federalism. The principles of fiscal federalism respond to the question: who should pay for public goods? The answer is: in principle everyone who can enjoy their benefits. When the externalities can be clearly separated, the national public goods must be funded from the central government's budget, while local public goods ought to be paid for by revenue raised by local governments and administrations. We call this *vertical fiscal symmetry*.[44] It describes a situation where the decentralised allocation of public goods is financed by decentralised sources of revenue and taxes.[45]

In general, the mobilization of resources and funds can take place at the central level, or at the local levels, or as a combination of both. Because local public goods can themselves generate broader externalities for the nation, either the central or regional governments or both together ought to contribute to the funding of such goods. In this case, we observe *vertical fiscal asymmetry*. The reason for this asymmetry is found in the large regional inequality in incomes that we find in most developing countries. Some regions are rich and could therefore contribute more to the financing of collective tasks; others are poor and have greater needs. Fiscal symmetry would impose unsustainable burdens on the poorer regions and this is why the central government must fund the fiscal gap between local revenue and expenditure.

The theory of fiscal federalism deals with the question how governments may combine fiscal power in order to serve the people. Yet, the experience over the last 30 years of fiscal decentralization all over the world has shown that "ideal type" theories of fiscal federalism are never implemented in practice. There are many models of federalism and what seems to matter most is that the process of decentralization is adapted to the context of specific countries. In the United States, the federal government gives grants to the states; in the European Union, wealthy states transfer structural funds to poorer regions. The German cooperative model combines federal grants with regional transfers between rich and poor states. In Myanmar, most public spending remains under the control of the Union Government.

Hence in reality, fiscal symmetry is rarely feasible. The need for public expenditure will not necessarily coincide with the regional capacity to raise revenue. We have seen the different levels of poverty across States and Regions in Myanmar, and they constrain the fiscal space for subnational administrations. For example, in order to fully integrate the transport system in Myanmar, it may be necessary to build a road in Chin or Eastern Shan State, but the local capacities of raising money are severely constrained by regional poverty. In this case, the central government ought to provide resources that help to develop the poorer regions. We find evidence for this in other countries. The

[44] See (Sharma, Beyond Gaps and Imbalances: Re-Structuring the Debate on Intergovernmental Fiscal Relations 2012).

[45] (Gadenne, Lucie and Monica Singhal 2014) have called the outcome of vertical fiscal asymmetry a *fiscal gap*. The observed that such gaps are more frequent and larger in developing than in developed countries.

limited power of the central government in India has prevented building an efficient national road system across states, while in China the central government has greatly improved the integration of the country.

However, one must take into consideration that taxes to finance these public goods can cause negative externalities. Higher taxes may impede private sector investment and slow down economic growth. If a poor region would have to raise all the financial resources necessary to develop its local economy, the high taxes would prevent private investment and therefore be counterproductive. For this reason, it is important to share the burden of paying for public goods fairly and equitably, without distorting incentives for the private sector. This has important consequences for the distribution functions of fiscal federalism. A high degree of decentralization with exclusive responsibilities for local taxes and revenue-raising powers is likely to generate deep regional inequalities. This poses threats to the stability and integrity of the country. To avoid such dangers, the German constitution proclaims the establishment of *equivalent living conditions throughout the federal territory* as a constitutional principle.[46]

Central government grants and transfers

As the agent acting for the country as a whole, the central government has a range of instrument through which it can direct the overall development, although the interaction with lower level administrations and institutions is complex.[47] We must also emphasize that these powers are subject to the fundamental rights, which protect the autonomy and freedom and equality of citizens. Typically, the government can regulate, subsidize, tax, provide goods and services, and redistribute income. The literature on fiscal federalism lists these instruments:

- The constitution empowers the central government to pass *laws and regulations*, which apply to all subnational institutions. These are fundamental rights like freedom of expression, religion and civic activities, but also regulations regarding the standards of education, healthcare, labour conditions, etc.
- The central government may assume the responsibility for *directly producing public goods* that are benefitting the nation. This is the case for the classic public goods of providing security through national defence and police forces (provided they come under the control of the democratically elected government and the constitution grants protection of basic human and political rights). In this case, the central government spends the tax income directly for the provision of public goods.
- The Union government can also *delegate* the administration of specific programs *to local governments*. The effects of these public goods would benefit the nation, but the implementation may be more effective at the local level where the administrators are in touch with the beneficiaries. This is effectively how the Union government in Myanmar approaches decentralization.
- The central government can create *incentives* for subnational bodies to implement policies that are in the interest of the nation. Usually, these incentives come in the form of conditional *grants*. A regional or State government may get financial transfers from the central government if it implements specific objectives set by the Union. These transfers come in two forms.

[46] See footnote 34.
[47] For a discussion of fiscal federalism in the United States, see (Stiglitz 1988)

- The central government may give *categorical grants* for specific programs such as education or urban development and the state governments organise the schools or urban infrastructure.
- *Matching grants* leverage local spending. For example in the European Union, structural funds double the spending capacity of poor regions when the matching ratio is 50:50. Of course, if a local government does not comply with the regulations, it may lose access to such funds.

- *Block grants* are a form of general revenue sharing. They are transfers from the central government that can be used for any purpose the local government desires. Often they are used to cover deficits in the subnational budgets. They are justified on grounds of efficiency and fairness. For example, the central government may be more efficient in collecting taxes than state or local administrations and the block grants transfer part of this revenue back to the states from where it came. Block grants are also a mechanism for the redistribution of income and wealth with the intention of generating *equivalent living conditions* and the maintenance of *legal or economic unity* across the nation.[48]

How these different mechanisms interact is a complex issue and there are no clear-cut rules for what is best. Nevertheless, two general principles deserve consideration.

First, we may focus on the nature of public goods. We have classified public goods according to the *range* or *reach* by which they affect citizens. From that perspective, the Union government should provide and finance national public goods, while regional goods are at the charge of subnational institutions. This represents fiscal symmetry. However, the reality is more complicated, when other aspects affect the evaluation of benefits. We have discussed that union highways would clearly benefit the nation by integrating the economy of a country and village roads mainly benefit the local population. However, a well-developed system of infrastructure would also support the local economy; farmers would become more productive, increase output and exports, and thereby benefit the nation as a whole. Similarly, a well-funded education system reaching even the most remote hill areas would enable people to contribute to the creation of national wealth. That would benefit everyone and therefore deserves to be supported by the Union government either financially through grants or directly by supplying public goods and services. However, in Myanmar direct Union expenditures are oversized. Union transfers to States and Regions were only 2.2% in 2011-12 although they have now improved to 8.75%, with Shan State, Sagaing Region and Kachin State receiving the highest level of transfers.[49] Though it is not perfect, the government uses objective formula system to transfer funds to different states and regions.

On the other hand, it is often the case that the central administration does either not have the necessary information to decide what is the right approach to serve the local people with their specific tastes and circumstances, or the administrative procedures are too long and insufficiently responsive to support local activities. For example, when small businesses require permits and licenses from the

[48] See footnote 34.

[49] This is explained by the relative large populations in these areas. In 2015-16, Chin State, Kayah State, and Tanintharyi Region received the highest levels of per-capita transfers from the Union government. These were equivalent to approximately 262 thousand kyats, 174 thousand kyats, and 103 thousand kyats per person, respectively. Although the underlying reasons for these allocations are unclear, it is notable that some of the states and regions receiving the highest per-capita transfers also suffer from higher levels of disadvantage and larger infrastructure gaps. See (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, p. 29)

Union government in order to export, the red tape may be an impediment for the rapidly changing conditions in markets. It would be preferable to let local administrations deal with regulating local businesses and just set some general norms at the Union centre that are easily applicable by local authorities.

Second, there is the difficult question of what determines collective preferences. This question is important, for welfare is defined as satisfying people's preferences (maximizing their utility). Economists usually assume preferences as given. That means that groups with different preferences ought to enjoy different public goods. For example, Buddhists should have pagodas, Christians should have churches, and Muslims should have mosques. Now, as long as each group has the capacity to finance its preferred public good, this is not controversial. However, assume the government believes that religious practices are good for the morality of the nation and will improve honesty and reduce corruption and the cost of maintaining a police force. In that case, it would be economically efficient to subsidize places of religious cults out of the savings made from the reduced police budget; but this raises the question who should get how much? Is supporting Muslims as valuable as supporting Buddhists?

One problem with highly centralized governments is *agency capture*. This term describes a form of government failure that occurs when a regulatory agency, in this case the central government, advances the commercial or political concerns of special interest groups or super-rich individuals,[50] instead of acting in the public interest. The Founding Fathers of the American Republic, Alexander Hamilton and James Maddison, have argued that a federalist system is less prone to agency capture because power is more equally shared.[51]

Another problem related to heterogeneous preferences is the fact that taxpayers may "vote with their feet". Assume one state, in the USA this is Florida, has a large population of retired people and therefore spends a large part of its tax revenue on health care for the elderly and little on child care. Therefore, families with small children will move to another state where they get better education for their children. Florida will end up with an unproductive population that is expensive to sustain and has little economic power. This cannot be in the interest of the country as a whole. Some regulation for health care and schooling must therefore come from the federal government.

The literature on fiscal federal federalism provides simultaneously arguments for centralisation and decentralization. This is confusing. The centralizing tradition aims at solving problems in the supply and production of public goods; the decentralizing tradition focusses on the difficulties of articulating preferences and demand for public goods.[52] The assignment also depends on the functions of public spending. Musgrave has argued that the *stabilization* and *distribution* functions of public finances are a task for the central Union level, because the externalities are likely to affect the country as a whole. By contrast, the allocation function for public goods calls for a decentralised system: "This is the case

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[50] The term in the literature is *oligarchs*. See (Winters 2011).

[51] (Hamilton, Alexander; Madison, James; Jay, John . 1788)

[52] "The conceptual framework of fiscal decentralization is well established in fiscal federalism literature, drawing largely on the contributions by Stigler, Samuelson, Musgrave, Oates, and Brennan and Buchanan the understanding of which is further expanding with the emerging second generation theory of fiscal federalism with important contributions from Inman and Rubinfields, Weingast and others. The central logic is that the core issues of growth and poverty (the justification offered for economic reforms across the globe after failure of the earlier paradigms) cannot be addressed without addressing efficiency— 'supplying services up to the point at which, at the margin, the welfare benefit to society matches its cost'. (Sharma 2005)

because the benefit incidence of social goods is spatially limited – the illumination provided by streetlights only extends so far – and because the preferences of different communities regarding the supply of social goods may differ. Fiscal decentralization permits the adaptation of budget patterns to the preferences of residents of particular jurisdictions".[53] However, a closer look at these theories reveals that they express important political cleavages regarding the role of the state in the economy. Economic liberals seek a minimal role for the state and believe that decentralization will reduce government interference in the market. Social liberals are concerned with issues of equity, fairness and social justice and wish to use the state as an instrument to remedy the inequalities which otherwise emerge from market dynamics.

The organisation of transfers

According to the 2008 Constitution, Myanmar has some of the formal attributes of a federal system, but in reality, power remains highly centralized. The catalogue of competences is listed in Schedule I and II of the Constitution, but the harsh realities for policy makers are dependent on access to financial resources.[54]

Although they are potentially efficient instruments for collecting taxes, Myanmar's sub-national institutions have little autonomy in deciding expenditure. Spending at the State and Region level is proposed by budgets, which are submitted by the Chief Ministers to the Union, where the Financial Commission under the authority of the two Vice Presidents reconcile them with the Union budget from where the sub-national bodies then receive aid and transfers. Administratively, Union ministries have their mirror in State and Union governments and the sub-national entities are accountable to their Union parent ministries.[55]

This system is far from the model of a modern federal state, where the tax and budget issues are debated and decided in a second chamber. In the vertical federal system of the *United States*, discussed above, the federal and state governments raise, collected and spent taxes independently, although the federal government gives them grants in order to promote economic efficiency. This is justified in instances where those subnational governments have localized knowledge that would permit them to implement a program more efficiently than the federal government, while they have insufficient incentives or funding to provide these public goods or services —infrastructure, for example—on their own. In addition, some grants use the broad federal tax base to redistribute resources among communities and individuals, and certain intergovernmental grants can help stabilize the economy. In some cases, federal policymakers turn to intergovernmental grants to encourage state and local governments to adopt federal policy priorities. In 2011, the US federal government provided $607 billion in grants to state and local governments, accounting for 17 percent of federal outlays, 4 percent of GDP, and a quarter of spending by states and localities. Nearly half of that amount was for Medicaid.[56]

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[53] (Musgrave, Richard A. and Peggy B. Musgrave 1989)

[54] (Constitution of the Republic of the Union of Myanmar 2008); (Government of Myanmar 2013);

[55] (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, p. 6)

[56] Medicaid in the United States is a social health care program for families and individuals with limited resources. Federal grants are defined and governed by the Federal Grant and Cooperative Agreement Act of 1977, as incorporated in Title 31 Section 6304 of the U.S. Code. A Federal grant is a: "...legal instrument reflecting the relationship between the United States Government and a State, a local government, or other entity when 1) the principal purpose of the relationship is to transfer a thing of value to the State or local government or other recipient to carry out a public purpose of support or stimulation authorized by a law of

The German system transfers funds vertically from the federal budget to the States, including municipal authorities, and also horizontally from richer to poorer states. This is called the Federal Financial Equalisation System (*Finanzausgleich*). For details see Box 2.

Box 2. The Federal Financial Equalization System in Germany

The Federal Republic of Germany comprises the Federation (*Bund*) and16 federal state (*Länder*). The *Länder* represent an independent level of government endowed with own rights and obligations. They have free and independent control over their financial resource.

The Constitution guarantees that the Federation and *Länder* receive appropriate levels of funding. The revenue sharing is divided into four phases:

1. First, the entire tax revenue is distributed to the two levels of government – namely the Federation and all the Länder – and the local authorities receive a supplementary grant of revenue (*vertical* distribution).

   Income tax, corporation tax and VAT are joint taxes, which are divided as follows:

   - Federation receives 42.5% of income tax, 50% of corporation tax, 52% of VAT
   - All Länder together receive 42.5% of income tax, 50% of corporation tax, 45.5% of VAT
   - Local authorities receive 15% of income tax, 2.5% of VAT

   Pure federal taxes are: excise duties (energy, tobacco, insurance tax)

   Pure *Länder* taxes are: inheritance tax; property transfer tax

   Local authorities receive revenue from property taxes and local excise taxes

2. Next, the total *Länder* portion of tax revenue is assigned among the various *Länder* (*horizontal* distribution).
   The tax revenue belonging to the *Länder* as a whole is distributed among the individual Länder. Apart from VAT, the individual Länder are entitled, in principle, to the tax revenue, which is collected by the revenue authorities on their territory (principle of local revenue). Some corrections are made to close the gap between rich and poor *Länder*.
3. In a third stage, there is *equalisation* between poor *Länder* and rich *Länder*
   Poor *Länder* receive adjustment payments, which are funded by the wealthy states. The starting point for the financial equalisation among the *Länder* is the financial capacity per inhabitant of the various *Länder*. The financial capacity of a Land is the sum of its receipts and 64 % of the sum of receipts of its local authorities per inhabitant.
   The system of financial equalisation among the *Länder* assumes that the financial requirement per inhabitant is the same in all the *Länder*. This assumption is not appropriate in the case of the *Länder* of Berlin, Bremen and Hamburg, which, as city-states, are simultaneously both local authorities and Länder in their own right with higher financial requirement per inhabitant. Therefore, for the purposes of the equalisation

the United States instead of acquiring (by purchase, lease, or barter) property or services for the direct benefit or use of the United States Government; and 2) substantial involvement is not expected between the executive agency and the State, local government, or other recipient when carrying out the activity contemplated in the agreement."

system, their populations are notionally increased by 35 %. Three sparsely populated Länder also have higher financial requirement per inhabitant.

The gap between a poor State's financial capacity and the national average is compensated by linear-progressive transfers from the rich (above average) *Länder*. Hence, the system of financial equalisation among the *Länder* reduces the differences in the levels of their financial resources. In the interest of the fiscal autonomy and sovereignty of the *Länder*, the differences in receipts among them are only partially reduced by the financial equalisation.

4. Poor *Länder* receive supplementary federal grants from the Federation.
   To complement financial equalisation among the *Länder*, the federal government makes supplementary federal grants to poor *Länder*. These funds are uncommitted block grants and serve to meet general financial requirements. There are two different kinds: general supplementary federal grants and supplementary federal grants for special needs.

In Myanmar, the Union Government controls 88% of all public expenditure, transferring only 12% to States and Regions.[57] This compares with 60% centralized expenditure in Germany and 50% in the United States. The reform of Myanmar's public finance system presently focuses on decentralization. However, the pace of this process needs to be carefully designed. As Sharma pointed out, one has to strike the right balance: "It is also clear that an improper attempt at fiscal decentralization in fact, could be a disaster-prone strategy while the 'proper' distribution of tax authority and expenditure responsibility is an extremely complex issue. The problem in many cases (…) is not *what* to decentralise (or whether a service should be provided by a central, regional or local government) but, rather *how* to organize the joint production (shared rule) of the service by various levels. The riddle can be solved only if a comprehensive view of the political economy of fiscal federalism is considered instead of a narrow approach to fiscal decentralization".[58]

The geographic distribution of resources stands in the context of allocating private and public goods. Private firms compete in markets for income and often they agglomerate around cities, which provide infrastructure and public goods. Regions and states also compete for resources, but this is reflected by the *horizontal fiscal relation* between public administrations. The potential tax bases available to a government varies from region to region. For example, Yangon and Mandalay generate much higher tax revenues than Western Chin State or Eastern Shan State. These unequal living conditions reflect a horizontal asymmetry, which is typical for federal states. For the reasons discussed above, vertical asymmetries can correct these horizontal asymmetries when transfers from the central government redistribute part of the wealth from rich to poor regions, although we saw that some federal states, like Germany, make partial corrections by horizontal transfers, too, but redistribution by grants from the centre is the more frequent method. This is also how the Burmese constitution deals with horizontal asymmetries.

A revenue sharing agreement must be reached not just for the distribution of income from taxes and resource extraction, but also for the management of resources. The 2008 constitution is biased in its allocation of responsibilities for resource management, with Schedule I giving the Union government

[57] See (Hook, David; Tin Maung Than; Kim N.B. Ninh 2015) and (Taylor 1987)
[58] (Sharma 2005)

jurisdiction over all main contributors to GDP, such as petroleum, natural gas, mines, and minerals. In stark contrast, Schedule II lists only five areas under regional state jurisdiction: small-scale electric power production, salt products, cutting and polishing of gemstones, village firewood plantation, and natural resources related to recreation centres. The asymmetry could not be clearer. Who would doubt that it has substantially contributed to rebellion and civil war in Myanmar? Whilst full control of resources is unlikely, state governments need to be involved in the decision-making and implementation process of development and extraction projects.[59]

Nevertheless, in recent years the Union Government has been using a formula to determine fiscal transfers to States and Regions. This formula has been expanded and is now designed to determine transfers based on population size, GDP per capita, poverty rate, number of Townships, land area, per capita tax collection, and urban population as a share of total population. These transfers could develop into a more rule-based system of revenue sharing. However, in practice subnational officials still tend to see transfers as being determined more by the size of States and Regions' budget deficits than by the formula.[60]

[59] (Chia, Jasmine; Aung, Yan Min; Kareng Brang Shawng; 2016)
[60] (Minoletti 2016, p. 18)

2. Sources of public finances: taxation and other revenues

In order to serve the collective needs and preferences of the citizens of a nation, the government must use and develop the available real physical resources. These resources are the productive capacities of the people and the products of the earth, such as natural raw materials, precious stones, and agricultural output. Public authorities gain access to domestic resources either by taxing people in kind or in money. In Myanmar, the government also receives profits from owning State-owned Economic Enterprises (SEE) and gets revenue from selling or leasing access rights to natural resources. Finally, if it wishes to spend more than it can collect in revenue, the government can borrow in financial markets.

The provision of public goods is also dependent on foreign resources. The most general way for an economy to gain access to foreign goods is through exports, which generate the foreign exchange that can be spent on imports. Direct investment from foreign investors (FDI) also provides productive resources, e.g. when foreign companies import machinery and equipment for their factories. However, these foreign resources are essentially mobilised by the private sector. The government will appropriate parts of them by taxing imports, exports and the additional income generated by the resulting growth. The government can also enlarge its capacity to act by receiving foreign development aid in the form of international grants and transfers, or it can borrow from global financial markets and from multilateral banks (like the World Bank, Asia Development Bank, IMF, etc.). Nevertheless, for long run successful sustainable development, mobilizing domestic capacities and resources is crucial. We shall now look at how the public sector is financed in Myanmar.

Tribute in Kind, Crovée Labour and Client-Patron Relationships

Before we discuss the modern ways of financing the public sector, we should mention a method of mobilizing resources that is not compatible with a modern economy or a democratic society. In traditional, underdeveloped societies, the government used to command people to deliver and transfer resources in kind directly to the government. In pre-colonial Burma, this system was widely used for constructing public buildings (royal palaces, pagodas) and maintaining the irrigation systems of the central dry zone.[61] Village populations were forced to build roads by *corvée* labour. Later under the Burma Socialist Program Party, farmers had to deliver fixed quota, say of rice, to the government that were then distributed to civil servants and soldiers.

The rigid tax assessment system based on money introduced by the British administration was a major cause for rebellion and the strive for independence. Many peasants and villagers lived close to the subsistence level. Taxes in the form of a fixed poll tax or a proportionate income tax on wages would push people below the secure level of survival when farmers had a bad year or storms devastated their crops and food prices went up. A “patron” was a landowner who assumed responsibility for the tenant and his family in bad times. He was entitled to a share of the crop in good times, but he was morally obliged to provide for the survival needs of his subjects in times of dearth. The “client” was tied to his landlord by personal deference, and a sense of obligation.[62] Tenancy agreements with landlords were judged by the insurance and safety protection for these peasants, on which they could count in a subsistence crisis. Such a traditional subsistence economy values safety higher than personal liberty or individual equality or impartial justice. The normative system of “safety first” and dependent loyalty became the foundation of the traditional state. In fact, it justified the power of the

[61] (Taylor 1987, p. 43)

[62] For details see (Scott 1976), notably chapter 2.

dhammaraja - the king who cared about the well-being of his subjects.[63] A good patron and a good king were generous and provided insurance against disaster; they helped with production costs, granted "fringe benefits" and supplied liberal credit.[64] A "bad king" or ruler used the resources to serve himself and his cronies. But even under a good and morally righteous ruler, individuals had no rights that would protect their property, freedom and mutual equality.

In developed economies, tributes in kind have been replaced by taxes in money and an impartial justice system that helps to enforce them. In a democracy, citizens collectively decide how much they wish to spend on public goods. The German philosopher Georg Simmel considered the development of a monetary economy as "the correlate of personal freedom of modern times", because it emancipated subordinated subjects from their masters and replaced personal bonds by impersonal relations that came with the taxation through money levies instead of payments in kind.[65] In fact, tributes in kind are incompatible with modern human rights.

In modern economies, the state appropriates real physical resources by means of money. The government buys the necessary goods and services for its actions from private suppliers or by hiring civil servants and it pays a price or wage that is comparable with the market conditions in the private sector. This requires, first of all that markets work correctly without serious distortions, and secondly that the state has an efficient structure to collect taxes and revenue in the form of money. The modern state with an impartial justice system requires that the mobilisation of financial resources remains compatible with the generally accepted standards of fairness and justice, although this logic often clashes with the "safety first" principle of the moral economy of the peasant. The conflict is acerbated when peasants lose their land rights and become migrant labourers without safe employment rights. The clash also manifests itself in the widespread forms of corruption where patrons appropriate monetary rents, which they then disburse to their clients as special benefits in exchange for favours.

It is important to keep this cultural background in mind when discussing the creation of a modern tax system in Myanmar. We have mentioned the problems of poverty above. Agriculture continues to be the mainstay of Myanmar's economy, despite the increase in industrial and mining activity over recent years. Some estimates say that the sector accounts for around 45% of GDP, while providing employment for 70% of the workforce.[66] Returns to farmers remain extremely low. Per capita agricultural income is the lowest in Asia, according to a report issued by the OECD, currently standing at around MK 202,000 ($200) a year. This compares to a national GDP per capita of MK 1.1m ($1100).[67] Hence, many peasants still live close to subsistence level – as they have done for hundreds of years – and the norms of the moral economy of the peasant remain valid for them. It is therefore clear that the tax base is not only narrow, but also that the acceptance for paying taxes must be supported by a "moral economy", which emphasises the "safety first" principle of subsistence economies. In terms of modernising the economy, this means that people must be protected against economic shocks by a system of social security.

[63] (Taylor 1987, p. 56)
[64] (Scott 1976, p. 50)
[65] See (Simmel 2001, 311) who explains that this transition occurred in Europe in the 12th century (CE).
[66] See footnote 25.
[67] http://www.oxfordbusinessgroup.com/news/agriculture-myanmar-struggles-grow-its-potential

Funding the Public Sector of the Myanmar Economy

We shall now look at the monetary sector of the Myanmar economy and analyse the expenditure and revenue flows for the public sector in Myanmar.

The public sector can be measured by the share of public spending relative to the total production of goods and services of a country (i.e. GDP). See Figure 9. In Myanmar it consists essentially of the central government, called Union Government, and the sector of State-owned Economic Enterprises, which are also controlled centrally by the government or the Tamadaw. However, as will be discussed below, in domestic and international NGOs and Ethnic Armed Organisation also provide public services that are not accounted for by this measure.

The expression *Union Government* covers effectively what is called *General Government* in developed countries. For example, the European System of Accounts (ESA) defines the General Government sector by four subsectors:

- Central government
- State governments, (only applicable in federal states like Belgium, Germany, Spain, Austria and Switzerland)
- Local government
- Social security funds.

In Myanmar the Union Budget Law has several "schedules" (up to 17), which are not ordered by the functions of public goods, but rather by the status and responsibility of the decision maker.[68] The provision of public goods by the public sector can take several forms:

- Direct administration spending through central or local government institutions, funded through taxation. In Myanmar, the central government does most of the public spending, while the share of taxation is extremely low with 6-7% of GDP.
- Publicly owned corporations (State Economic Enterprises); they have greater commercial freedoms than government administrations. While such firms operate usually according to commercial criteria in developed countries, in Myanmar this is not the case.
- Partial outsourcing through private-public partnerships. In Myanmar, the Shan State receives a relatively large share of revenue from various projects and public-private partnerships.
- The social welfare system in developed countries is based on legal entitlements (such as pensions and health care) and by social contributions, which consist of payments by employers to insurers (social security funds, general government and private funded schemes) for the benefit of their employees as insurance against social risks or needs. These payments are common in developed countries, but hardly significant in Myanmar. See Figure 8.

Figure 8

[68] Often, but not always, the President is the "Responsible Person", even for grants to States and Regions. Interestingly, the amended Budget Law of August 2016 has changed the order of spending items by putting Foreign Affairs and the State Councillor's Office above the President. .

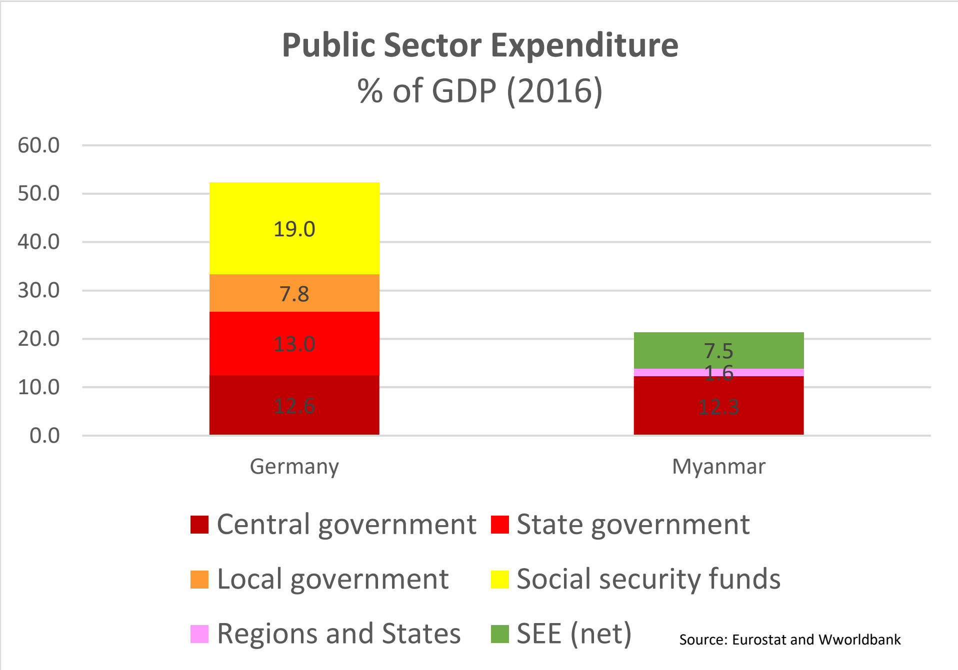
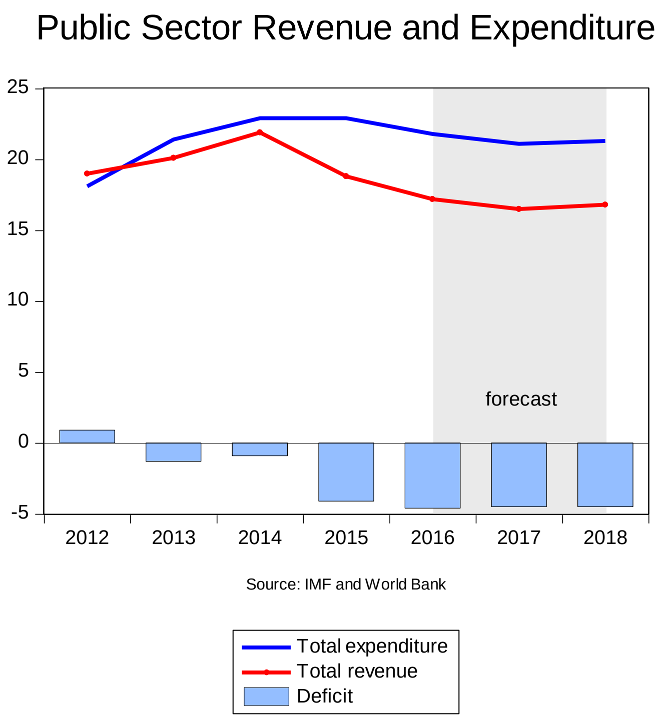


Figure 9 gives the overview for total Myanmar public spending and revenue as percent of GDP. Expenditure is close to 22 percent and revenue slightly above 17 percent. This yields a deficit just below 5 percent of GDP.[69] This deficit severely limits the government's capacity to improve the allocation of public goods. Given that the IMF considers a deficit in excess of 5 percent dangerous for the macroeconomic stability of the Myanmar economy, the new government has recently reigned in public expenditure. This has slowed down economic growth in the short run, although – as we saw above - it has shifted some of the priorities for spending and this should support growth in the long run. For example, the Budget Law first signed by President Htin Kyaw in August 2016 showed an increase in Education spending (+8.6%) and a reduction in Construction (-13.7%).

However, macroeconomic challenges in recent years have contributed to deteriorating fiscal conditions. Part of these challenges are structural – Myanmar is dependent on commodity receipts, like gas and oil, is prone to natural disasters, and has a narrow production base. Declining gas prices since 2015/16 and natural disasters have increased risks to sustained growth. Growth has fallen from an average of 7.8 percent between 2011 to 2015 to an estimated 6.5 percent in 2016/17, inflation peaked at 14 percent (year-on-year) in October 2015, and the Kyat depreciated by nearly 30 percent between 2015 and 2017.[70]

[69] These data are from IMF in the context of Article IV Consultation. The data published by the *The Law Amending the Union Budget Law, 2016* (The Pyidaungsu Hluttaw Law No. 37, 2016), 31. August 2016 shows a deficit closer to 4%. See Table 1 below.
[70] (World Bank Group 2017)

Figure 9.



While State and Region Governments may have executive functions and formally enjoy the rights of setting up budgets and taxing people, in reality it is the Union Government that is in charge. The President and the Financial Commission must authorize sub-national budgets and can overwrite the proposals coming from the lower level. The national ministries have a mirror ministry at the State and Region level and they charge these lower level institutions with the implementation of national policies. They cover 50% of all State and Region revenue. There is little autonomy at this level.

The second most important player is the Public Works Department (24% of revenue), which plays a key role in the construction of transportation infrastructure (such as roads, bridges, airports, and buildings). The Development Affairs Organizations (DAO) provide maintenance for their infrastructural projects only. They don't provide maintenance for the Ministry of Construction's infrastructural projects. The DAO articulate local preferences and organise their economic role most efficiently at the level of townships. Yangon and Mandalay have separate Development Committees, which are major players in deconcentrated economic policy. The revenue of all DAOs represents 5% of State and Region revenues, Mandalay City Development Committee 3% and Yangon City Development Committee 10%. However, even the districts are under the tutelage of the Ministry of Home Affairs, which exercises its control through a senior official of the General Administration Department (GAD).[71]

Table 2 is a condensed presentation of the August 2016 Budget Law. According to the Budget Law, revenue generated by Taxes and other contributions is roughly of the same size as that generated by State-owned Economic Enterprises. Sales taxes and income taxes have also roughly equal weight, although they represent less than 3% of GDP each. State-owned enterprises active in Energy

[71] (Zaw Oo; Cindy Joeline; Paul Minoletti; Phoo Pwint Phyu; Kyi Pyar Chit Saw; Ngu Wah Win; Ian Porter; Mari Oye; Andrea Smurra; 2015 (June) , p. 22)

production generate the same amount of revenue as these taxes. On the expenditure side, defence dominates all other spending items. Agriculture, Health and Pensions amount to only 3% of GDP; SEE take over some important spending functions, especially with respect to energy. Transfers to State and Region Governments are less than 10% of the budgeted expenditure, only 2% of GDP.

The budgeted (not the realised) deficit is 3.9% of GDP, which is equivalent to 8.4% of the Broad Money stock. If the deficit is fully monetized, it will push money supply up by this amount. Broad money increased by 17.4% from 2016 to 2017, while real GDP growth was 6.5%. These data confirm that the fiscal deficit has been an important factor in excessive money growth and inflation (see overview in Table 2).

Table 2. Union Budget 2016

amended 31. August 2016

Revenue	*Million Kyat*	Share of *revenue*	*GDP*
Tax levied on inland production and public consumption	**2,486,939.8**	15.1%	2.9%
Taxes levied on income and ownership	**2,370,434.6**	14.4%	2.8%
Customs duties	**475,000.0**	2.9%	0.6%
Taxes levied on utility of State-owned resources	**887,384.3**	5.4%	1.0%
Receipts from the Union Economic Organizations & SEE	**385,525.9**	2.3%	0.5%
Central Bank of Myanmar	186,563.4	1.1%	0.2%
Agriculture, Livestock and Irrigation	500,793.3	3.0%	0.6%
Transport and Communications	163,377.1	1.0%	0.2%
Planning and Finance	184,445.9	1.1%	0.2%
Construction	333,033.2	2.0%	0.4%
Defense & Border	100,380.2	0.6%	0.1%
Other	403,495.3	2.4%	0.5%
Subtotal Taxes	**8,477,373.1**	51.4%	10.0%
Other schedules			
Soocial security	49,198.3	0.3%	0.1%
SEE Information	18,606.7	0.1%	0.0%
SEE Agriculture	48,910.0	0.3%	0.1%
SEE Transport	657,453.6	4.0%	0.8%
SEE Natural resources	546,197.6	3.3%	0.6%
SEE Energy	4,813,974.3	29.2%	5.7%
SEE Industry	314,552.6	1.9%	0.4%
SEE Finance Ministry	419,517.1	2.5%	0.5%
outside Union Budget Fund	1,155,185.8	7.0%	1.4%
Subtotal	***8,023,596.0***	***48.6%***	9.5%
Total Receipts	***16,500,969.1***	***100.0%***	19.5%

Overview		%of GDP
Total Receipts	**16,500,969.1**	19.5
Total Expenditure	**19,823,097.6**	23.4
Balance	- **3,322,128.5**	-3.9
GDP (million kyat)	84,744,936.6	
Broad Money	39,602,957.0	
Deficit/Broad money	-8.4	
Broad money growth	17.4	
GDP real growth	6.5%	
GDP-Inflation	9.3%	

Expenditure		Share of *expenditure*	*GDP*
Defence	2,900,663.544	14.6%	3.4%
Education	1,630,945.873	8.2%	1.9%
Planning and Finance	1,187,385.408	6.0%	1.4%
Agriculture,Livestock and Irrigation	1,133,666.990	5.7%	1.3%
Health and Sports	850,644.706	4.3%	1.0%
Pensions and Gratuities	626,042.500	3.2%	0.7%
Construction	503,005.435	2.5%	0.6%
Electric Power and Energy	307,734.160	1.6%	0.4%
Home Affairs	300,967.243	1.5%	0.4%
Transport and Communications	136,993.098	0.7%	0.2%
Border Affairs	111,123.763	0.6%	0.1%
Gratuities and Commuted Pensions	101,343.000	0.5%	0.1%
Reserve Fund	100,000.000	0.5%	0.1%
Foreign Affairs	50,883.623	0.3%	0.1%
Information	38,998.290	0.2%	0.0%
Labour, Immigation and Population	34,590.814	0.2%	0.0%
Religious Affairs and Culture	31,651.053	0.2%	0.0%
Natural Resources and Environment	27,878.857	0.1%	0.0%
Social Welfare, Relief and Resettlement	18,520.892	0.1%	0.0%
Industry	16,267.873	0.1%	0.0%
Commerce	15,102.841	0.1%	0.0%
Hotels and Tourism	4,450.796	0.0%	0.0%
State Counsellor's Office	2,075.849	0.0%	0.0%
Ethnic Affairs	1,594.580	0.0%	0.0%
Subtotal	***10,132,531.188***	***51.1%***	12.0%
Transfers to States and Regions			
Shan State Government	216,408.000	1.1%	0.3%
Grant and Loan to Sagaing Region	175,506.000	0.9%	0.2%
Grant and Loan to Kachin State	152,290.000	0.8%	0.2%
Grant and Loan to Taninthargi Region	145,391.000	0.7%	0.2%
Grant and Loan to Magwe Region	141,525.000	0.7%	0.2%
Rakhine State Government	140,408.000	0.7%	0.2%
Grant and Loan to Chin State Govern-	130,739.000	0.7%	0.2%
Grant and Loan to Bago Region	126,365.000	0.6%	0.1%
Ayeyarwady Region Government	116,200.000	0.6%	0.1%
Grant and Loan to Manadaly Region	107,225.000	0.5%	0.1%
Grant and Loan to Kayin State Govem-	73,899.000	0.4%	0.1%
Grant and Loan to Mon State	70,967.000	0.4%	0.1%
Grant and Loan to Kayar State	50,438.000	0.3%	0.1%
Yangon State Government	40,858.000	0.2%	0.0%
Grant to Region/State for Pyidaungsu	32,200.000	0.2%	0.0%
Subtotal	***1,720,419.000***	***8.7%***	2.0%
Other schedules			
Schedule 6 Social security	14,452.323	***0.1%***	0.0%
Schedule 8			
SEE Energy	4,620,240.050	***23.3%***	5.5%
SEE Transport	732,614.145	***3.7%***	0.9%
SEE Industry	547,179.201	***2.8%***	0.6%
SEE Finance Ministry	484,984.556	***2.4%***	0.6%
SEE Natural resources	361,698.649	***1.8%***	0.4%
SEE Agriculture	40,881.745	***0.2%***	0.0%
SEE Information	19,250.793	***0.1%***	0.0%
Schedule 10 outside Budget Fund	1,140,950.558	***5.8%***	1.3%
Schedule 14 NaPiTaw	10,230.380	***0.1%***	0.0%
Subtotal	***7,972,482.400***	***40.2%***	9.4%
Total expenditure	***19,825,432.588***	***100.0%***	23.4%

One particularity of the Myanmar public finance management is the fact that at least once a year the initial budget is amended and usually authorizes additional spending. Data for actual spending are not easily accessible and this may explain the difference between the Budget Law in Table 2 and the data published by IMF and World Bank. The 2013 *Public Financial Management Performance Report* by the World Bank gives an idea of how large budgeted and actual expenditures can vary. See Table 3. The government administration, finance and the military had the largest overshootings. The variances in these three sectors amounted to 20% of the original budget. These large overshoots are inconsistent with a long term strategy of stable economic growth. Improving the budgeting process and constraining ministries to keep within the set budget is therefore an important requirement for reform.

Table 3. Comparaison of Budgeted and Actual Expenditure (Kyat, billions)

	2010-11				
	Original	Adjusted	Actual	Variance	*Variance in %*
Administrative Organizations	666.0	1,432.4	1,261.8	595.8	*89.5%*
Finance & Rev, excl. Reserve fund	488.9	625.9	558.2	69.3	*14.2%*
Defence	849.8	1,323.1	1,297.1	447.2	*52.6%*
Home Affairs	94.1	112.5	115.4	21.4	*22.7%*
Education	262.9	266.9	266.7	3.8	*1.4%*
Health	69.8	78.4	77.0	7.3	*10.5%*
Environment	143.2	146.7	147.7	4.5	*3.1%*
Transport	85.2	83.2	83.0	-2.3	*-2.7%*
Communication	288.7	302.9	309.1	20.4	*7.1%*
Electric Power 1	227.6	242.5	239.3	11.8	*5.2%*
Electric Power 2	445.2	451.5	415.5	-29.8	*-6.7%*
Energy	932.7	865.9	817.1	-115.6	*-12.4%*
Mines	52.2	47.8	47.6	-4.6	*-8.8%*
Industry	433.4	375.7	348.9	-84.5	*-19.5%*
Construction	301.3	422.9	446.9	145.6	*48.3%*
Information	29.4	30.9	27.4	-2.0	*-6.8%*
Agriculture and Irrigation	216.5	289.7	282.1	65.6	*30.3%*
Livestock, Breeding, Fisheries	55.9	55.9	40.0	-15.9	*-28.4%*
Science	34.6	42.5	42.3	7.7	*22.3%*
Rail Transport	171.3	187.1	186.1	14.8	*8.6%*
All Other	99.4	112.7	138.2	38.9	*39.1%*
Total for PI-2	5,947.9	7,496.9	7,147.3	1,199.4	*20.2%*
Contingency	0.1	0.0	-0.1		*0.0%*
Total for PI-1	5,948.0	7,497.0	7,147.3	1,199.3	*20.2%*

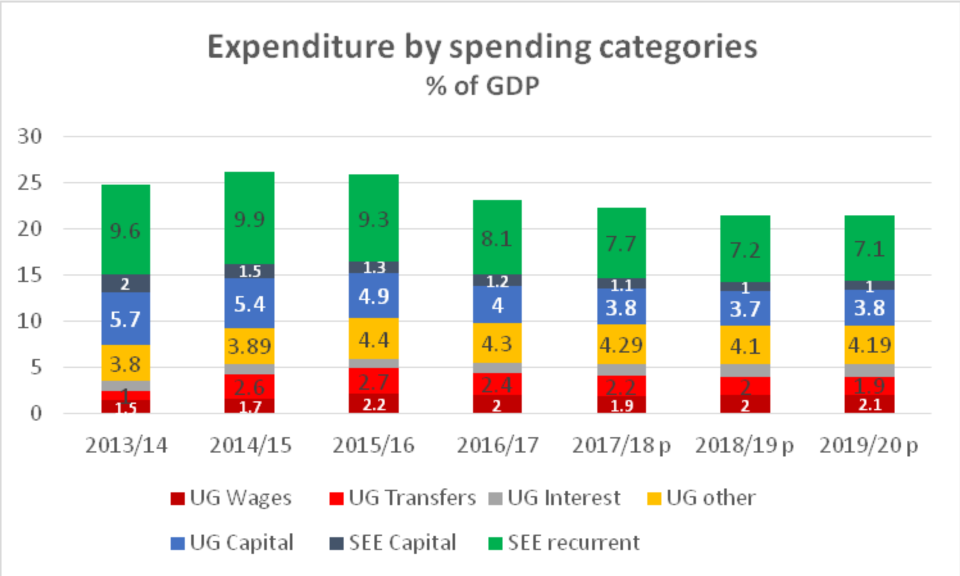
Source: World Bank 2013

Expenditure

The public sector consolidates the revenue and expenditure from the Union Government with States and Regions and the State-owned Economic Enterprises. In Myanmar, 6 out 22 ministries account for more than 80 percent of total ministry spending: Defence, Education, Planning and Finance, Agriculture, Livestock and Irrigation, Health and Sports, Pensions and Gratuities (see Table 2).

We shall now look at the actual expenditure and revenue data as recorded by IMF and World Bank. Figure 10 shows the expenditure of the Union Government and SEEs as a percentage of GDP. While the Union Government benefitted from high gas prices and the overheating economy in 2014-16, it is now expected to return to the level of 13 % of GDP, with the share of SEEs shrinking and roughly one third of Union Government spending. The share of wages paid by the government is low and roughly equal to the transfers to State and Region government. A low volume of wage payment means that the social contributions to the government's welfare system are also low. Public consumption is broadly equal to the amount of spending on capital goods, although investment is shrinking. The long run economic drivers for economic growth are therefore seriously handicapped.

Figure 10.



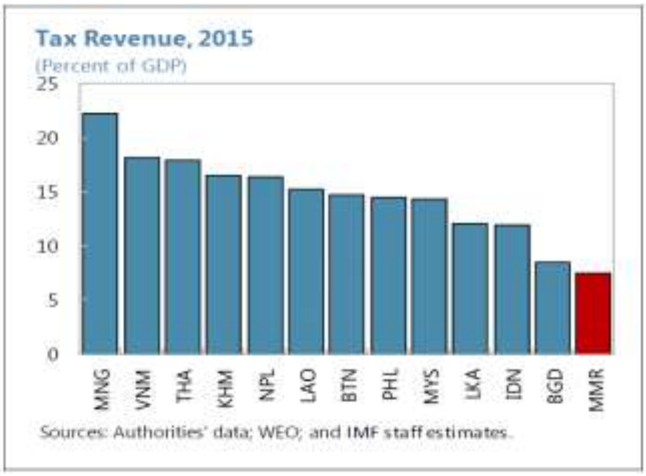
Author's construction based on data source: (World Bank Group 2017)

Revenue and Taxes

Public expenditure is financed by revenue and debt. In most countries, taxes are the main source of public finance, although the government may also raise revenue by imposing charges, fees and stamp duties or customs excises. In Myanmar, State-owned Enterprises are an important additional source of revenue. If the government's capacity to mobilise revenue is weak because poverty constrains the tax base and debt must not increase for stability purposes, it is unlikely that it can provide the public goods and services necessary for economic development. Myanmar has one of the lowest ratios of tax revenue to GDP in ASEAN, which demonstrates the urgent need for improving the system of public finance and taxation. See Figure 11. In developed countries like the USA, government revenue is well over a third of GDP, in Scandinavia even over 50 percent.[72]

[72] The chart is from (IMF, Myanmar 2016 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Myanmar February 2017); data for developed countries from OECD Data Bank.

Figure 11.



What constitutes a "good tax structure" has been widely discussed by economists over the centuries and there is general agreement that a good system ought to satisfy the following criteria:[73]

- The distribution of the tax burden should be equitable so that everyone pays a fair share
- Taxes should minimize interference with economic decisions in otherwise efficient markets. If possible, market inefficiencies should be corrected by taxes
- The tax structure should facilitate the fiscal policy stabilisation function and support long run growth.
- The administration of the tax system should be efficient, non-arbitrary, transparent, and understandable by all taxpayers.
- The administration and compliance costs should be as low as possible without hampering efficiency and distorting incentives for the private sector.

State-owned Economic Enterprises generate revenue for the government when they are selling goods or services, and then transfer their profits to the government. However, because of their predominantly monopolistic market power and the lack of competition, these State-owned Economic Enterprises are often not performing well, so that profits are not optimal. This is, in fact, one reason why socialist non-market economies have failed. In developed countries, public companies often compete with private companies and are run like highly efficient capitalist firms. Frequently, these public companies are owned by regional or municipal governments, because their products and services are used mainly locally. Examples are public utilities like electricity, water and sanitation, waste disposal, public transport, etc., but if the range of services is nation-wide, as in the case of postal services or railway systems, or if management skills are scarce, it may be preferable to have national utility companies.

The government may also earn money by selling durable assets. Assets are legal claim-rights on material resources. One of the most important assets sold by the government is the use of land and the provision of licences for certain activities such as mining or logging. However, raising money in this way must satisfy three basic conditions: first, property rights must be clearly defined and legally

[73] For a summary see (Musgrave, Richard A. and Peggy B. Musgrave 1989)

claimable by all property owners. In Myanmar this is not the case. Courts must have laws that stipulate how the property rights are implemented in a fair and equitable way.

Second, the selling of publicly owned assets must take place in open markets which give equal access to whoever wishes to bid for them. This alone guarantees that the income from the sale is market conform, i.e. yields the best and fairest return. If such open access is not guaranteed, a privileged class of oligarchic cronies will benefit at the expense of the general public. The non-transparent procedures for selling public assets is a major source of corruption. As a consequence, the government will be short of money and unable to provide the service citizen expect.

Third, the government relies heavily on tax and non-tax revenues from gas exports and other transfers from State-owned Economic Enterprises. Some estimates indicate that this income could have been as large as 1/3 of total government revenue, although the highly overvalued official exchange rate has distorted the true value of the income of State-owned Economic Enterprises (SEEs) operating in the gas and oil industries.[74] In addition to the high share (37%) of natural gas exports, Myanmar exports significant values of jade and gems (more than 20% of total exports), so that the extractive industries are a major source for financing the government. However, Global Witness has estimated that the value of official jade production in 2014 alone was well over the US$12 billion, as indicated by Chinese import data, and appears likely to have been as much as US$31 billion. This figure equates 48% of Myanmar's official GDP and 46 times government expenditure on health. It implies a huge loss of tax revenue.[75]

It is well known that resource-rich countries grow more slowly than resource-poor countries, because the rents from natural resources often inhibit the accumulation of human and physical capital in other sectors of the economy, especially agriculture. This is known as the *Resource Curse*. There is therefore a need to reform the system of public finances by increasing the transparency and accountability for revenue flows from natural resources, by focussing on the tax implications for investment and macroeconomic stability, and diverting incentives from extractive to productive activities. Revenue generated from selling non-renewable natural resources, like gas and oil, should not finance running expenses. Instead, it ought to be put into an investment fund that will generate income over the long run. On the one hand, it is clear that it will run out one day and an investment fund would be an insurance against such income loss. On the other hand, revenue from natural resources is usually highly volatile, which makes budget planning highly uncertain. Thus, Myanmar's gas revenues have in the past been impacted by global price shocks, which have caused sharp drops in gas prices in the summer of 2015. Data from the last three fiscal years suggest a consistent overestimation of gas receipts in the Union Budget, which fed into unrealistic spending plans.[76]

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[74] (Zaw Oo; Cindy Joeline; Paul Minoletti; Phoo Pwint Phyu; Kyi Pyar Chit Saw; Ngu Wah Win; Ian Porter; Mari Oye; Andrea Smurra; 2015 (June))

[75] (Global Witness 2015)

[76] Tax payments and contributions from state participation in the gas sector through Myanmar Oil and Gas Enterprise (MOGE) was on average overestimated by around 30 percent in the Union Budget. This would have contributed to a 5-6 percent decline between budgeted revenue and actual. At the same time, however, regular tax receipts (i.e. net of MOGE's tax payments and net of one off payments (e.g. license fees)) were underestimated by on average 60 percent per year over the past three fiscal years. The experience form other resource-rich countries shows that National Wealth Fund where such income is accumulating, allows safer and more sustainable public finance. (World Bank Group 2017, pp. 24-25)

Box 3. Resource Curse[77]

The resource curse refers to the paradox that countries rich in natural resources like oil and gas often perform worse than countries with few natural resources. The reasons why this happens vary.

An oil and gas boom can distort the economy as changes in the exchange rate cause traditional sectors to decline. Commodity prices can rise and fall very quickly.

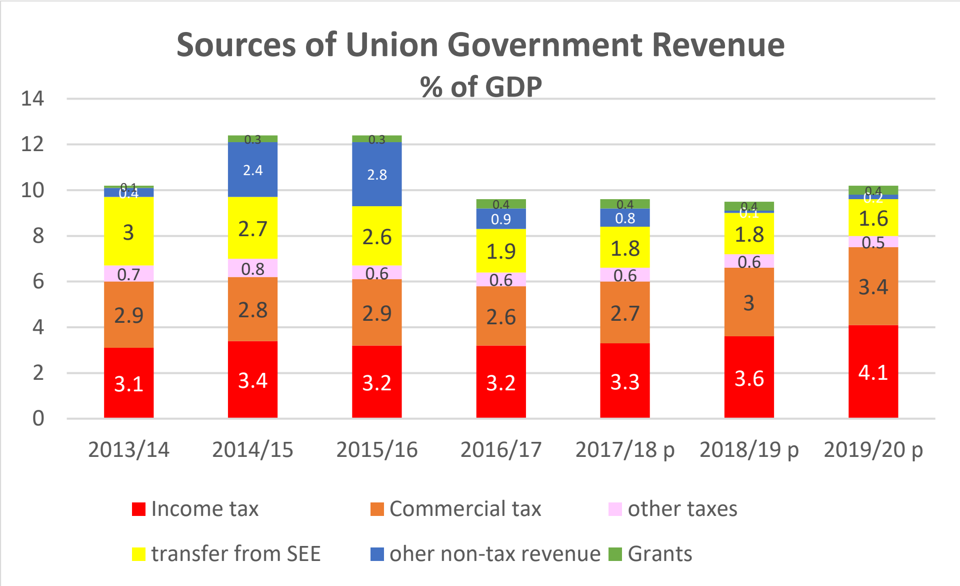
A sudden influx of wealth often leads to problems of corruption, social inequality and even political instability. For all these reasons, it is extremely important for Myanmar to establish an effective governance regime for development of natural resources. The decision of the Government of Myanmar to seek accreditation as part of the Extractive Industries Transparency Initiative is a step in the right direction.

Figure 13 shows the sources of revenue for the Union Government in Myanmar. In recent years, the sum of tax and non-tax revenue has been nearly as important as the transfers the government received from State-owned Economic Enterprises (SEE), although the IMF now expects that the revenue share from these enterprises will fall. While this could be a sign that the free market economy expands, unfortunately this is not the case. Although economic growth seems to occur, it does not increase tax revenue significantly and this severely hampers the government's capacity to act.

With the economic slow-down in 2016/17, the revenue from commercial taxes has fallen, but it is expected to go up again as the economic climate improves. The windfall from oil and gas prices has also inflated the non-tax income. However, the challenge for Myanmar in the medium to long term is the need to improve tax revenue.

[77] From (Hook, David; Tin Maung Than; Kim N.B. Ninh 2015, p. 23)

Figure 13.



Taxes and Tax Rates

Myanmar uses the usual panoply of taxes. Tax income is fairly equally split between income tax and commercial taxes. We have seen that the low productivity of agriculture does not support high revenues from income tax, although that situation will improve as the economy develops. A stronger manufacturing and service sector will raise revenue through commercial taxes on sales, income and capital gains. The main taxes are:

- The *commercial tax* rate is a sales tax that stands at 5%, but some exceptions exist. A lower rate applies for certain goods, such as grains and vegetables produced in the country for domestic sale (no tax is charged), or, to encourage competition with imported goods, it exempts proceeds from the sale of goods produced and sold by registered entrepreneurs or businesses owned by citizens or state-owned enterprises (a 2% rate is charged).[78] The Union Tax Law 2017 kept the system and rates in place, but the government intends to replace the present commercial tax by VAT in the future.[79] Myanmar would then join the community with most countries in the world. See Box on VAT.
- *Corporate tax* is 25% on profits, "levied on companies registered under the Myanmar Companies Act or the Special Companies Act of 1950, state-owned enterprises, enterprises, and companies or cooperatives with a permit from the Myanmar Investment Commission."[80]
- The *Capital Gains Tax* rate levied under the new 2017 Tax Law stays at 10%, but if a company is engaged in the oil and gas sector, graduated rates of 40%-50% will be applicable to its profit.
- A *Special Goods Tax* was first introduced in 2016 to apply to "special goods that are produced in the country, imported or exported," and "payable in addition to the standard commercial tax." [81] The list of goods subject to the tax "includes tobacco and alcohol products, teak and

[78] http://www.loc.gov/law/foreign-news/article/burma-2017-union-tax-law-passed/
[79] (Turnell 2017)
[80] (Zeldin 2017)
[81] (Myanmar: Union Tax Law 2016 Passed, EY TAX INSIGHTS (May 2, 2016) quoted by (Zeldin 2017).

hardwood logs, precious stones, jewellery, luxury cars, fuel and natural gas." The 2017 Union Tax Law introduced significant rate changes in the tax rates for importing and manufacturing of such goods as cigarettes (an extra MMK 1 per cigarette), cheroots, cigars, pipe tobacco, and betel (an increase of 20% to an 80% tax rate); liquor and wine (but not beer, which is still at a 60% rate). Most significant are taxes on wood logs (a reduction from a 20% rate to 5%); and uncut gems. For exports, the tax rate was reduced in the new tax law from 20% to 10% for wood logs and from 20% to 15% for uncut jade and 20% to 10% for other gemstones.[82]

3. Box on VAT

Value-added tax (VAT) is a tax on goods and services.[83] It is a general consumption tax that is imposed on the *value added* to the price of a product at each stage of production. The government decides the amount of VAT as a percentage of the end-market price.

Consider a production process (e.g., a tea-shop starting from the initial teal leaf collection) where the product get successively more valuable at each stage of the process. When the final end-consumers make a purchase, they are not only paying for the VAT for the product at hand (e.g., a cup of tea), but in effect, the VAT for the entire production process (e.g., the purchase of the tea leafs, their transportation, processing, cultivation, restaurant costs, etc.), since VAT is always included in the prices.

The value-added effect is achieved because *end-consumers are prohibited to recover VAT* on their purchases, but *businesses are allowed to do so*. The VAT collected by the state is therefore difference between the VAT of sales earnings and the VAT of those goods and services upon which the product depends. The difference is the tax due to the value added by the business. In this way, the total tax levied at each stage in the economic chain of supply is a constant fraction of the additional.

Value-added tax is superior to ordinary sales taxes, which apply a fixed rate to every sale, because it avoids the cascade effect of sales tax on the full value of each transaction by taxing only the *value added* at each stage of production. It therefore treats producers more fairly and avoids incentives for creating vertically concentrated firms (e.g. harvesting, processing, storing and distributing rice). For this reason, throughout the world, VAT has been gaining favour over traditional sales taxes.

The case of Bangladesh

Value-added tax in Bangladesh was introduced in 1991 replacing Sales Tax and most of Excise Duties. Within the passage of 25 years, VAT has become the largest source of Government Revenue. About 56% of total tax revenue is VAT revenue in Bangladesh. Standard VAT rate is 15%. Exports are zero rated. Besides these rates, there are several reduced rates called Truncated Rate for the service sectors. Different rates for different services are applied.

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[82] This reduction in tax rates for natural resources is somewhat puzzling. As we pointed out in the introduction, the NLD had promised: *In order to broaden the tax base, we will reduce tax rates.* In view of natural resource preservation or the exhaustability of jade and other precious stones, it is not understandable why and how a tax-induced increase in output would serve the economy.

[83] See also: https://en.wikipedia.org/wiki/Value-added_tax

State-owned Economic Enterprises

As we see in Figures 12 and 13, State-owned Economic Enterprises are still a large source of government revenue. In 2015, Myanmar had 44 SEEs operating in many sectors. Most are very large. For example, Myanmar Timber enterprise has around 20,000 employees and contributes value added of about 7% of GDP. The military-owned Myanmar Economic Holding Ltd and Myanmar Economic Corporation covers a wide range of sectors from gem mining, logging, saw mills, furniture and garment manufacturing, food and beverage imports, supermarkets, banking, real estate, hotels, transportation, telecommunication, steel and cement industries. These companies contribute directly to the financing of the Tamadaw and are not accountable to Parliament or reported in the Union Budget.[84] Many SEEs are profitable due to their monopoly position, but this often hampers efficient services. Yet, the experience of the reform of the telecom sector is an example, how more competition (also from foreign investors) can improve the overall performance. SEEs contribute to the budget through a profit tax of 25% and a Union dividend of 20%, with the rest being used for self-finance of investment or the military.

[84] (Hook, David; Tin Maung Than; Kim N.B. Ninh 2015)

3. Financing Decentralization

Myanmar is still a highly centralized state, because despite the provisions in the 2008 constitution the sub-national administrations are not autonomous in a significant sense. This becomes clear when we study how State and Region Governments are financed.

State and Region Expenditure

The provision of public goods in Myanmar is primarily the task of the Union Government. These include education, public health, infrastructure, energy production and distribution, resource extraction and processing, and social welfare. They are partially deconcentrated down to the district and township level. State/Region responsibilities are mostly confined to localized, small-scale services. For example, in the agricultural sector, the Union Ministry of Agriculture is generally in charge of "Dams, embankments and irrigation works managed by the Union", while State /Region governments are responsible for "Dams, embankments and irrigation works having the right to be managed by the region or state". Many provisions are of this nature in the Constitution, which opens the door for arbitrary management arrangements, uncertainty and inefficiencies.[85]

State and Regions accounted for 7.4 percent of total public sector expenditure in 2013/14, which compare with an average of 25 percent across other countries. Table 4 shows the distribution of spending with respect to the State/region administrations, lower level authorities and SEEs. Shan, Yangon and Magway are the economically largest subunits. In per capita terms, Chan State and Kayah State are the largest spenders.

64 percent of this subnational spending was financed out of Union transfers, because local revenue was insufficient.[86] The share of wages and salaries is generally low in States and Regional administrations (11-20%), while capital spending and public investment varies widely across States and Regions.

Capital spending per capita highlights significant variance amongst States/Regions. In 2014/15, Chin invested close to 177,400 Kyat per capita in capital spending as contrasted with Bago, which only spent 8,300 Kyat per capita. Densely populated States/Regions like Yangon, Mandalay, Shan and Ayeyarwady have the lowest capital spending per capita. In 2014/15, close to half of all capital spending by States/Regions was directed to the transport sector but with wide variances: in some Regions like Ayarwaddy and Magwe, close to 80 percent of the States/Regions' capital budget was directed to transport. In line with the literature on public goods and externalities, State/Regions have responsibility for addressing local economic services and specifically, the construction and maintenance of secondary roads (non-highways) and urban roads.[87]

The level of per-capita spending across States/Regions seems weakly correlated with poverty levels. Expenditures in poorer States/Regions with low population density are expected to play a bigger role due to higher service needs (especially transport) and costs of delivering those services. Chin for example, has high poverty incidence and low population density, which has translated into high per-

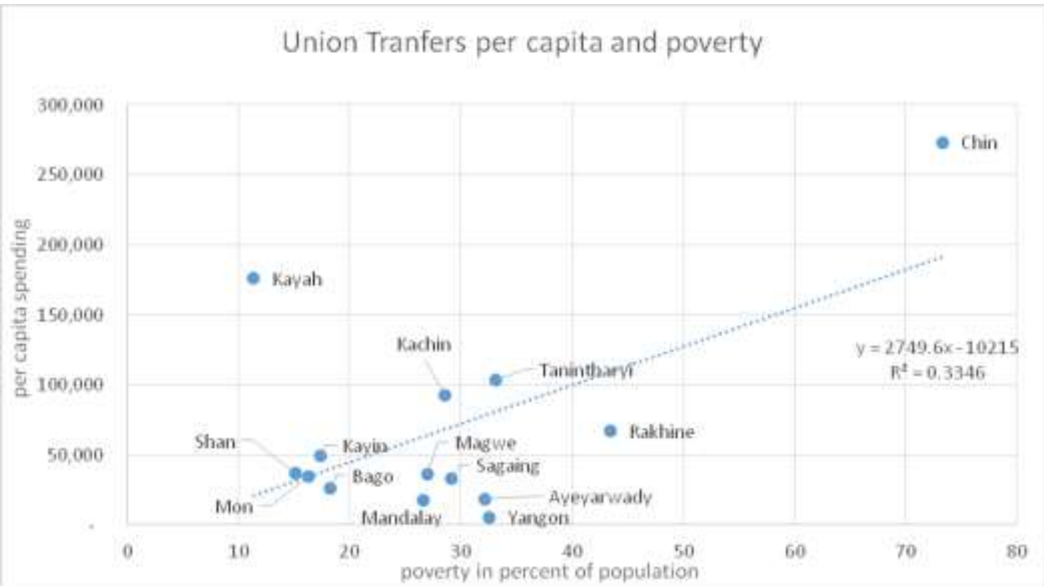
[85] For a detailed list see (World Bank Group 2013, Annex 3)
[86] (World Bank Group 2013, p. 83)
[87] (World Bank Group 2017, p. 55)

capita spending. This was thanks to higher transfers. Figure 15 shows that Union Government transfers per capita were positively correlated with poverty. However, Chin, Kayah, Kachin and Tanintharyi received higher than usual transfers. Given that Tanintharyi Region (32 persons/km2), Kayah State (24 persons/km2), Kachin State (19 persons/km2) and Chin State (13 persons/km2) have the lowest population densities, it seems clear that Union Government transfers respond to poverty and low population density.

Table 4.

2013/14	**Expenditure (million Kyat)**						
	Governance and Administration	*Departments and DAOs*	*SEEs*	*Total Mio Kyat*	*% share*	*Total per capita expenditure (Kyat 000)*	*%of GDP*
Shan	7,463	96,080	68,662	172,205	14.7	29.57	0.2
Yangon	18,368	146,373	3,942	168,683	14.4	22.92	0.2
Magway	4,948	110,244	25,922	141,113	12.1	36.03	0.2
Sagaing	11,562	63,600	29,274	104,436	8.9	19.61	0.1
Ayeyawady	4,543	61,225	34,165	99,933	8.5	16.16	0.1
Mandalay	8,092	80,795	10,934	99,822	8.5	16.19	0.1
Rakhine	12,971	40,497	25,424	78,892	6.7	37.59	0.1
Bago	5,424	41,701	18,882	66,006	5.6	13.56	0.1
Kachin	3,598	33,971	16,875	54,444	4.7	33.14	0.1
Chin	10,611	23,961	14,398	48,969	4.2	102.27	0.1
Tanintharyi	8,689	24,416	13,347	46,453	4.0	32.98	0.1
Mon	3,610	18,972	9,191	31,773	2.7	15.47	0.0
Kayin	3,726	16,777	9,524	30,028	2.6	19.96	0.0
Kayah	4,770	13,197	8,236	26,204	2.2	91.42	0.0
Total	**108,376**	**771,808**	**288,778**	**1,168,961**	**100.0**	23.25	**1.4**

Figure 15



Source: own elaboration with data from (World Bank Group 2017)

State and Region Revenue

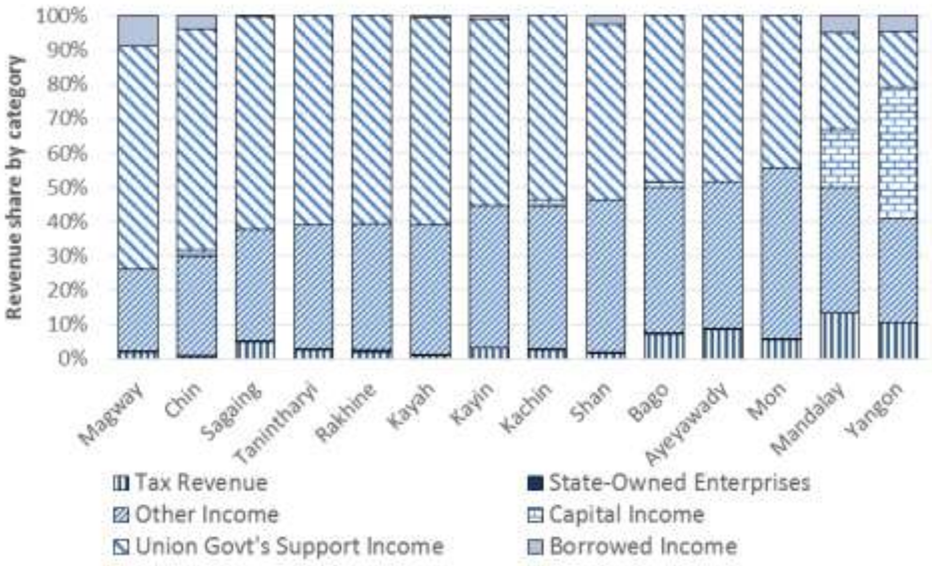
The distribution of the revenue side of the State and Region administrations seems remarkable similar to the expenditure side. See Table 5. Revenue and expenditure seem to match closely. However, this is only because the government "balances" the shortfalls in local revenue by making transfers. Figure 16 reveals that the poor States and Regions are highly dependent on transfers; more than 50% of their revenue is in the form of transfers. By contrast, tax revenue is extremely low at the State/Region level. This means that the autonomy formally granted by the Constitution does not find its economic counterpart in reality.

Moreover, most of the revenue at this level is aided from providing what we have called "club goods" above. DAOs are mainly responsible for the delivery of public services, such as waste removal and water supply for which they can collect fees and charges. Typical local taxes are property and wheel taxes and other service fees. Mandalay and Yangon regions receiving larger proportions of their revenue from wheel taxes than many other states and regions, while Sagaing Region receives a large proportion of its DAO revenue from property taxes.

Table 5.

	Revenue (million Kyat)						
	Governance and Administration	*Departments and DAOs*	*SEEs*	*Total*	*% share*	*Total per capita revnue (Kyat 000)*	*%of GDP*
Shan	2,845	105,358	64,002	172,205	14.8	29.57	0.2
Yangon	1,492	164,480	2,711	168,683	14.5	22.92	0.2
Magway	1,954	114,124	25,035	141,113	12.1	36.03	0.2
Sagaing	2,337	64,330	29,770	96,437	8.3	18.11	0.1
Ayeyawady	1,754	63,661	34,519	99,934	8.6	16.16	0.1
Mandalay	3,353	85,480	10,989	99,822	8.6	16.19	0.1
Rakhine	1,110	52,097	25,684	78,891	6.8	37.59	0.1
Bago	3,056	44,874	19,076	67,006	5.8	13.77	0.1
Kachin	2,414	35,870	17,160	55,444	4.8	33.75	0.1
Chin	2,066	33,802	14,102	49,970	4.3	104.36	0.1
Tanintharyi	2,045	31,004	13,572	46,621	4.0	33.10	0.1
Mon	2,401	20,042	9,331	31,774	2.7	15.47	0.0
Kayin	1,499	19,075	9,454	30,028	2.6	19.96	0.0
Kayah	1,214	14,692	8,317	24,223	2.1	84.51	0.0
Total	**29,540**	**848,889**	**283,722**	**1,162,151**	**100.0**	23.11	**1.4**

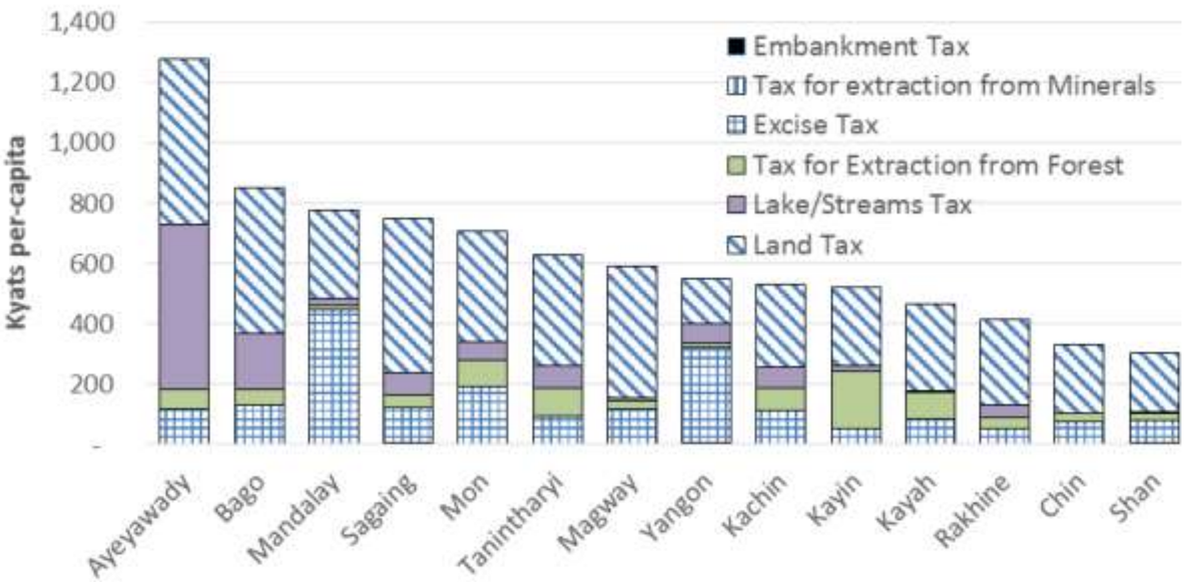
Figure 16. 2013-14 State and Region Revenue by Category



Source: (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, p.24)

However, on a per capita basis the tax for extraction of minerals seems to be the most important tax outside Yangon and Mandalay. In 2013-14, land and excise taxes generally accounted for the majority of non-DAO revenues, with the main exception being Mandalay and Yangon regions, which both collect relatively higher levels of excise revenue. Aside from land taxes, Kayah State mainly collects its taxes through forestry and excise taxes, while Ayeyawady Region collects most of its tax revenue from lake and stream taxes. See Figure 17.

Figure 17. 2013-14 Per-Capita Tax Revenues



Source: (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, p. 26)

Dickenson et. alt.[88] have looked at the evolution of tax revenues over one decade and they found that

- Transportation tax, excise tax, and lake/stream taxes have accounted for proportionally similar levels of revenue. Excise and wheel taxes have accounted for more than half of receipts,
- Taxes like embankment tax and taxes on mineral extraction have contributed relatively small amounts of overall revenue over the period examined.
- Forestry and land taxes appear to differ substantially both in terms of size and their relative contribution to subnational revenues. In particular, while forestry tax has historically been an important source of revenue, since the establishment of state and region governments, its relative size has declined, perhaps because of the rights to this revenue are shared between both the Union and subnational governments under the 2008 Constitution.
- The significant increase in land taxes in 2013-14 appeared to be predominantly a result of users of farmland being required to apply to the Township Land Records Department for a Land Use Certificate.

Decentralization and the Stability Function

An important feature of the centralist Union-subnational relation is the fact that State and Region Governments are not able to issue debt, although the Union Government may borrow *on behalf* of the States or Regions.[89] The Union government finances its public deficits by borrowing from banks including the Myanmar Central Bank. Transfers from the centre cover imbalances between revenue and expenditure at the State and Region level. With respect to the stabilisation function of public finance, this is an important potential institutional advantage. We have seen that the public finance literature say that the stabilisation function ought to be centralized. We know from many countries, especially from Latin America, that budget autonomy at the sub-national level combined with the power to borrow can generate incentives for local authorities to free-ride on other institutions, thereby creating larger deficits and seriously undermining macroeconomic stabilization policies.[90] Strict fiscal rules could contain these problems, but non-compliance is an enduring issue. By centralising the borrowing authority in the Union Government, it is potentially easier to enforce the stability function, although we have seen that Myanmar is still far from doing so.

Hence, because of the Union transfers, the overall subnational budget is practically in balance (see Table 4 and 5), although there are some small regional imbalances. The expenditure in none of the 7 States and 7 Regions exceeds 0.2 percent of Myanmar's GDP. Unfortunately, no regional GDP data are published that would allow to measure their relative size. Total expenditure by State and Region Governments is 1.4 percent of Myanmar's GDP. Shan State and Yangon are the two biggest spenders, followed by Magway.

[88] (Dickenson-Jones, Giles; S. De Kanay; Andrea Smurra September 2015, p. 27-8)
[89] The *Public Debt Management Law* (Pyidaungsu Hluttaw Law No. 2, 2016), says in Chapter II (Borrowing and Authorization for Borrowing): "3. The Government may borrow money from local or abroad with the approval of the Pyidaungsu Hluttaw *on behalf of the State* for the following matters:
(a) to finance the Union budget deficits;
(g) to lend as Government loan or credit to Region or State Governments, Development"
[90] (Poterba, James M. and Jürgen von Hagen 1999)

4. The Transition from a War Economy to a Genuine Market economy

So far, we have looked at the structure of the state in Myanmar, based on the 2008 Constitution and its application. We must now look at the bigger picture, which includes the transition from a permanent war economy to a peaceful modern market economy.

According the *Oxford Essential Dictionary of the U.S. Military*, a war economy is the organization of a nation's economic activities in such a way that it maximizes its ability to sustain a war.[91] Dennis et al.[92] argue that "as it is the first duty of a government is to defend the state against insurrection from within and aggression from without, the nation at war has but one aim to which everything else is largely subordinated. Wars are powerful agents of change, and the economy, the *sine qua non* of a nation's well-being, necessarily undergoes many stresses and changes in wartime. At the outset, business rarely continues as usual and the state is forced to intervene by setting priorities, allocating or rationing resources and controlling a greater proportion of the national product than in peacetime to meet the changes in demand for the goods and services that war brings".

A war economy establishes a centralised command over the allocation of goods and services. Military authorities have the power to use all available resources for the realisation of military-strategic objectives. The preference of national or – on the opposite side - ethnic security dominates all other options. Consequently, the permanent war economy continuously draws resources into the military sector at the expense of the private economy. The price mechanism is discarded and the employment of resources does not reflect the balance between marginal costs and utilities that defines an efficient economy. The longer the war economy lasts, the deeper are the distortions and the longer they will last into the period after the war is finished.[93]

The rebellion by ethnic minorities, who felt discriminated by the Burman majority, was used to justify the military coup by General Ne Win in 1962 that established a permanent war economy in Myanmar. The Tamadaw subordinated all economic objectives to sustain and fight ethnic rebellion. However, the same subordination happened at the other side, where Ethnic Armed Organisations (EAOs) resisted domination by the Burman military regime. Both sides of the conflict took a strong top-down approach to the economy by prioritizing resource allocation in order to fight the civil war. Military authorities controlled the main resources directly, while market relations were confined to illicit black markets. These alternative armed organisations often controlled important territories from which they mobilized resources by taxing local populations, extracting natural resources and entering illegal trades or even getting involved in the drug industry. Often taxation was in cash and kind.

This did not prevent the different parties from generating some form of support and legitimacy by providing public goods in their respectively controlled territories. In fact, the support for EAOs was sometimes strengthened by semi-democratic structures for consulting citizens and providing essential means of subsistence and public services for health and education – even if the resources were rarely sufficient and poverty remained widespread.

Many EAOs play an active role in providing services to local populations, including: health, education, infrastructure, security, justice, forestry management and/or agricultural support. In some locations EAOs have sole control of governance, but more often they play a governance role in 'mixed-authority' areas alongside the Burmese government, Tatmadaw, other EAO(s), militias, and/or Border Guard

[91] (The Oxford Essential Dictionary of the U.S. Military 2001)
[92] (Dennis, et al. 2009)
[93] (Duncan 2013)

Forces (BGFs). In some locations, the governance actors operating in mixed authority areas have positive relations and some sort of agreement on their respective responsibilities, while in other areas they are in conflict with one another. Table 6, reproduced from Paul Minoletti's Report, shows the complexity of the provision of public goods by the EAO. [94]

Table 6. Summary of EAOs Administration and Service Provision

Ethnic Armed Organisation	Designated governance/ administration department(s)?	Governance/ Administration department(s) separate from military?	Investment in infrastructure and public buildings	Fully provided social services
DKBA	No	N/A	Yes	No
KIO	Yes	Yes	Yes	Yes
KNPP	Yes	Yes	Limited	Yes
KNU	Yes	Yes (but with automatic military representation)	Limited	Yes
NDAA	Unknown	Unknown	Yes	Unknown
NMSP	Yes	Yes	Yes	Yes
PNLO	Yes	No	Limited	Limited
PSLF	Yes	No	Limited	Yes
RCSS	Yes	No	Limited	Limited
UWSA	Yes	Yes	Yes	Yes
SSPP	Yes	No	Unknown	Limited

The fact that EAOs are providing public services has certainly avoided the decent into social chaos and human disasters. However, the EAOs did not have access to sufficient resources to develop the regions under their control. Studies from experiences in other countries with insurgency movements, illegal drug trade and widespread violence have shown that irregular methods for raising revenue rarely have been effective in reducing violence and the illegal drug trade.[95] The same is true for Myanmar. The hypertrophy of a military-induced public sector has inhibited the development of a properly functioning market economy throughout the country.

While the supply of collective goods may guarantee survival at the subsistence level, the absence of market transactions and the distorted allocation of credit through state-owned banks has minimised the role of individual decision-making. In this environment, the norms and values of individual liberty, equality of all citizens, and democratic choices are hardly making any sense. Overcoming the permanent war economy is therefore an indispensable element in the transition to a genuine federal democratic union of Myanmar.

[94] (Minoletti 2016, 32-34)
[95] (Franz 2016)

Perspectives for a genuine federal democratic Union

The legitimacy of EAO to represent citizens of their ethnic groups has been recognized by the fact that the new government led by Daw Aung San Suu Kyi has opened the dialogue with some EAO in the Pang laung Peace Process. The economic transformation of the country under a new peace agreement will also benefit from the fact that all EAOs accept the principles of a market economy, even if there may be divergences about what that means for concrete policies. Nevertheless, there are some basic considerations and guidelines, which need to be respected if this transformation is to be successful.

- For a genuine federal democratic Union, the competences between Union, State and Regions, and District levels must be redefined, so that local preferences can be articulated and implemented more efficiently, without generating negative externalities for other States or Regions or for the Union as a whole. This reform requires more than just rebalancing Schedule I and II of the constitution. For it is important that subnational institutions have a greater degree of autonomy and that the citizens concerned by these pubic goods are able to monitor and influence their governance. This implies, among other things, that Chief Ministers are elected by State and Region Parliaments and not appointed by the Union Government.
- Ethnic Armed Organisations as well as parts of the Tamadaw are effectively states within the state. Both must be integrated into the future Union of Myanmar under civilian control. Merging the ethnic armed forces with the Tamadaw would generate substantial savings, provided the supreme command is under democratic control.
- One way to integrate EAOs is to set up multilevel police and security forces as in most federal countries, where the federal police is responsible for the implementation of national laws and regulations, while States and Regions dispose over local police forces to sustain law and order in accordance with local requirements.
- Cultural diversity ought to be respected, and this must be reflected in the autonomy of educational and religious institutions. However, at the level of secondary (high schools) and tertiary education (Universities), common standards must be set that are coherent with the quality requirements of international scientific skills.
- While local tax setting powers increase the autonomy of subnational authorities, the inequality of income and poverty between different states requires a revenue sharing mechanism that must be rule-based and not subject to political discretions.
- Transfers from the Union to the subnational units must follow clear and transparent rules and not be subject to political discretion.
- Public debt ought to remain under the exclusive authority of the Union Government. However, State and Union Governments ought to be represented in a federal policy-making council of the Myanmar Central Bank (MCB).
- In order to facilitate local economic development, Regional and State development banks or cooperative savings associations should be set up, which stand under the financial banking supervision of the MCB, but focus on providing financial means and credit to local farmers and enterprises. State and Union governments would be allowed to borrow from these banks.
- The Supreme Court ought to be the final instance to decide if there are conflicts between Regions, States and the Union.
- Sharing sales taxes (VAT) and personal income tax at fixed proportions is the most efficient way to finance public goods.
- Tax rates for very high incomes and capital gains ought to be increased in order to generate higher income and satisfy norms of equity and social justice. There is no danger that rich

Myanmar citizens would leave the country for tax reasons, if rates were higher. However, the transfers of capital abroad ought to be regulated.

- State-owned Economic Enterprises ought to be decentralised with respect to services that benefit local communities.

These principles reflect the norms of a genuine federal democratic union anywhere in the world. They are necessary to accelerate economic development as well as peace, stability and harmony in a future democratic Union of Myanmar.

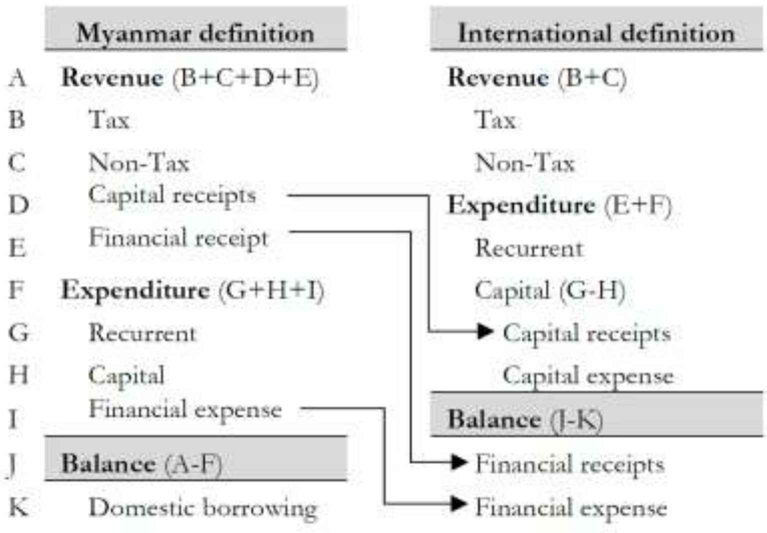
Annex I. Estimating the budget balance – Accounting vs. Analytical Methods

From (World Bank Group 2017, p. 39)

There are two distinct methods for estimating budget balance.

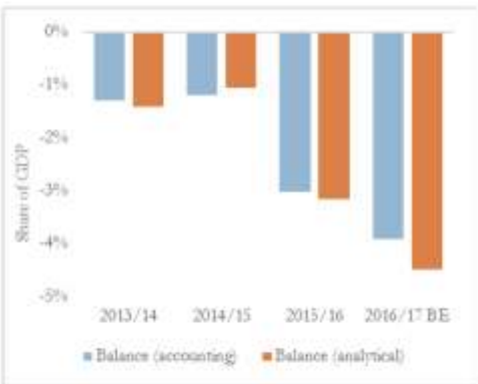
Accounting method: The definition of the overall budget balance in Myanmar differs from standard definition. The Accounting Method, as it is referred to in Myanmar is the difference between total receipts (Government revenue and borrowing) and total payments (Government expenditure and debt amortization). Any deficit is covered by gross domestic borrowing.

Analytical method: Revenue and expenditure items however should exclude financing operations, and the overall balance should correspond to the change in Government net indebtedness (i.e. new borrowing less repayment). This enables the Government to analyze changes in Government assets and liabilities. Capital receipts therefore also need to be subtracted from capital expense to arrive at net capital expenses (or net acquisition of non-financial assets).

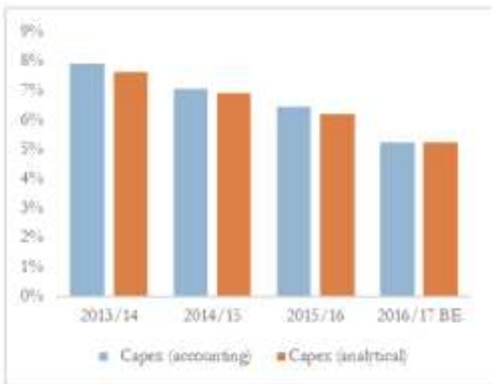


The *analytical method provides a more accurate picture of the fiscal stance*. It enables the Government to have a more effective borrowing target. To date, the State Budget Law adopts a borrowing cap, which corresponds to gross domestic financing needs derived from the accounting method (i.e. row K). This, however, excludes domestic borrowing or foreign financing.

Overall balance (Analytical vs. Accounting)



Capital expenditure (Analytical vs. Accounting



Annex II. Constitutional Schedules I, II, II, V

SCHEDULE ONE
Union Legislative List
(Refer to Section 96)

1. Union Defence and Security Sector

(a) Defence of the Republic of the Union of Myanmar and every part thereof and preparation for such defence;
(b) Defence and Security industries;
(c) Arms, ammunition and explosives including biological and chemical weapons;
(d) Atomic energy, nuclear fuel and radiation and mineral resources essential to its production;
(e) Declaration of war and conclusion of peace;
(f) Stability, peace and tranquility of the Union and prevalence of law and order; and
(g) Police force.

2. Foreign Affairs Sector

(a) Representatives of the diplomatic, consular and other affairs;
(b) United Nations;
(c) Participation in international, regional and bilateral conferences, seminars, meetings, associations and other organizations and implementation of resolutions thereof;
(d) Conclusion and implementation of international and regional treaties, agreements, conventions and bilateral agreements and treaties;
(e) Passports and identification certificates;
(f) Visas, admission into the Republic of the Union of Myanmar, stay, departure, immigration and deportation; and
(g) Extradition and request for extradition.

3. Finance and Planning Sector

(a) The Union Budget;
(b) The Union Fund;
(c) Currency and coinage;
(d) The Central Bank of Myanmar and financial institutions;
(e) Foreign exchange control;
(f) Capital and money markets;
(g) Insurance;
(h) Income tax;
(i) Commercial tax;
(j) Stamp duty;
(k) Customs duty;
(l) Union lottery;
(m) Tax appeal;
(n) Services of the Union;
(o) Sale, lease and other means of execution of property of the Union;
(p) Disbursement of loans from the Union Funds;
(q) Investment of the Union Funds;
(r) Domestic and foreign loans;

(s) Acquisition of property for the Union; and
(t) Foreign aid and financial assistance.

4. Economic Sector

(a) Economy;
(b) Commerce;
(c) Co-operatives;
(d) Corporations, boards, enterprises, companies and partnerships;
(e) Imports, exports and quality control thereon;
(f) Hotels and lodging houses; and
(g) Tourism.

5. Agriculture and Livestock Breeding Sector

(a) Land administration;
(b) Reclamation of vacant, fallow and virgin lands;
(c) Settlements and land records;
(d) Land survey;
(e) Dams, embankments and irrigation works managed by the Union;
(f) Meteorology, hydrology and seismic survey;
(g) Registration of documents;
(h) Mechanized agriculture;
(i) Agricultural research;
(j) Production of chemical fertilizers and insecticides;
(k) Marine fisheries; and
(l) Livestock proliferation, prevention and treatment of diseases and research works.

6. Energy, Electricity, Mining and Forestry Sector

(a) Petroleum, natural gas, other liquids and substances declared by the Union Law to be dangerously inflammable;
(b) Production and distribution of electricity of the Union;
(c) Minerals, mines, safety of mine workers, and environmental conservation and restoration;
(d) Gems;
(e) Pearls;
(f) Forests; and
(g) Environmental protection and conservation including wildlife, natural plants and natural areas.

7. Industrial Sector

(a) Industries to be undertaken by the Union level;
(b) Industrial zones;
(c) Basic standardization and specification for manufactured products;
(d) Science and technology and research thereon;
(e) Standardization of weights and measures; and
(f) Intellectual property such as copyrights, patents, trademarks and industrial designs.

8. Transport, Communication and Construction Sector

(a) Inland water transport;
(b) Maintenance of waterways;
(c) Development of water resources and rivers and streams;
(d) Carriage by sea;

(e) Major ports;
(f) Lighthouses, lightships and lighting plans;
(g) Shipbuilding, repair and maintenance;
(h) Air transport;
(i) Air navigation, control and airfields construction;
(j) Land transport;
(k) Railways;
(l) Major highways and bridges managed by the Union;
(m) Posts, telegraphs, telephones, fax, e-mail, internet, intranet and similar means of communication; and
(n) Television, satellite communication, transmission and reception, and similar means of communication and housing and buildings.

9. Social Sector

(a) Educational curricula, syllabus, teaching methodology, research, plans, projects and standards;
(b) Universities, degree colleges, institutes and other institutions of higher education;
(c) Examinations prescribed by the Union;
(d) Private schools and training;
(e) National sports;
(f) National health;
(g) Development of traditional medicinal science and traditional medicine;
(h) Charitable hospitals and clinics and private hospitals and clinics;
(i) Maternal and child welfare;
(j) Red cross society;
(k) Prevention from adulteration, manufacture and sale of foodstuffs, drugs, medicines and cosmetics;
(l) Welfare of children, youths, women, the disabled, the aged and the homeless;
(m) Relief and rehabilitation;
(n) Fire Brigade;
(o) Working hours, resting-hours, holidays and occupational safety;
(p) Trade disputes;
(q) Social security;
(r) Labour organizations;
(s) Managements by the Union, the following:
(i) Ancient culture or historical sites, buildings, monuments, records, stone inscriptions, ink inscriptions on stucco, palm-leaf parabaiks, handwritings, handiworks, inanimate objects and archaeological works;
(ii) Museums and libraries.
(t) Literature, dramatic arts, music, traditional arts and crafts, cinematographic films and videos; and
(u) Registration of births and deaths.

10. Management Sector

(a) General administration;
(b) Administration of town and village land;
(c) Tenants;

(d) Narcotic drugs and psychotropic substances;
(e) Union secrets;
(f) Associations;
(g) Prisons;
(h) Development of border areas;
(i) Census;
(j) Citizenship, naturalization, termination and revocation of citizenship, citizenship scrutiny and registration; and
(k) Titles and honours.

11. Judicial Sector

(a) Judiciary;
(b) Lawyers;
(c) Criminal Laws and procedures;
(d) Civil Laws and procedures including contract, arbitration, actionable wrong, insolvency, trust and trustees, administrator and receiver, family laws, guardians and wards, transfer of property and inheritance;
(e) Law of Evidence;
(f) Limitation;
(g) Suit valuation;
(h) Specific relief;
(i) Foreign jurisdiction;
(j) Admiralty jurisdiction; and
(k) Piracies, crimes committed in international waters or in outer space and offences against the international law on land or in international waters or in outer space.

SCHEDULE TWO
Region or State Legislative List
(Refer to Section 188)

1. Finance and Planning Sector

(a) The Region or State budget;
(b) The Region or State fund;
(c) Land revenue;
(d) Excise duty (not including narcotic drugs and psychotropic substances);
(e) Municipal taxes such as taxes on buildings and lands, water, street lightings and wheels;
(f) Services of the Region or State;
(g) Sale, lease and other means of execution of property of the Region or State;
(h) Disbursement of loans in the country from the Region or State funds;
(i) Investment in the country from the Region or State funds;
(j) Local plan; and
(k) Small loans business.

2. Economic Sector

(a) Economic matters undertaken in the Region or State in accord with law enacted by the Union;

(b) Commercial matters undertaken in the Region or State in accord with law enacted by the Union; and
(c) Co-operative matters undertaken in the Region or State in accord with law enacted by the Union.
3. Agriculture and Livestock Breeding Sector
(a) Agriculture;
(b) Protection against and control of plants and crop pests and diseases;
(c) Systematic use of chemical fertilizers and systematic production and use of natural fertilizers;
(d) Agricultural loans and savings;
(e) Dams, embankments, lakes, drains and irrigation works having the right to be managed by the Region or State;
(f) Fresh water fisheries; and
(g) Livestock breeding and systematic herding in accord with the law enacted by the Union.
4. Energy, Electricity, Mining and Forestry Sector
(a) Medium and small scale electric power production and distribution that have the right to be managed by the Region or State not having any link with national power grid, except large scale electric power production and distribution having the right to be managed by the Union;
(b) Salt and salt products;
(c) Cutting and polishing of gemstones within the Region or State;
(d) Village firewood plantation; and
(e) Recreation centers, zoological garden and botanical garden.
5. Industrial Sector
(a) Industries other than those prescribed to be undertaken by the Union level; and
(b) Cottage industries.
6. Transport, Communication and Construction Sector
(a) Ports, jetties and pontoons having the right to be managed by the Region or State;
(b) Roads and bridges having the right to be managed by the Region or State; and
(c) Systematic running of private vehicles within the Region or State.
7. Social Sector
(a) Matters on traditional medicine not contrary to traditional medicine policies prescribed by the Union;
(b) Social welfare works within the Region or State;
(c) Preventive and precautionary measures against fire and natural disasters;
(d) Stevedoring;
(e) Having the right of management by the Region or State, the following:
(i) preservation of cultural heritage;
(ii) museums and libraries.
(f) Theatres, cinemas and video houses; and
(g) Exhibitions such as photographs, paintings and sculptures.
8. Management Sector
(a) Development matters;
(b) Town and housing development; and

(c) Honorary certificates and awards.

SCHEDULE THREE
List of Legislation of the Leading Body of Self-Administered Division or Self-Administered Area
(Refer to Section 196)

1. Urban and Rural Projects
2. Construction and Maintenance of Roads and Bridges
3. Public Health
4. Development Affairs
5. Prevention of Fire Hazard
6. Maintenance of Pasture
7. Conservation and Preservation of Forest
8. Preservation of Natural Environment in Accord with Law Promulgated by the Union
9. Water and Electricity Matters in Towns and Villages
10. Market Matters of Towns and Villages

SCHEDULE FIVE
Taxes Collected by Region or States
(Refer to Section 254)

1. Land revenue.
2. Excise revenue.
3. Water tax and embankment tax based on dams and reservoirs managed by the Region or State and tax on use of electricity generated by such facilities managed by the Region or State.
4. Toll fees from using roads and bridges managed by the Region or State.
5. (a) Royalty collected on fresh water fisheries.
(b) Royalty collected on marine fisheries within the permitted range of territorial water.
6. Taxes collected on vehicles on road transport and vessels on inland waterway transport, in accord with law, in a Region or a State.
7. Proceeds, rent fees and other profits from those properties owned by a Region or a State.
8. Fees, taxes and other revenues collected on services enterprises by a Region or a State.
9. Fines imposed by judicial courts in a Region or a State including Region Taya Hluttaw or State Taya Hluttaw and taxes collected on service provision and other revenues.
10. Interests from disbursed by a Region or State.
11. Profits returned from investment of a Region or State.
12. Taxes collected on extraction of the following items from the forests in a Region or a State:
(a) Taxes collected on all other woods except teak and other restricted hard

woods;
(b) Taxes collected on firewood, charcoal, rattan, bamboo, birdnests, cutch, thanetkha, turpentine, eaglewood and honey-based products.
13. Registration fees.
14. Taxes on entrainments.
15. Salt tax.
16. Revenue received from the Union Fund Account.
17. Contributions by development affairs organizations in a Region or State concerned.
18. Unclaimed cash and property.
19. Treasure trove

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