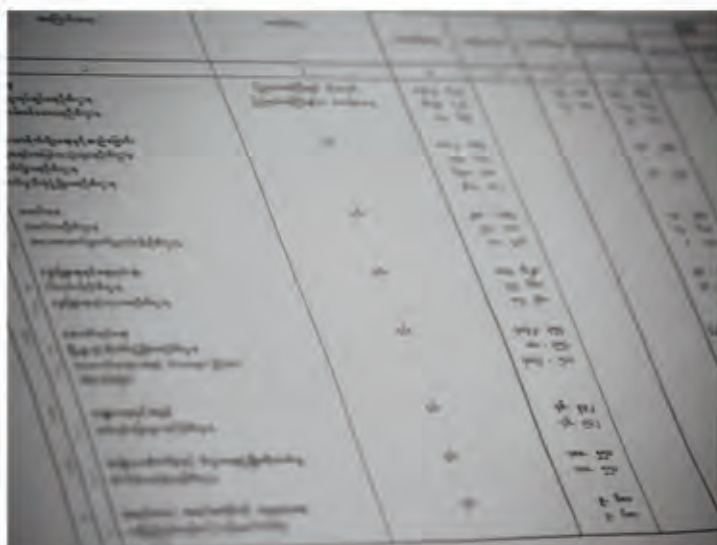


Subnational Governance in Myanmar Discussion Paper Series

# Fiscal Decentralization in Myanmar

## Towards a Roadmap for Reform



Hamish Nixon and Cindy Joelene

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**The Asia Foundation**  
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***Fiscal Decentralization in Myanmar: Towards a Roadmap for Reform***

**Hamish Nixon and Cindy Joelene**

**June 2014**

**Hamish Nixon** is an independent governance specialist focusing on the areas of decentralization, peace and conflict, and public service delivery. **Cindy Joelene** is a researcher at MDRI's Centre for Economic and Social Development. The authors would like to thank all the individuals who gave time to help them better understand Myanmar's decentralization context. The paper benefited significantly from comments by Robert Ebel on earlier work, and from suggestions from Jamie Boex on international strategies for fiscal decentralization reforms. Andrea Smurra, Susanne Kempel, Henri Schreurs, Paul Minoletti, and Matthew Arnold all provided helpful comments on earlier drafts. Christopher Freeman carefully edited the manuscript, The Myanmar Translation Company ably translated the report. Any errors of substance or argument rest with the authors.

The ***Subnational Governance in Myanmar Discussion Paper Series*** is a collaborative research initiative between the Myanmar Development Resource Institute's Centre for Economic and Social Development and The Asia Foundation. The paper series aims to provide Myanmar policy-makers at national and local levels, civil society organizations, the business community, development partners, and other interested stakeholders with timely research on subnational governance issues that directly inform policy and reform processes. The research behind the series incorporates the perspectives of a range of government, political, non-governmental, civil society, and community stakeholders in subnational governance, while also bringing to bear the most relevant policy analysis and international experience. The sponsoring organizations welcome inputs and suggestions on published, ongoing, or future research.

**The Myanmar Development Resource Institute's Centre for Economic and Social Development** is an independent think-tank dedicated to the economic and social transformation of Myanmar. The Centre undertakes participatory policy research studies related to economic reform, poverty-reduction, sustainable development, and good governance in Myanmar. It also provides training and education services for key institutions and organizations contributing to the ongoing process of reform.

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## Preface

The Myanmar Development Resource Institute's Centre for Economic and Social Development (MDRI-CESD) and The Asia Foundation are pleased to present this fifth volume in the Subnational Governance in Myanmar Discussion Paper Series.

The pace of change in Myanmar is rapid and constantly evolving, and decentralization and local governance are issues of critical importance to the country's long-term development and priorities in the government's reform agenda. As such, there is a real need for timely research and analysis on key reform areas related to decentralization and local governance. As an extended collaboration between the Foundation and MDRI-CESD, this series of discussion papers aims to provide Myanmar's policy-makers at national and local levels, civil society organizations, the business community, development partners, and other interested stakeholders with research findings on subnational governance issues that directly inform policy and reform processes.

Fiscal decentralization forms the backbone of Myanmar's efforts to strengthen public services, encourage development across the country, and secure peace and stability. The country has made important first steps in the decentralization process, but as yet these do not form a consistent framework for distributing budgetary resources. This discussion paper by Hamish Nixon and Cindy Joelene intends to inform the wider discussion about how best to proceed with fiscal decentralization in Myanmar. Its goal is to inform policy makers, civil society, political parties, and international development partners of principles and processes to guide fiscal decentralization policy. The paper presents ideas for a fiscal decentralization roadmap that are grounded in the country's context, and that build on existing structures and reforms while leaving space for the longer-term evolution of the decentralization process.

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Dr. Zaw Oo

Executive Director

MDRI-CESD

Dr. Kim Ninh

Country Representative

The Asia Foundation

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## **Acronyms**

CDF	Constituency Development Funds
GAD	General Administration Department
MBA	Ministry of Border Affairs
MDRI-CESD	Myanmar Development Resource Institute – Centre for Economic and Social Development
FESR	Framework for Economic and Social Reform
MIMU	Myanmar Information Management Unit
MoF	Ministry of Finance
MNPED	Ministry of National Planning and Economic Development
NCDD	National Community Driven Development Project
PFM	Public Financial Management
PRF	Poverty Reduction Funds or Poverty Eradication Funds
SEE	State Economic Enterprises
SPDC	State Peace and Development Council
TDAC	Township Development Affairs Committee
TDSC	Township Development Support Committee
TMC	Township Management Committee

## Executive Summary

**In theory, decentralization can create important benefits consistent with the policy priorities of the government and the needs of Myanmar’s people.** Decentralization is supposed to align public services more closely to the preferences and needs of local people, increasing responsiveness. By enabling stronger accountability and transparency, and reducing administrative bottlenecks, decentralization may improve the technical efficiency and improve the quality of public services. And as a means to achieve greater equity and participation, decentralization may support state legitimacy, and help address some, though perhaps not all, kinds of internal conflict.

**But, decentralization is very risky and difficult in practice.** There is evidence that – on the whole – more fiscally decentralized countries enjoy higher income and other benefits, but there is little evidence that the process of decentralization systematically produces these benefits. This gap between theory and reality is a result of lack of attention to contextual factors and poor design or implementation of decentralization reforms. Successful decentralization reforms entail aligning decentralization strategy with the political drivers for decentralizing, the institutional starting points, and the capacity of the existing system.

**This paper introduces a “roadmap” for Myanmar’s fiscal decentralization** that is: (1) based in Myanmar’s current political, institutional, and fiscal realities and addresses key local policy aims; (2) informed by international and theoretical lessons, and (3) cautious and flexible enough to limit fiduciary and capacity risks while allowing for the possibility of more significant future reforms, including developments in Myanmar’s peace process.

**The process of decentralization has accelerated since the Thein Sein government came into power in 2011.** The government has emphasized “people-centered development,” creating consultative bodies or elected positions at district, township and village levels. It has also ordered state and region level civil servants to coordinate with state and region government over Union level responsibilities, and increased the budgets available for local public functions and development projects.

**However, important longer-term political aspects of the decentralization process are still unclear.** Several major policy processes that are still at an early stage will shape the long-term direction of Myanmar’s decentralization. There are active discussions about constitutional change, both within the legislative branch and among political parties as the election draws nearer. It is also clear that should the peace process proceed to the “political dialogue” stage, the position of most ethnic armed groups calls for a reorientation of center-local relations towards a more federal model. In large territories of contested governance, administration takes place via various

hybrid or non-state systems, and decentralizing central government services has political implications that may bear on the peace process. Finally, achieving increased transparency, equity, sustainability and justice in the sharing of natural resource revenues is intimately related to the broader issue of effective fiscal decentralization, as well as the peace process.

**Myanmar's reform is at a balance point.** The end goals of the fiscal decentralization are difficult to see, but there are still opportunities to achieve results while laying the ground for a longer-term decentralization process of which the full scope and nature is as yet, unclear. To do this means building upon the institutions that are currently functioning and the reforms that have been undertaken, while leaving space for more than one possible future.

**Myanmar's current subnational fiscal structure is a mixture of horizontal and vertical decentralization.** There are three main channels for fiscal resources from the Union to the state/region level:

- Channel 1: Line ministries or departments that remain under Union jurisdiction, and which have assigned, to a greater or a lesser degree, some activities and their accompanying budget to their state and region departments, through a *deconcentrated channel*.
- Channel 2: The Union budget gives aid in the form of grants or loans to the state/region fund to support a range of devolved departments through a *devolution channel*; these state/region budgets are also supported by tax and non-tax revenues and local SEE income.
- Channel 3: Various separately budgeted funds mainly for capital expenditure on local infrastructure, also *devolved* to the state/region level, local parliamentarians, or townships according to various distribution and management criteria detailed below.

**The thrust of government fiscal decentralization policy has been to increase the share of national expenditure included in state and region budgets**, which tripled in the last year to 11.8 percent. This type of policy is quite common around the world, but is inadequate because it focuses attention on the state and region. Thus it does not address the central systems for determining *why* the center should devolve a certain share of the budget, or *how* that share should be divided among different states and regions. It also focuses on one or two of the channels between the center and state/region level, and ignores the major sector deconcentration channel.

**A vertical deconcentration process for important sectors in Channel 1 has already begun in Myanmar.** These steps represent important advances in decentralizing service delivery. However, they do not as yet form a systematic and transparent framework for allocating these resources across the country. An incremental fiscal decentralization strategy should build upon them by introducing a more systematic



approach to the deconcentration of functions, providing the resources to fund them (vertical fiscal balance), and distributing these resources across the country in line with policy objectives (horizontal fiscal balance).

**Budgeting for state/region departments is currently based on the deficit between departments' revenue and expenditure, or *ad hoc* negotiations with the central level.** This method of budget preparation results in inequitable budgets that mirror *current* rates of spending, not what spending *should be* to carry out assigned responsibilities. When deficits are the main determinant of the levels of transfers, states and regions and other local governments do not have an incentive to improve revenue collection.

**Myanmar has also introduced a number of overlapping committees and subnational development funds broadly aimed at poverty alleviation and local development through increased discretionary resources and "bottom-up" planning.** Different fund structures and the proliferating committees that have grown up to ensure local participation carry overlapping objectives and mandates, which make coordination difficult and risks poor targeting of resources. At the same time, the complex and varied allocation procedures mean that the overall effect of these flows on the horizontal distribution of resources across the country may be difficult to discern. At a time when Myanmar should be aiming for greater budget integration, there is actually considerable budget fragmentation occurring.

**This report proposes an incremental fiscal decentralization reform strategy with three reform tracks,** corresponding to the major existing channels of subnational resource flows to states and regions.

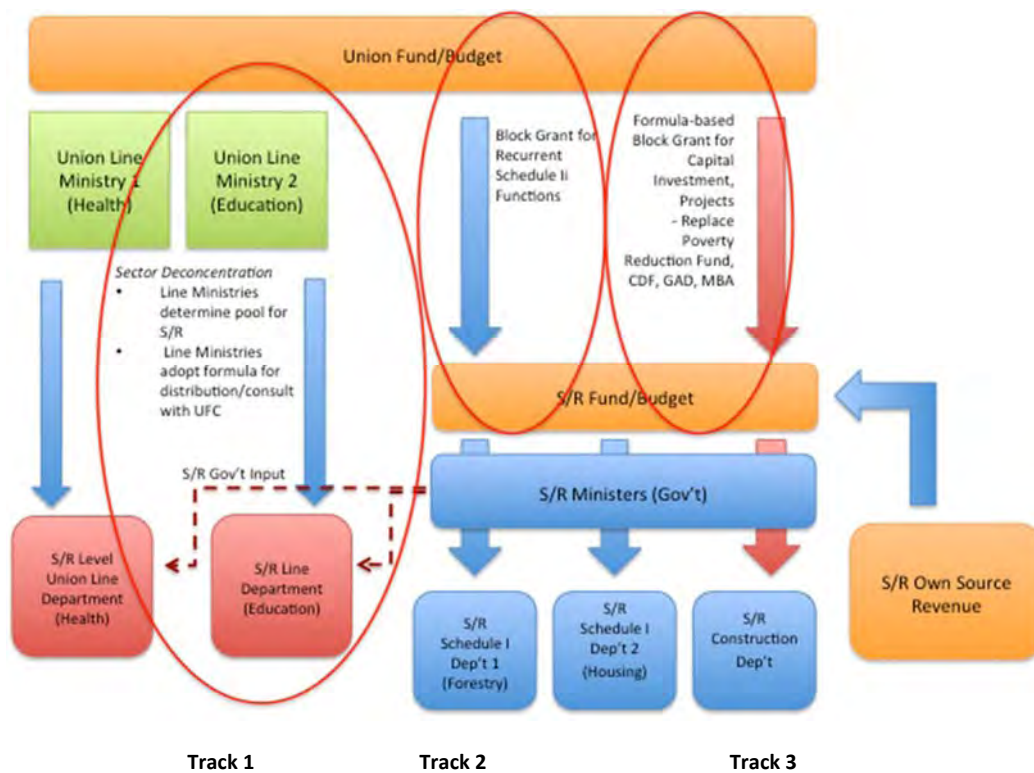
**The first track consists of a framework for sectoral deconcentration built on a systematic analysis and adjustment of functional assignments, followed by the introduction of sector budgeting formulae to improve subnational budget allocations within major line ministries.** This process must run in parallel with changes to budget preparation and presentation to allow ceilings and final allocations to state/region departments to be transparent within the union budget, and to allow line ministries to provide budget ceilings for deconcentrated functions and activities to their state and region departments.

**Alongside the process of sectoral deconcentration, Myanmar should move towards a system of transfers that works to meet the objectives of the government for its devolved activities in the second and third channels.** The immediate priority is to move from the current system of budgeting for state/region transfers to one that rationalizes (1) the vertical balance of resources between levels; (2) the horizontal balance across the country; (3) the incentives for own source revenue collection, while (4) not overwhelming fiscal or implementation capacity in weak or small states and regions.

The best starting point for designing a state/region transfer system for Myanmar would be for those responsibilities already under the control of state/region government, and the various development aims of the poverty reduction funds. Based on analysis of Myanmar’s situation, a tentative transfer system proposal for state and region transfers might include:

- an unconditional block grant for ordinary functions assigned to that level, possibly with either a matching or mild performance-based component aimed at improving planning and revenue performance relative to local capacity and conflict sensitivities; and,
- an additional unconditional grant aggregating the Poverty Reduction Fund and, if politically feasible, the Constituency Development Fund, but with guidelines for coordination with deconcentrated sector services;
- a possible general purpose grant for equalization, compensation or derivation based on natural resource revenues.

Figure 1: Three reform tracks



Coordinating and eventually integrating these three tracks, is a massive policy task, but there is currently no clear policy home for this activity within the Myanmar government. Decentralization can demonstrate benefits quickly – for example through local development projects and new staff in sector departments – but it is not a “quick win” reform. It requires a consistent and clear effort to establish objectives,

coordinate many stakeholders, and develop and implement overarching policies. There is an urgent need for a national policy coordination capacity.

**The policy coordination mechanism needs to balance the requirements of political decision-making and support for sound technical analysis and policy development.**

As decentralization is a cross-cutting issue that influences public financial management of all kinds, it needs participation of all key budgetary institutions.

**A high political body such as a national commission or secretariat is likely most suited to Myanmar's context** where political decentralization leads administrative and fiscal dimensions and its pending high-level questions about the constitution, the peace process, and natural resources.

**In addition to a higher level body to guide policy with wider participation, the Financial Commission should be given – through law in accordance with the constitution – a policy role to design the fiscal frameworks for deconcentration and devolution called for in the roadmap introduced in this paper.** The Commission should move from being a forum for inter-governmental bargaining to being a policy setting body for the transfer system. To do so would require substantial investment in a technical secretariat, and legislative requirements for it to consult widely within and beyond government.

## ONE: Fiscal Decentralization in Theory and Practice

Along with other reforms, Myanmar is undertaking the most significant decentralization in its history. The 2008 Constitution established state and region governments with partially elected assemblies, or *hluttaws*, under the direction of centrally appointed Chief Ministers.<sup>1</sup> More recently the government has established various indirectly or directly representative bodies at township and village or village-tract levels, though these fall short of devolved local governments and are dependent on centralized institutions, particularly the General Administration Department (GAD) of the Ministry of Home Affairs.<sup>2</sup> The government of Myanmar recognizes that there is still confusion over the administrative and expenditure roles of different administrative levels, and difficulties coordinating Union level functions with state and region governments.<sup>3</sup> Various presidential orders have been issued to increase the role of state and region ministers, and for Union ministries to decentralize some of their functions to their local offices.<sup>4</sup>

The mantra of “people-centered development” has been widely proclaimed by central and local officials, and the government’s Framework for Economic and Social Reform (FESR) “attaches a high priority to developing a participatory process of local budgeting, which should reflect local priorities and needs, while corresponding with national policy directions.”<sup>5</sup> A range of potential and actual revenue sources now lie with the subnational levels of administration in line with Schedule Five of the Constitution, including land and excise taxes, a range of fees, and revenues from a few of the smaller State Economic Enterprises.<sup>6</sup> Along with these measures, there has been a significant decentralization of the government budget to the newly established state and region budgets. In the year from FY 2013-14 to FY 2014-15 the share of the Union budget estimate assigned as “aid” to state and region governments tripled, from about 3.6 percent to 11.8 percent.<sup>7</sup>

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<sup>1</sup> Hamish Nixon et al., *State and Region Governments in Myanmar* (Yangon: The Asia Foundation/MDRI-Centre for Economic and Social Development, September 2013).

<sup>2</sup> Kyi Pyar Chit Saw and Matthew Arnold, *The General Administration Department: An Overview of Myanmar’s Administrative Backbone* (Yangon: The Asia Foundation/MDRI-Centre for Economic and Social Development, forthcoming 2014).

<sup>3</sup> Government of the Union of Myanmar, “Framework for Economic and Social Reform,” December 2012, Para. 105.

<sup>4</sup> “Speech of President Thein Sein delivered to Union Ministers, Region and State Chief Ministers, and Deputy Ministers” (9 August 2013).

<sup>5</sup> Government of the Union of Myanmar, “Framework for Economic and Social Reform,” Para. 106. People-centered development figures prominently, among elsewhere, in “Speech of President Thein Sein” (9 August 2013).

<sup>6</sup> Constitution of the Republic of the Union of Myanmar, Schedule Five (reproduced as Annex 4).

<sup>7</sup> Union budget laws 2013-14, as published in Union Government Gazette.

In theory, decentralization can have important benefits consistent with the priorities of the government and the needs of Myanmar's people.<sup>8</sup> Decentralization is supposed to increase the responsiveness of public services to the preferences and needs of communities.<sup>9</sup> By enabling more accountability and transparency, and reducing administrative bottlenecks, decentralization may improve the efficiency and quality of public services. And if it succeeds in achieving greater equity and participation across different parts of the country, decentralization may support state legitimacy, and help address some kinds of internal conflict.

A paradox of decentralization is that while there is evidence that – on the whole and in the long-term – more fiscally decentralized countries enjoy higher income and other benefits, the process of decentralization does not produce these benefits easily, particularly in developing countries.<sup>10</sup> Instead, there is broad agreement that “although there have been meaningful and productive decentralization reforms and development partner support programs ... many perform well below expectations.”<sup>11</sup> Decentralization in general, and fiscal decentralization in particular, is risky and difficult in practice.

This gap between theory and reality is now understood to come from lack of attention to contextual factors and poor design or implementation of decentralization reforms. Key sources of these weaknesses include a failure to recognize and work with the political drivers of the decentralization process; inconsistencies in institutional design and poor integration of political, administrative and fiscal dimensions of decentralization (see Annex 1); and sequencing mistakes that overwhelm existing capacity.<sup>12</sup> There can be many political drivers for decentralization. The population may feel that decentralization will improve government performance; groups of

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<sup>8</sup> Jesper Steffensen, *Fiscal Decentralization and Sector Funding Principles and Practices* (DANIDA, November 2010), 3. There is an extensive literature on the theoretical benefits of fiscal decentralization and fiscal federalism dating from the 1950s. A useful overview is Paul Smoke, *Fiscal Federalism in Developing Countries: A Review of Current Concepts and Practices* (New York: United Nations Research Institute for Social Development, 2001).

<sup>9</sup> In economics this form of responsiveness is called “allocative efficiency” and is considered most important when there is “heterogeneity of demand,” or widely varying needs and preferences across different places.

<sup>10</sup> Balázs Égert and Hansjörg Blöchliger, *Decentralisation and Economic Growth - Part 2: The Impact on Economic Activity, Productivity and Investment*, OECD Working Papers on Fiscal Federalism, (June 3, 2013): [http://www.oecd-ilibrary.org/taxation/decentralisation-and-economic-growth-part-2-the-impact-on-economic-activity-productivity-and-investment\\_5k4559gp7pzw-en](http://www.oecd-ilibrary.org/taxation/decentralisation-and-economic-growth-part-2-the-impact-on-economic-activity-productivity-and-investment_5k4559gp7pzw-en) [accessed 26 May 2014].

<sup>11</sup> Kent Eaton, Kai Kaiser, and Paul J. Smoke, *The Political Economy of Decentralization Reforms* (Washington, D.C: World Bank, 2011), 7.

<sup>12</sup> For a comprehensive and up to date review of the literature on implementation problems in decentralization, see Local Development International, *The Role of Decentralisation/Devolution in Improving Development Outcomes at the Local Level: Review of the Literature and Selected Cases* (DFID/Local Development International, November 2013).

citizens who are disconnected due to ethnic or cultural difference may seek decentralization to recognize their differences; and politicians and bureaucrats may support it to generate electoral legitimacy or appease political demands for autonomy.<sup>13</sup> Successful decentralization reform strategies must align with the prevailing political drivers for decentralizing, the institutional starting points, and the capacity of the existing system.

Within such a strategy, *fiscal* decentralization – the adequate and effective resourcing of the responsibilities given to subnational administration – is central to realizing the benefits of decentralization:

Whereas the decision to decentralize is political, the economic and financial payoff flows from a well-designed system of *fiscal decentralization*—that is, the intergovernmental sorting out of responsibilities for expenditures and financing among the various types, tiers, or levels of government, in a manner that is in harmony with the political framework.<sup>14</sup>

*If different contexts and designs can lead to such different results, how can a country design a fiscal decentralization strategy that is most likely to succeed?*

### **1.1 The “textbook” approach to fiscal decentralization, and its limits**

Technical input to decentralization processes tends to suggest a common set of “building blocks” and a sequenced process to define a fiscal decentralization strategy, “shaped by normative principles and considerations of ‘best’ or good international practice.”<sup>15</sup> Fundamental among these building blocks are what are often called the “four pillars” of fiscal decentralization, each with their own set of best practices:

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<sup>13</sup> Roy W. Bahl and Jorge Martinez-Vazquez, *Sequencing Fiscal Decentralization* (World Bank Publications, 2006), 7.

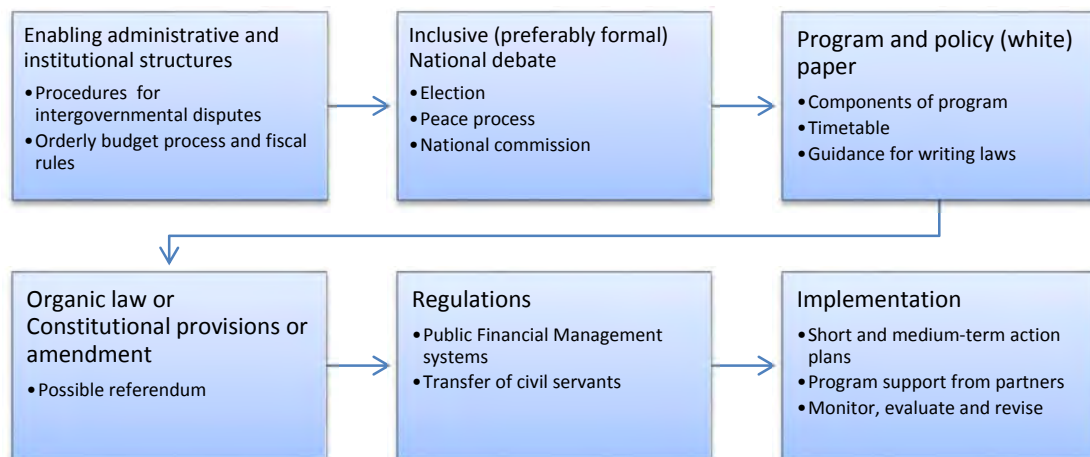
<sup>14</sup> Abdu Muwonge and Robert D. Ebel, “Intergovernmental Finances in a Decentralized World,” in *Municipal Finances: A Handbook for Local Governments*, ed. Catherine Farvacque-Vitkovic and Mihaly Kopanyi (Washington, DC: World Bank, 2014), 2.

<sup>15</sup> Eaton, Kaiser, and Smoke, *The Political Economy of Decentralization Reforms*, 7.

1. *Assignment of expenditure responsibilities* according to associated principles of public finance such as subsidiarity, economies of scale, externalities and equity.
2. *Assignment of revenue sources* according to the types of services that are to be funded, avoiding economic distortions, and promoting subnational fiscal autonomy.
3. *Design of intergovernmental transfer systems* to meet any gap between revenue and expenditure for assigned functions, and to promote equity across locations and other policy goals.
4. *Subnational borrowing and fiscal discipline* to ensure long-term investment and prevent fiscal decentralization from creating excess debt.

International experience suggests additional elements that are essential for a sound fiscal decentralization process, including effective civil service rules, financial management and coordination procedures, and clear political accountability.<sup>16</sup> Since each of these building blocks needs careful technical consideration, there is an ideal or “best practice” sequence for the development of fiscal decentralization strategy (Figure 2). Broadly speaking, assuming a minimum set of state capacities already exists, an inclusive and popular debate about the goals of decentralization should be followed by the development of a policy and a program structure to carry it out, passage of necessary legislation, and implementation support.

**Figure 2: A normative approach to sequencing fiscal decentralization<sup>17</sup>**



While each of these steps are important to the overall success of reforms, they are rarely implemented this way in practice – a problem that is also acknowledged by many of those proposing them. This idealized approach where each step happens in

<sup>16</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 14; Steffensen, *Fiscal Decentralization and Sector Funding Principles and Practices*, 5.

<sup>17</sup> Adapted from Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 2–5.

the right order is usually not possible, and in the real world there is “no single best approach to sequencing fiscal decentralization.”<sup>18</sup>

There are many examples of failed or delayed grand designs for decentralization. In Afghanistan, a Subnational Governance Policy of 400 pages was painstakingly developed with extensive and costly international assistance in 2008, but remains largely unimplemented. In Nepal, many elements of the Local Self-Governance Act of 1999 remain on paper 15 years later, with intentions to decentralize services unfulfilled and only a small proportion of the budget given to local governments. Cambodia, after ten years of post-conflict state-building, only embarked on a “model” process with a 2005 strategy, a subnational Organic Law in 2008, and the beginning of a ten year decentralization program in 2010.<sup>19</sup>

In reality, the “textbook” approach to decentralization confronts the constraints set by the underlying political motivations and conditions for reform, which are often different from the theoretical benefits. As a result,

Countries embarking on decentralization often struggle with decisions about the essential components of decentralization including the order of an introduction of decentralization policies, the number of years necessary to bring a full program on line, and the components of the transition strategy.<sup>20</sup>

As well as difficulties with clarifying policy aims, the design and implementation of decentralization policy often encounters political and bureaucratic resistance as it proceeds: “In the real world ... there are important constraints that steer countries away from such an optimal sequencing. And sometimes, these departures are in the best interests of getting the job done.”<sup>21</sup> For successful decentralization reforms a way must be found between the ideal sequence and these real political conditions.

## **1.2 Between grand plans and “muddling through”**

Recently, development policy research has focused on the practical challenges of successfully implementing public sector reforms including decentralization programs.<sup>22</sup> To be successful, reforms should build on contextual and institutional

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<sup>18</sup> Ibid., 2.

<sup>19</sup> On Cambodia’s painstaking decentralization process see Pak Kimchoeun, *Fiscal Decentralisation in Cambodia: A Review of Progress and Challenges*, CDRI Working Paper Series 50 (Phnom Penh: CDRI, 2011); Tariq H. Niazi, *Deconcentration and Decentralization Reforms in Cambodia* (Philippines: Asian Development Bank, 2011).

<sup>20</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 1.

<sup>21</sup> Ibid., 5.

<sup>22</sup> See Leni Wild and Marta Foresti, *Working with the Politics*, 2013, <http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8587.pdf>; Matthew Andrews, *The Limits of Institutional Reform in Development – Changing Rules for Realistic Solutions*



realities, address specific and grounded problems, and proceed incrementally with ongoing learning and adjustment: “[e]ven though a clear vision of longer-term reform is needed, initial steps should be modest and logically phased.”<sup>23</sup> For example, policymakers can take advantage of momentum offered by other reforms, as in Indonesia, Poland and Estonia.

While a lot of knowledge exists about what one *should* do to fiscally decentralize successfully, developing an understanding of what one *can* do – and a workable plan to do it – is a more complex and difficult process. This paper is an effort to support that process in Myanmar. It introduces a potential “roadmap” for Myanmar’s fiscal decentralization that is: (1) based in Myanmar’s current political, institutional, and fiscal realities and addresses key local policy aims; (2) informed by international and theoretical lessons, and, (3) cautious and flexible enough to limit risks to public finances and services, while allowing for the possibility of much more significant future reforms including developments in Myanmar’s peace process.

It is important to begin from where we are now, so the next section reviews the current political and institutional context for Myanmar’s fiscal decentralization reforms, and introduces the main existing channels of the subnational fiscal system. The third part of the paper reviews the current state of reform across each of these channels, and introduces a framework for strengthening each of them, while preparing the ground for longer-term reforms. The last section emphasizes the importance of coordinating institutions and policies to manage such complex reforms, and presents some recommendations for them.

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(Cambridge: Cambridge University Press, 2013). This approach has been given the somewhat inaccessible label: “Problem-Driven Iterative Adaptation,” and echoes earlier work on incremental policy change: Charles E. Lindblom, “The Science of ‘muddling through,’” *Public Administration Review* 19, no. 2 (Spring 1959): 79–88.

<sup>23</sup> Paul Smoke, “Strategic Fiscal Decentralization in Developing Countries: Learning from Recent Innovations,” in *Local Dynamics in an Era of Globalization*, ed. Shahid Yusuf, Weiping Wu, and Simon Evenett (World Bank, 2000), 107.

## **TWO: Myanmar's Fiscal Decentralization Environment**

Effective decentralization strategies need to build on existing context. Important contextual factors include the political drivers behind decentralization, the roles and interests of key actors and stakeholders, and the current state of reform.<sup>24</sup> Key actors and stakeholders may be political or bureaucratic, and it is important to include development partners among them.<sup>25</sup> Reforms also need to start with the existing fiscal institutions for planning, budgeting and spending institutions, even while aiming to improve them.

### **2.1 Political and institutional context for decentralization reform in Myanmar**

Myanmar's formal process of decentralization began with the adoption of the 2008 Constitution, itself the culmination of the State Peace and Development Council (SPDC) regime's carefully managed "seven-step road map" towards a "modern, developed, and democratic nation." As part of a carefully orchestrated transition, decentralization has been subject to clear limits that are apparent in constitutional provisions relating to the structure of the state. In particular, the constitution sets some crucial constraints on Myanmar's early fiscal decentralization process.

First, it establishes a mixed political system at the state and region level that combines a semi-elected local representative body with an, essentially, centrally appointed Chief Minister.<sup>26</sup> This type of arrangement is quite common in decentralizing countries:

Full horizontal accountability to voters is limited in other developing and transition countries by less than full direct elections of executive and legislative branches of government. In a common modality, the legislative branch is democratically elected but the executive branch is appointed by the center.<sup>27</sup>

This combination allows the centrally appointed executive to oversee the activities of newly democratic local governments, and exercise control over implementation, and

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<sup>24</sup> Eaton, Kaiser, and Smoke, *The Political Economy of Decentralization Reforms*, 8.

<sup>25</sup> There is evidence that development partner practices pose particular risks to decentralization in more aid dependent countries: Local Development International, *The Role of Decentralisation/Devolution in Improving Development Outcomes at the Local Level: Review of the Literature and Selected Cases*, 40–44.

<sup>26</sup> "Constitution of the Republic of the Union of Myanmar" (Ministry of Information, Government of Myanmar, 2008), Art. 261. As in the national parliament, 25 percent of state and region representatives are directly appointed by the Commander-in-Chief of the armed services.

<sup>27</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 16. On comparison between Cambodia and Myanmar, see Lee Jones, "The Political Economy of Myanmar's Transition," *Journal of Contemporary Asia* 44, no. 1 (January 2, 2014): 20–24.

is particularly common where there is an emphasis on centrally dominated and managed reform processes, as in Russia's regions or Cambodia's provinces.

Second, the constitution mandates important administrative roles in the state and region governments, in the self-administered zones, and in the Nay Pyi Taw council, for the General Administration Department under the direction of the military-led Home Affairs ministry.<sup>28</sup> Finally, the constitution establishes a division of responsibilities between central and subnational levels that retains many developmentally and fiscally important responsibilities – such as health, education and major economic sectors – as Union-level responsibilities and therefore subject to the Union budget process (See Annex 3).

In addition to the constitutional constraints, Myanmar's public sector transition is taking place via a civil service that "has long been characterized by a high degree of centralization, a weak degree of administrative and managerial autonomy and an almost nonexistent consultative process."<sup>29</sup> At subnational levels, the bureaucracy were sidelined by the *Tatmadaw's* regional commander system until the return of civilian government after 2011. In addition to this bureaucratic culture, Myanmar's political culture echoes that of some neighbours, with wide acceptance of political and bureaucratic elites, patronage, limited experience of accountability, and vertically managed approaches to managing territory through governors or officers.<sup>30</sup> This organizational culture means that reform is primarily being accomplished via top-down *fiat* rather than more organic or locally-driven processes, and that ambiguities created by changing policies from above tend to result in stasis rather than innovation.<sup>31</sup>

Despite these somewhat rigid foundations, the process of decentralization has accelerated and created new spaces for reform since the Thein Sein government came into power in 2011. This decentralization is aimed at rapid improvement of public services and development with "quick wins," bolstering efforts to conclude a nationwide cease-fire and advance the peace process, and to generate legitimacy before the 2015 election.<sup>32</sup> Concrete decentralization reforms since 2011 have thus had a primarily developmental focus. The government has emphasized "people-centered development" by creating consultative bodies or elected positions at district,

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<sup>28</sup> "Constitution of the Republic of the Union of Myanmar", Art. 260, 283, 287. See also Kyi Pyar Chit Saw and Arnold, *The General Administration Department: An Overview of Myanmar's Administrative Backbone*.

<sup>29</sup> Alex M. Mutebi, "Myanmar's Civil Bureaucracy and the Need for Reform," in *Myanmar: Beyond Politics to Societal Imperatives* (Singapore: Institute of Southeast Asian Studies, 2005).

<sup>30</sup> Tariq H. Niazi, *Deconcentration and Decentralization Reforms in Cambodia* (Philippines: Asian Development Bank, 2011), ix.

<sup>31</sup> Nixon et al., *State and Region Governments in Myanmar*, 35.

<sup>32</sup> Jones, "The Political Economy of Myanmar's Transition," 12.

township and village tract levels, although these bodies are mostly appointed and not necessarily representative. It has also ordered state and region level civil servants to coordinate with state and region government over Union level responsibilities, and increased the budgets available for local functions and development projects. These efforts are limited, but they have begun to address an imbalance between the politically significant establishment of state and region governments and the relatively weak administrative and fiscal systems to support them.<sup>33</sup>

However, the longer-term political direction of the decentralization process is still unclear. Several major policy processes that will shape Myanmar's decentralization are still at an early stage. There are active discussions about constitutional change, both within the legislative branch and among political parties as the election draws near.<sup>34</sup> The constitutional review being managed through legislative committees registered strong interest in amendment of the state structure provisions of the constitution, but has not yet committed to supporting any particular reforms. The report of the joint parliamentary committee on constitutional reform shows that 161 of 162 submissions relating to Chapter Two of the Constitution (State structure) suggest revisions or rewriting, while all 245 suggestions relating to Schedules One, Two and Five setting out the powers of the states and regions, requested changes (Annex 3).<sup>35</sup>

It is clear also that should the peace process proceed to the "political dialogue" stage, the position of most ethnic armed groups calls for a reorientation of centre-local relations towards a more federal model, possibly through a redrafted rather than amended constitution.<sup>36</sup> It is a vital caveat to the recommendations in this paper that in large territories of contested governance, administration takes place via various hybrid or non-state systems, and decentralizing central government services has political implications that may bear on the peace process. The situation in these areas

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<sup>33</sup> On the balance between political, administrative and fiscal decentralization in these early stages of state and region government see Nixon et al., *State and Region Governments in Myanmar*, 69–73. On the political, administrative and fiscal dimensions of decentralization, see Annex 1.

<sup>34</sup> See for example, Nyein Nyein, "USDP Leader Urges Committee to Review Key Constitutional Reforms", *The Irrawaddy* (18 February 2014).

<sup>35</sup> By far the largest number of requests (5865 separate submissions) for changes to the constitution relate to Chapter 12, which sets out the provisions for constitutional amendments: Pyidaungsu Hluttaw, *Report of Constitutional Review Joint Committee's Findings and Assessment* (Nay Pyi Taw: 31 January 2014).

<sup>36</sup> Burma News International, *Deciphering Myanmar's Peace Process* (Chiang Mai: BNI, March 2014), 32-33.

is described in *Ethnic Conflict and Social Services in Myanmar's Contested Regions*, a new discussion paper in this series.<sup>37</sup>

Finally, among existing states/regions and the centre, political parties, and non-state political and armed groups, the issues of increased transparency, equity, sustainability and justice in the sharing of natural resource revenues are intimately related to the broader issue of effective fiscal decentralization, a topic taken up by the MDRI-CESD and Asia Foundation research paper *Natural Resources and Subnational Governments in Myanmar*.<sup>38</sup>

Myanmar's reform is therefore at a balancing point. Unlike the "textbook" sequence that suggests a broad national consensus should precede reform, there is already considerable political drive for some decentralization in action at both central and local levels. But ongoing differences in the constitutional reform and peace processes mean that a national consensus is still developing. In short, there is not yet a "political settlement" regarding decentralization or central-local relations in Myanmar.<sup>39</sup> The end goals and full scope of fiscal decentralization are therefore difficult to see, but there are still opportunities to achieve results while laying the ground for a longer-term decentralization process. To do this means building upon the institutions that are currently functioning and the reforms that have been undertaken, while leaving the space for more than one possible future.

## **2.2 Myanmar's current subnational fiscal structure**

These political and institutional factors mean that so far fiscal decentralization has been largely driven from the top, focused on service-delivery and development spending, and hampered by limited administrative capacity. It has had to accommodate the mixed political system for states and regions, and the division between the relatively minor state and region responsibilities that have been devolved under Schedules Two and Five of the Constitution, and the more significant Union functions (Annex 3).

Decentralization occurs through both horizontal (territorially-based) and vertical (sector-based) processes. Horizontal decentralization refers to the assignment of

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<sup>37</sup> Kim Joliffe, *Ethnic Conflict and Social Services in Myanmar's Contested Regions* (Yangon: The Asia Foundation/Myanmar Development Resource Institute-Centre for Economic and Social Development, June 2014).

<sup>38</sup> Thet Aung Lynn and Mari Oye, *Natural Resources and Subnational Governments in Myanmar* (Yangon: The Asia Foundation/Myanmar Development Resource Institute-Centre for Economic and Social Development/International Growth Centre, June 2014).

<sup>39</sup> For an overview of the concept of "political settlement", see Thomas Parks and William Cole, *Political Settlements: Implications for Development Policy and Practice*, Occasional Paper (The Asia Foundation, July 2010).

functions to a unified local government. In *devolution*, that local government has autonomy over decisions about these functions, and is usually made accountable for those decisions to local people through elections.<sup>40</sup> In contrast, vertical decentralization, sometimes called *deconcentration*, 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 (Box 1). A third form of decentralization, not as important for the purposes of this paper, is *delegation*.

**Box 1: Deconcentration vs. devolution**

**Deconcentration** is the redistribution of decision making, financial and management responsibility among different levels of the central government. It occurs within ministries or to administrative units of the central government, and is considered a relatively weak form of decentralization as accountability remains largely upward to the centre.

**Devolution** is the transfer of responsibilities and powers from the central government to independent local governments with their own corporate identity, budget, legal status and rights. Devolution still requires a national policy framework but involved downward (democratic) accountability and usually covers several sectors.

There are important differences between devolution and deconcentration. In devolution there is typically much greater accountability to the people because the local government has more decision-making power, and is elected. There is also usually scope for local governments to make decisions about resource allocation across different sectors. For these reasons, devolution is normally considered “more” politically decentralized than deconcentration.

In reality, almost all countries have some mixture of these forms of decentralization:

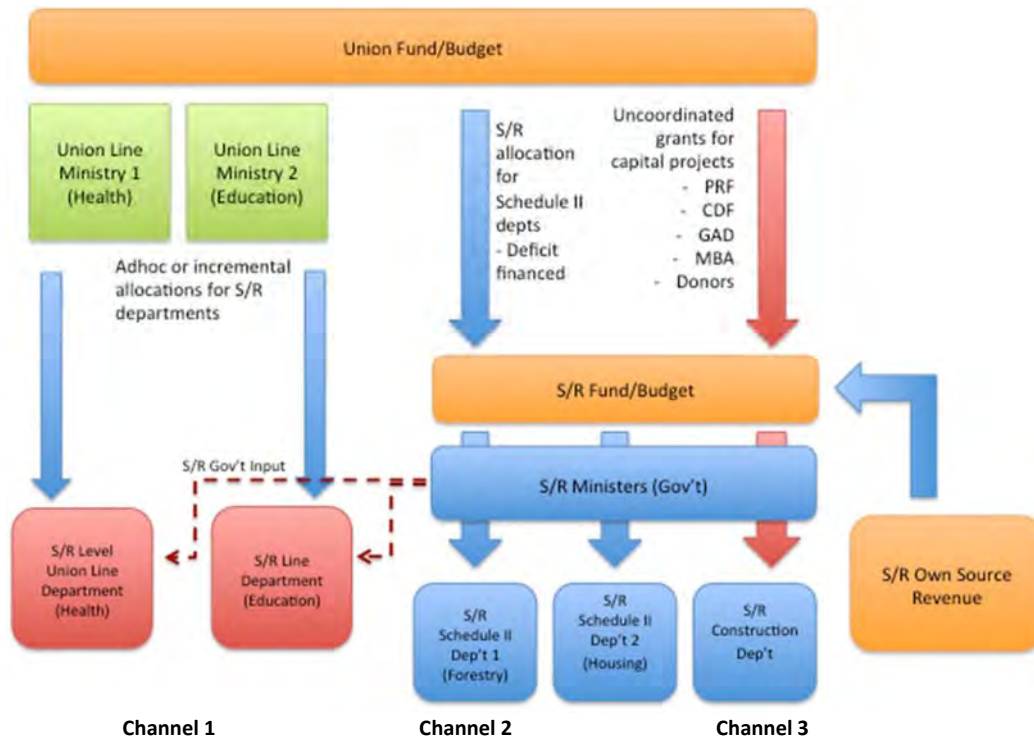
The term ‘fiscal decentralization’ encompasses three distinct arrangements or variants, each of which has a place in a country’s intergovernmental financial system. The three are deconcentration, devolution, and delegation. An important policy question is which of the three variants can be said to dominate a nation’s public finances.<sup>41</sup>

The defining characteristic of Myanmar’s current subnational fiscal structure is its mixture of horizontal and vertical decentralization. In Myanmar, while there are devolved subnational governments in the states and regions with their own sources of revenue and a distinct budget for some functions, a large majority of fiscal resources are retained in the budget of the Union line ministries. Figure 3 illustrates this hybrid fiscal structure at state and region level, using a few sample departments and ministries.

<sup>40</sup> This is sometimes referred to as “democratic decentralization.”

<sup>41</sup> Muwonge and Ebel, “Intergovernmental Finances in a Decentralized World,” 5.

**Figure 3: Myanmar's hybrid vertical and horizontal fiscal structure to state/region level**



There are, broadly speaking, three channels for fiscal resources to flow from the Union budget to subnational levels.

1. On the left are line ministries or departments that remain under Union jurisdiction, and which may have assigned, to a greater or a lesser degree, some activities and their accompanying budget to their state and region departments (in red), through this *deconcentrated channel* (Channel 1).
2. On the right, the Union budget gives aid in the form of grants or loans to the state/region fund to support a range of departments that operate under state/region control through a *devolved channel*; these state/region budgets are also supported by tax and non-tax revenues collected at state/region or township level, and local SEE income (Channel 2).
3. Finally, there are various separately budgeted funds mainly for capital expenditure on local infrastructure, also *devolved* to the state/region level, local parliamentarians, or townships according to various distribution and management criteria detailed below (Channel 3).

This fiscal structure has important implications for both current and future fiscal decentralization policies. First, each of these three “channels” has different arrangements for determining both the total pool of available resources, and its distribution across the different parts of the country. These arrangements determine

if a decentralized fiscal system can correct *vertical and horizontal fiscal imbalances*, which refer to a mismatch between the expenditure needs and available revenue between levels of administration, and across different parts of the country (Box 2). In Myanmar, the arrangements for each channel are not yet designed to compensate these vertical and horizontal imbalances.

**Box 2: Vertical and horizontal fiscal balance**

**Vertical fiscal balance** is the ratio between the expenditure needs of each level of government as a whole and the sources of revenue available to it. A **vertical imbalance** exists if revenues are inadequate to meet spending requirements (unfunded mandates) or, less often, if they exceed them.

**Horizontal fiscal balance** is the degree of equity of available resources between different subnational units at the same level, such as states or regions. **Horizontal imbalance** exists when some localities have more resources and others less for equivalent expenditure requirements.

Second, the division between what responsibilities fall under each of these channels is unclear. As outlined in *State and Region Governments in Myanmar*, some ministries are assigned to either Union or state/region level, but the constitution is also unclear about the assignment of other functions, or even assigns different functions of the same ministry to different levels.<sup>42</sup> As a result, different sub-departments of the same Ministry may be funded through different channels, with some forming part of their parent ministry budget, while others are assigned to the state/region fund. In practice in states and regions, this means that some departments have budgets via both the Union and state/region budget channels, which can lead to poor use of resources, and weak accountability.

State/region budget staff confirm that some departments receive funds from both channels, and sometimes spend available deconcentrated union funds while leaving state and region funds unspent. The budget process is also not set up to allow coordination of the funding sources: the Union ministries submit their budget estimates before there is any opportunity for these to be discussed locally, while state/region finance departments do not have time afterwards to discuss needs department-by-department before submitting their state/region budget proposal to the *hluttaw* and then the Financial Commission which finalizes the state/region and union budget proposals at national level.<sup>43</sup> This situation weakens accountability by preventing a clear link between the two types of financial flows and the functions they are meant to support.

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<sup>42</sup> Nixon et al., *State and Region Governments in Myanmar*, 25–26. For example, some departments and activities of the Ministry of Agriculture and Irrigation, or Forestry and Mines, are devolved to states and regions, while other parts of the same ministry are not.

<sup>43</sup> Interview, State/Region Budget Director (March 2014).



Finally, and related to these structural features, each channel of subnational financial resources is presented differently in Myanmar's budget. The devolved "aid" to states and regions, and each state and region's own source revenues, are presented in union and state/region budget documents (Channels 2 and 3). However, the deconcentrated funds for states and region departments of Union ministries in Channel 1 are not specified in national budget documents; the parent Union ministry is the primary budget unit, and there is currently no secondary budget classification that clearly indicates Union ministries' state/region spending in the national budget, making it difficult to distinguish the policies for how these ministries allocate across the country in terms. Ministries do have budgets for their subnational units but these are mainly for management and budget control reasons.

Together, these factors mean that it is currently very difficult to answer the most basic question about fiscal decentralization: *how much of Myanmar's public spending is decentralized, to what levels, and for what purposes?* If we understand decentralized public spending to be just the state and region budgets, then indeed we can see increased fiscal decentralization. The thrust of government policy has been to increase the share of national expenditure included in state/region budgets. As noted in the introduction, the share of the Union budget assigned as "aid" to states and regions indeed tripled in the last year, to 11.8 percent. During the 2014-15 national budget preparation process the Ministries of Finance and National Planning and Economic Development were under instructions from the President's Office to increase this share substantially in order to support decentralized development, potentially up to 15 percent.<sup>44</sup>

This type of policy – a top-down directive to give an increased share of revenue, expenditure, or GDP to be distributed to subnational units – is quite common around the world:

Politically, at the central level, it is rather easy for a President to propose and a parliament to approve a proposition for a given percentage of central government revenues to be shared with local governments.<sup>45</sup>

However, it has some very important problems and "pernicious" effects.<sup>46</sup> First, while it does indicate the budget over which the state/region has some decision making power, this figure does not represent the true extent of subnational spending since most of the expenditure on important social and economic services is budgeted at national level.

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<sup>44</sup> Interviews, Ministries of Finance and National Planning (November/December 2013).

<sup>45</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 17.

<sup>46</sup> *Ibid.*, 2.

Most important, it removes the link between the functions assigned to different levels of government, and the availability of resources to carry them out. As expressed by government finance officials:

We face difficulties in knowing how to finance this expenditure in states and regions, because the guidelines for what is state and region spending are still unclear, and much spending is for union ministries.<sup>47</sup>

In practice, this kind of policy means that state and region budgets are manipulated and pieced together to meet a policy quota, instead of being an expression of policy objectives and priorities, plans, and explicit service standards. One response, adopted already in Myanmar, is to shift activities from one budget to another arbitrarily, in order to make up the politically determined level of expenditure:

The President's Office ministers were pushing for increased budgets for the states and regions, so during the budget negotiations some works were transferred onto the state and region budgets.<sup>48</sup>

Some of these works may not even be matched to state/region responsibilities according to the constitution. Similarly, some states and regions are "trying to increase [Union] grants by shifting SEE expenses to ministerial departments"; by increasing the deficit between state/region revenues and expenditures the Union would be forced to increase its "aid," making the distinction between union grants and loans unclear and inconsistent across different territories.<sup>49</sup>

Often a lack of connection between funding sources and the functions they support results in "unfunded mandates," when a subnational government is assigned insufficient resources for its responsibilities. An opposite risk may be emerging in Myanmar: given the limited expenditure responsibilities currently *devolved* to state and region control, further increases in the state and region budgets may in fact take resources away from essential social and economic services that are in the Union budget – for example by overfunding local services at the cost of education or health. Without costing the actual functions under state and region control, it is possible that the budget-share approach to fiscal decentralization currently used will risk *overfunding* a narrow range of local services, while creating shortages and potentially larger deficits at national level. Such a situation in which local governments were able to overspend while central government became cash-strapped occurred in China in the mid-1990s, during a similar "revenue-led" fiscal decentralization.<sup>50</sup> In order to prevent these scenarios the four pillars of fiscal decentralization described in the

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<sup>47</sup> Interview, Union Government Official (November 2013).

<sup>48</sup> Interview, Union Government Official (February 2014).

<sup>49</sup> Interview, Union Government Official (November 2013). In general, Union aid for ministry department has been considered grants, but for SEEs has been accounted as loans.

<sup>50</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 17.

introduction require alignment, and a clearer division of functions between the Union and subnational levels will be needed.

### THREE: Sketching Myanmar's Fiscal Decentralization Roadmap

Decentralization reform strategies need to consider the full range of channels by which resources reach subnational levels: “A comprehensive analysis of the local public sector should take into account that there are different approaches by which governments interact with—and deliver services to—the people.”<sup>51</sup> The most important feature of the context and institutions described in the previous section is the mixture of deconcentration and devolution that is used to plan and deliver resources to the state/region and local levels.<sup>52</sup> Each of these “channels” is not only about the organizations and capacities at the local level. Instead they describe the relationships *between* the central and subnational levels, as well as local governance and accountability systems at the center. Any strategy to address these channels also includes “building the capacity of the center to become intergovernmental.”<sup>53</sup>

This “multilevel” approach is increasingly seen as essential to understanding and reforming decentralizing systems:

Rather than isolated actors, subnational authorities and central governments are “mutually dependent.” In this context ... the key underlying question is not whether to “decentralise or not” or even opt for a specific decentralisation model, but to look at ways to improve capacity and co-ordination among public stakeholders at different levels of government to increase efficiency, equity and sustainability of public spending.<sup>54</sup>

A successful strategy for fiscal decentralization in Myanmar should therefore start by working on all these channels, and focus on improving fiscal relationships between the center and local levels for each of them. Against this background, the main thrust of fiscal decentralization reform in Myanmar up to this point – top-down efforts to increase the share of the budget appearing on state and region budgets – is inadequate in two ways.

First, it focuses attention mostly on one level of governance, the state and region, but does not yet address the central systems for determining *why* the center should devolve a certain share of the budget, or *how* that share should be divided among different states and regions. Second, it only focuses on one or two of the channels

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<sup>51</sup> Local Public Sector Initiative, “Measuring the Local Public Sector: A Conceptual and Methodological Framework” (The Urban Institute, December 2012), 1.

<sup>52</sup> For the purposes of this paper, and consistent with general usage in the decentralization literature, “state/region level” is used to refer to itself, “local” refers to township and village level where services are most directly delivered, and “subnational” refers to all these layers below the Union government.

<sup>53</sup> Muwonge and Ebel, “Intergovernmental Finances in a Decentralized World,” 9.

<sup>54</sup> Claire Charbit, *Governance of Public Policies in Decentralised Contexts*, OECD Regional Development Working Papers (Paris: Organisation for Economic Co-operation and Development, July 19, 2011), 5.

between the center and state/region level – the channel of devolved funds in the state and region budget for their limited functions, and the provision of capital investment through the various local development funds (on the right of Figure 2). Given the large fiscal importance of the social and economic functions still under Union guidance and delivered via deconcentration (Channel 1), this reform misses an important component of the “Local Public Sector”: it does not include the full range of channels by which resources and functions reach local levels.<sup>55</sup>

This section develops initial steps for a fiscal decentralization roadmap that builds on the existing channels already described, and focuses attention on the relationships between the center and the state/region level and the required reforms and capacity at each level. The remainder of the section follows the structure of the three channels introduced in the previous part of the paper:

- Channel 1: the deconcentration of sector specific resources;
- Channel 2: the devolved state/region budget for assigned functions;
- Channel 3: provision of local capital development funds.

It describes the current situation in each channel, and suggests ways to improve their functioning. In this sense, it is an incremental approach as suggested in the introduction. At the same time, because of the open-ended nature of the “big picture” aspects of Myanmar’s reform environment described in the second part of this paper, these approaches must not close off too many options for more substantial or dramatic reforms in the future.

### **3.1 Channel 1: Strengthening sectoral deconcentration**

A vertical deconcentration process for important sectors in Channel 1 has already begun in Myanmar. While it is beyond the scope of this paper to examine the situation in all sectors, from 2012 onwards ministries such as education and health have increased the number and the responsibilities of staff at state/region, district, and township level. Increased responsibility for implementing and managing both recurrent and capital parts of the budget have also been deconcentrated in these sectors. From the progress in sectors still centralized under Schedule One of the constitution, such as health and education, conclusions may be drawn about how to strengthen the deconcentration framework.

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<sup>55</sup> The term “local public sector” has recently been adopted by one internationally transferable way to take account of these differing systems around the world elaborated by the Local Public Sector Initiative at the Urban Institute: Local Public Sector Initiative, “Measuring the Local Public Sector: A Conceptual and Methodological Framework.”

In education, district level offices headed by a deputy director and ten staff were established, and the grades and numbers of sanctioned state/region and township officers were increased. Township education officers were elevated from the same rank as headmaster to assistant director. However, progress in filling these posts has been slower than their creation. In 2013 one region's education office estimated it would take until 2015 to fill all of their sanctioned posts.<sup>56</sup> Along with these staffing changes, some human resource management functions were deconcentrated – township officers would assign or transfer primary school staff, and the state/region can do the same for secondary teachers. All hiring and firing remained with the central level or the three Departments of Basic Education until 2013, when the hiring of primary school teachers was deconcentrated to state/region education offices by Presidential order.<sup>57</sup>

There has also been deconcentration of implementation of the capital budget for education. The procurement and management of school construction is now with the state/region education office, and they work through the state/region government procurement board to select construction contractors, and involve the township education department in supervision.<sup>58</sup> However, these budget execution responsibilities do not correspond to decision-making power over the numbers or types of school construction projects, or their locations. Bottom-up input is sought from township offices, and education officers reported that it has some impact on decisions. But they also reported that poor siting of projects and the selection of new construction over their recommendations for refurbishment of unsafe or overcrowded schools were still weaknesses in translating bottom-up input into real planning results.<sup>59</sup>

An equally important issue is that this input is not really planning or budgeting input at all – it is gathered *during* the fiscal year and projects are then approved for that same year. For example, a township submits its priorities for capital projects in June or July, receives funds for procurement around October, and must carry out the construction by the year-end in March. This input is not shaping the budgeting process, only its execution, and some of the gains of having local input are surely lost by reducing the available implementation period.

There are also other sources of capital spending in education, notably projects supported by the various local development fund mechanisms described later in this paper. These projects are difficult to coordinate with the Union ministry's sector

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<sup>56</sup> Interviews, State and Region Education Officers (January 2013-March 2014).

<sup>57</sup> "Speech of President Thein Sein delivered to Union Ministers, Region and State Chief Ministers, and Deputy Ministers" (9 August 2013).

<sup>58</sup> Interviews, Region Education Officer (January 2014) and Township Education Officer (March 2014).

<sup>59</sup> Interview, Township Education Officer (March 2014).

spending, since project selection does not take place until well into the year, so there is little chance to create a consolidated list of projects prior to submitting either the ministry or the state/region budgets. These funds are welcomed. One remote state's education director and chief minister observed that the new availability of construction funds meant that parents – who they estimated had been paying for up to 40 percent of the school construction – no longer were asked to contribute.<sup>60</sup> However, they also noted that a local preference for refurbishment tended to be overridden by Union officials in favour of new school construction. Finally, there is a channel for school improvements that is decentralized to school level via the school grants program supported by the World Bank and other donors.

Changes in the health sector in staffing levels and human resource management have been less dramatic, in part due to the different technical nature of health service delivery. For example, in the Health Ministry there is no role yet for township offices in staff assignment, transfer or promotion, other than reporting on vacant posts.<sup>61</sup> Health officers at state/region and township level point to unfilled posts as seen in the education sector.<sup>62</sup> The management of doctors and other technical staff is still the Union ministry's responsibility, and some health directors have pointed to the need for more consultation on these assignments, as well as regulations and incentives for staff to work in remote areas.<sup>63</sup> However, state/region health boards are now given a role in deploying doctors, nurses and pharmacists, though decisions about the numbers to be hired and the hiring itself are done by the Union.<sup>64</sup>

Significant capital and operating budget management now also take place in health at subnational levels. At the end of 2012 the procurement of medicine and materials were deconcentrated to the state/region level for clinics, with hospitals purchasing their own medicines and materials.<sup>65</sup> However, as with education, decisions over the budget levels for these items are still centralized. Some spending from the devolved capital development funds (Channel 3) is also directed towards health, and the same issues as in education were noted: spending is not always coordinated with ministry plans due to a lack of time in the budget preparation cycle. This channel also tends to favour suggestions from the Union level for new construction over local preferences for renovations, and has not always used the most up to date building standards determined by the ministry.<sup>66</sup>

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<sup>60</sup> Interviews, State Education Officer and Chief Minister (March 2013).

<sup>61</sup> Interview, Township Health Officer (March 2014).

<sup>62</sup> Interview, Region Health Officer (January 2013).

<sup>63</sup> According to one official, rules requiring doctors to serve a time in remote places were in place through the 1980s: Interview, State Health Director (March 2013).

<sup>64</sup> Interview, Township Health Office (March 2014).

<sup>65</sup> Interview, Region Social Affairs Minister (January 2013).

<sup>66</sup> Interview, State Health Director (March 2013).

These steps represent important advances in decentralizing service delivery. However, they do not yet form a systematic and transparent framework for allocating these resources across the country. The first phase of an incremental fiscal decentralization strategy should build upon them by introducing a more systematic approach to the deconcentration of functions, providing the resources to fund them (vertical fiscal balance), and distributing these resources across the country in line with policy objectives (horizontal fiscal balance).

*Introduce a systematic framework for deconcentrating functional assignments*

The steps to deconcentrate service delivery so far have been taken by individual ministers to respond to the objective of people-centered development, or in response to specific instructions from the President's Office. In August 2013 the President directed education authorities to begin appointing primary level staff at state/region level with the participation of those governments, and told the Ministry of Health it must assign nurses and midwives in coordination with state and region governments.<sup>67</sup> Other ministers in the Union government show varying interest in making these kinds of changes. This echoes the situation described, for example, in Cambodia:

in important sectors for local development, such as health, education and natural resources, most decisions are still made at the central level despite ministries having offices and staff at provincial and district levels and there is often a lack of disclosure of the full detail of the cost of implementing different functions.<sup>68</sup>

This kind of piecemeal, top-down deconcentration may be useful to get the process started, but should transition into a rational and systematic framework for deciding what functions are assigned to what administrative levels. As this is done, appropriate costing methods can be used to decide the appropriate level of overall spending for that level (vertical fiscal balance). There are two general steps in systematically assigning functional assignments for any sector.

The first is to unbundle the service (usually a subsector) into its component functions and activities. This means outlining both the general functions required to deliver the service, and the activities that are needed to fulfill those functions. The broadest functions that can be separated are typically policy (setting rules and standards), provision (ensuring through finance and accountability that the service is delivered),

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<sup>67</sup> "Speech of President Thein Sein delivered to Union Ministers, Region and State Chief Ministers, and Deputy Ministers" (9 August 2013).

<sup>68</sup> *Factors Affecting Fiscal Decentralization in Cambodia* (Parliamentary Institute of Cambodia, November 2012), 2.



and production (actual delivery). These need to be further broken down and the constituent activities listed in detail, as in the examples for education given in Table 1.

**Table 1: Unbundling functions in basic education**<sup>69</sup>

Function	Examples of Activities
Policy, Standards	<ul style="list-style-type: none"> <li>• syllabus</li> <li>• language</li> <li>• teacher-student ratio</li> <li>• catchment size</li> </ul>
Planning	<ul style="list-style-type: none"> <li>• school location and numbers</li> <li>• room standards</li> <li>• teacher requirements</li> </ul>
Asset Creation	<ul style="list-style-type: none"> <li>• construction of schools and other facilities</li> </ul>
Operation	<ul style="list-style-type: none"> <li>• teaching</li> <li>• maintenance of schools</li> <li>• selecting/purchasing teaching materials and books</li> <li>• hiring, training, and deploying teachers</li> </ul>
Monitoring & Evaluation	<ul style="list-style-type: none"> <li>• examination of students and teachers</li> <li>• internal audit</li> </ul>

The next step is to consider the assignment of these functions and activities in terms of appropriate principles of fiscal decentralization and accountability, as described in Box 3, and propose adjustments. Some of these principles will tend to suggest functional assignments that are more centralized, while others might encourage more decentralization. It is important to note that these principles largely apply in the same ways whether decentralization is through deconcentration to lower administrative offices, or devolution to subnational governments. These principles can therefore also be used to consider additional functions for devolution to subnational governments later in a reform process.

**Box 3: Principles of fiscal decentralization and accountability for functional assignments**<sup>70</sup>

**Subsidiarity and differences in preferences and conditions:** a function should be carried out at the lowest level it can be performed effectively. This may depend on capacity, beneficiary

<sup>69</sup> Adapted from Lant Pritchett and Varad Pande, *Making Primary Education Work for India's Rural Poor: A Proposal for Effective Decentralization*, Social Development Papers (Washington, D.C.: World Bank, June 2006), 24–29.

<sup>70</sup> Adapted from Pritchett and Pande, *Making Primary Education Work for India's Rural Poor: A Proposal for Effective Decentralization*, 30–40.

population, and land area. It also depends on how varied local preferences are for the function (“heterogeneity of demand”). This principle tends to suggest more decentralized functions.

**Economy of scale:** a function should be carried out where its unit cost is lower. Production of some functions may be cheaper at higher levels. This principle, unlike subsidiarity, may suggest less decentralization, and if so, a balance needs to be found between them.

**Externality/spillover:** a function should be at the level that minimizes benefits that spill over to other jurisdictions without compensation. This depends on the type of “catchment area.”

**Equity/equalization:** a function should be carried out at a level that ensures equitable treatment. This is very important for many social services such as health and basic education where the goal may tend to be universality and equality of access.

**Local discretion:** When decisions can be made locally without higher involvement, then local accountability is important.

**Intensity of transactions:** Activities with many repeated transactions/actions should have local accountability because they are inefficient to monitor from a distance.

**Requires technical or local monitoring:** Some activities require more technical verification and checks due to the complexity of the service, and may need more centralized accountability.

In the end, the precise mix of functional assignments is a matter of local context and history, and not a one-size-fits-all process. However, it requires a framework and guidelines set at the national level to guide the process, and technical support in implementing it.<sup>71</sup> It is also important that the framework to govern this process should have clear time-bound steps and should initially target a few of the most important functions – otherwise it can become caught up in an extended and overly detailed process that can take years to implement. For example, in Cambodia functional mapping began in 2010 and reassignment is still ongoing.<sup>72</sup> Most important is that the assignments for the main functions and activities that have large budget implications are very clear.

An effective system of fiscal decentralization, whether deconcentrated or devolved, ensures that budgets are sufficient to meet these clearly assigned functions. Initially budget levels may be determined by high-level policy goals or existing overall spending on a given function or activity. Later, more complex activity-based costing models might be used. However, this costing process is complex and sector specific and would require more detailed analysis and discussion. The eventual goal is that transparent budgets for clearly assigned functions can allow local discretion in *how*

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<sup>71</sup> For example, in Cambodia the national decentralization program recognizes that national coordinating institutions, the Ministry of Economy and Finance, and Ministry of Planning have an important role in finalizing policies on functional assignments, which should not just be left to sector ministries: Niazi, *Deconcentration and Decentralization Reforms in Cambodia*, 59.

<sup>72</sup> *Factors Affecting Fiscal Decentralization in Cambodia*, 10.

things get done, while supporting accountability. Deconcentration can be a first step in the process of reaching that goal.

#### *Horizontal allocation and local input to planning and budgeting*

Once ministries develop a clear, sequenced plan for deconcentration of functions, and norms for costing, planning and budgeting those functions, they can rationally allocate resources among their administrative units. While some parts of line ministry budgets are increasingly being managed or executed by subnational offices as described above, the planning and budgeting process is not yet decentralized. Subnational ministry departments do not plan within a forecast budget ceiling in advance of the start of the year. Instead, budget decisions are still made centrally and the subnational units are only aware of their allocations after the budget has been passed.

At the same time, in line with the notion of “people-centered development” many ministries have tried to gather more planning information and priorities from their subnational units. This information is important, but it does not in itself constitute decentralization of planning or budgeting:

Under decentralized financing conditions, local planning is no longer the preparation of a wish list of projects that are meant to be fed bottom-up to regional-national agencies for their selection, financing and implementation as part of sector programs they administer. Instead, local resource availability and discretion over their use allows a more meaningful local planning process—one in which local choices can and must be made under clear budget constraints.<sup>73</sup>

What is needed is a budget process that allows the line ministry to provide budget estimates for deconcentrated functions and activities to, at least, its state/region departments. This needs to happen early enough in the budget preparation cycle for the local department to plan its activities within those constraints, and to consult and coordinate with the state/region government and potentially the public as it prepares its own budget (see next section). An example of how this could work for basic education capital school construction is given in Box 4.

#### **Box 4: Deconcentrating capital planning and budgeting in basic education**

1. The Union ministry, based on policy goals and using analysis of data on school-aged children, current enrolment and schools, assigns a transparently formula-based budget ceiling for school construction to each state and region in advance of the union budget submission.
2. State/region education offices complete a consultative process with their local units, the state/region government and the public, and select the combination of repair, renovation

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<sup>73</sup> Leonardo Romeo, *Taking Risks: Decentralized Development Planning, Issues and Early Lessons from UNCDF-Supported Local Development Fund Programmes*, (New York: UNCDF 1999).

and new construction they wish to undertake, using national standards and guidelines for construction and costs.

3. As the state/region education department already implements this budget through the local branch of the Myanmar Economic Bank, and procurement takes place locally, the works should be able to start virtually as soon as the budget is passed in April, rather than sometime in October.
4. The state/region government, by knowing in advance from their own budget submission what work will be undertaken by the Department of Education, can plan to supplement these or pursue other priorities with the devolved capital resources available to them.

This approach has two very important advantages. First, it allows for a more meaningful role for state/region governments in planning and implementation/monitoring of sector services even though these are not devolved to state/region control. State and region government ministers and *hluttaw* members continue to complain that their role in influencing these sector services is weak. This is in part because their input into planning things like school construction does not feed directly into a local budget preparation process, but must be filtered up to Union level later.<sup>74</sup>

Second, it provides a much more effective way to connect the bottom-up information being gathered by ministries themselves with the top-down budgeting process. When township officers create prioritized lists of activities for their parent ministries, these are done without knowledge of the available resources and only approved after frequent and inefficient processes of adjustment and negotiation at higher levels during the fiscal year. For example, with support from UNICEF, the Ministry of Education is developing Township Education Improvement Plans in targeted townships in line with local needs and conditions, but these are not prepared in the context of a budget ceiling or constraint, and therefore will inevitably require review and adjustment.<sup>75</sup> A clear subnational budgeting system would help this bottom-up planning information to better find its way into the final budget.

There are important prerequisites in the budget formulation process for this approach to be successful. The Union budget preparation calendar and procedures should be adjusted to allow ceilings to be provided to state/region sector departments for their deconcentrated functions near the beginning of the budget cycle. State and region officials would be provided a supplementary budget circular with guidelines on consultation with state/region government on the use of the funds, and that outlines limitations and restrictions on the use of these resources. Crucially, the budget classification system must be adjusted to allow for state/region departments to be designated as budget units within the Union budget for these line ministries, to allow

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<sup>74</sup> Interviews, Region Hluttaw Members, Region Education Director (January 2014).

<sup>75</sup> Presentation, UNICEF staff (February 2014).

for the transparent allocation of funds by state/region as well as by function.<sup>76</sup> Since these important Public Financial Management changes would require joint action by, at a minimum, the Ministries of Finance, National Planning and Economic Development, and the line ministries, there is a pressing need for policy coordination on fiscal decentralization, as discussed in the final part of this paper.

A final important consideration about deconcentration reforms for the Myanmar context is that successful deconcentration can help prepare the ground for more democratically decentralized public services in the future, whether through broadened devolution or even more federal arrangements. The new local planning and budgeting responsibilities achieved through deconcentration can be an important source of capacity:

In a country with a long tradition of centralization, that local governments lack the capacity to be self-governing is an observation that is likely to be both true and tautology. As local governments in several newly developing countries have demonstrated, developing capacity to govern is a learning-by-doing process.<sup>77</sup>

At the Union level, introducing the planning tools to effectively cost and equitably distribute resources are also important precursors to the kinds of transfers and block grants that would be needed to support a system where more services are devolved to state/region and local governments. This kind of preparation for planning and budgeting through deconcentrated delivery is seen as contributing to the success of Indonesia's well-documented decentralization reforms:

A successful deconcentration of central government service delivery may provide an important platform for implementing decentralization successfully ... When the decentralization policy is eventually crafted, the local civil service will be more ready to take on the responsibilities assigned to the subnational level, and the risks of extreme disruption of service delivery will be less. This appears to be a major reason why Indonesia's "big bang" decentralization was accomplished without a breakdown in public service delivery.<sup>78</sup>

Given the uncertainty over Myanmar's longer-term decentralization process, this "deconcentration first" strategy has the advantage of generating rapid improvements in the targeting of budgets and creation of local capacity within the existing subnational fiscal framework, while laying the ground for possible future changes to the intergovernmental fiscal system.

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<sup>76</sup> Elements of this process draw on recommendations in Hamish Nixon and Jamie Boex, "Implementing GIROA's Subnational Planning and Finance Policy: Options and International Practice" (World Bank: Policy Note Prepared for Government of Afghanistan, 2010).

<sup>77</sup> Muwonge and Ebel, "Intergovernmental Finances in a Decentralized World," 23.

<sup>78</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 5-6.

### 3.2 Channel 2: Rationalizing state and region budgets

Subnational budgets in Myanmar have three broad sources of revenue, as outlined in the previous part of this paper: aid from the Union government to the various state and region departments; several mechanisms for delivering discretionary funds for local development and infrastructure initiatives; and own source revenues from a range of taxes and fees collected through several departments as set out in Schedule Five (Annex 3).

The size of the aid flows to state and region governments are currently based on past patterns, the need to finance the deficit between departments' revenue and expenditure, and/or *ad hoc* negotiations with the central level. Broadly speaking the Union budget preparation process begins with both the ministries and states/regions submitting their proposals, including estimates of revenue and expenditure for all their constituent departments and SEEs. The office of the second Vice-President assesses these, primarily against the aggregate five percent deficit target which is the primary fiscal guidance used in budget preparation, as well as the main priorities of the government.<sup>79</sup> These are submitted to the Financial Commission mandated in the Constitution to be aggregated and submitted to the *Pyidaungsu Hluttaw* for approval as the national budget. State and region budgets are therefore largely a control mechanism on revenue and expenditure, not an expression of state/region level policy or planning goals in financial terms.

This method of budget preparation has two important weaknesses. First, it tends to result in budgets that mirror what *current* rates of spending are among different states and regions, not what they *should be* to carry out their assigned responsibilities. If a given state or region has historically spent more than its share, it will tend to continue to receive higher allocations. Places that have had limited capacity to spend may receive less, even if their needs are as great or greater. If budgets grow incrementally (i.e. by a certain percentage each year), the gap between those receiving the most and the least will grow over time. This situation also creates a perverse incentive among states and regions to "bid up" their budget proposals: by asking for more and showing larger deficits they hope to end up with higher allocations from the Union. As one regional budget director observed: "Some states and regions submit their needs only, while others submit a broader list of wants" in order to secure more resources.<sup>80</sup> This incentive may also contribute to the generally large supplementary budgets in Myanmar, both at central or state/region level.<sup>81</sup> In turn, this can have implications for the budget deficit as a whole.

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<sup>79</sup> Interview, Budget Department, Ministry of Finance and Revenue (November 2013).

<sup>80</sup> Interview, Region Budget Director (March 2014).

<sup>81</sup> World Bank, *Republic of the Union of Myanmar Public Financial Management Performance Report, Public Expenditure and Financial Accountability Report* (Yangon: World Bank, May 2013), 9, 17, 46.

Secondly, when the difference between state/region revenues and expenditures are the main determinant of the levels of transfers, states and regions and other local governments do not have an incentive to improve their revenue collection. If local departments show more own-source revenue in their budget submission, it is likely that this will result in a lower level of transfer, or at least a lower rate of increase. Under such circumstances, what are the benefits to state/region and township departments to undertaking the politically unpopular business of taxation? The resulting incentive structure is for states and regions to boost expenditures without considering revenue. In the words of one budget director: “Departments want to spend, and think less about revenue or reducing expenditure.”<sup>82</sup>

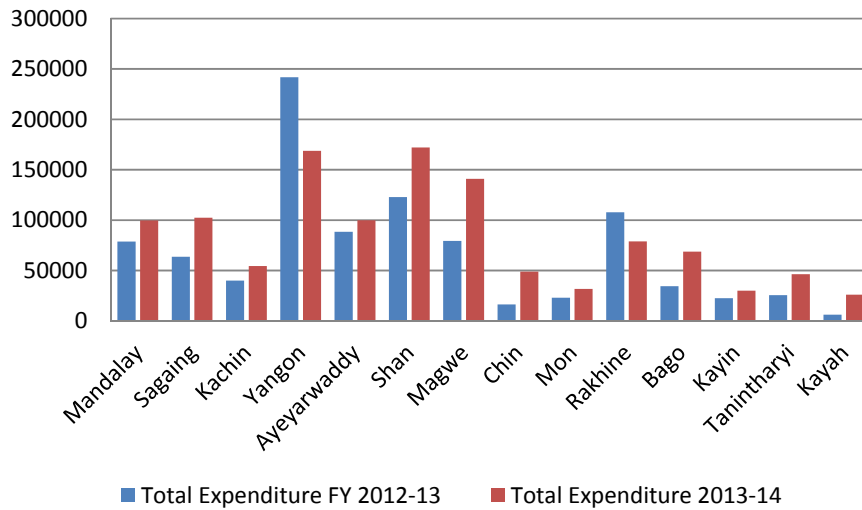
Figures 4 and 5 illustrate the evolution of the state/region budgets between FY 2012-13 and FY 2014-15. Budget estimates for total state and region expenditures for FY 2014-15 have not been published at the time of writing, but in the previous two years budgets have generally grown, with the exception of Yangon (which experienced a huge supplemental budget at the end of 2012-13), and Rakhine. However, figures for Union aid to states and regions, which are available for the current FY 2014-15, show a dramatic increase to all states and regions except Yangon and Mandalay over the previous two years. This change means that the overall state and region budgets grew quickly (as noted in the introduction), and that the relative share of the budget funded by Union aid will also grow. In other words, states and regions are receiving bigger budgets, but are also more dependent on Union transfers.<sup>83</sup>

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<sup>82</sup> Interview, Region Budget Director (March 2014).

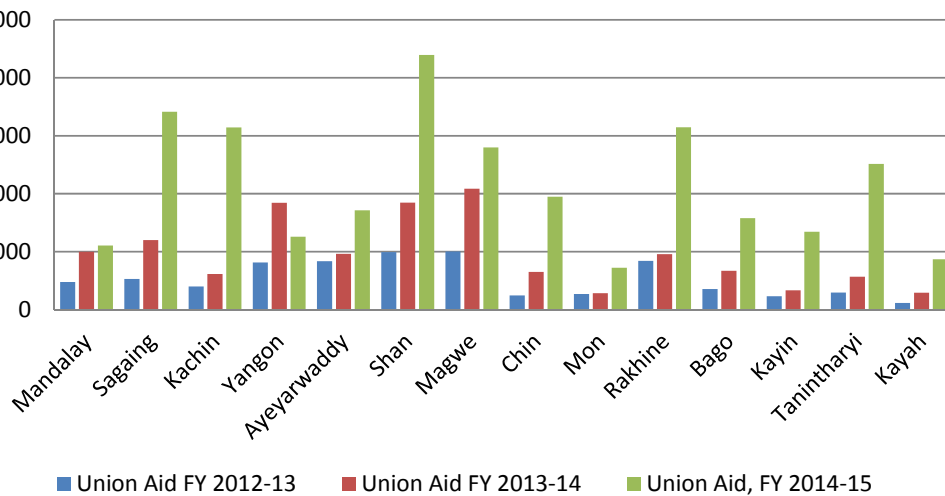
<sup>83</sup> Figures for Union aid have included both grants and loans for two reasons: there is an unclear expectation of repayment, and there have been changes in policy over which departments and SEEs receive grants or loans. It should be noted that this is contrary to typical public accounting practice, in which loans would not be considered a transfer.

**Figure 4: State/region expenditure FY 2012/13 and 2013/14<sup>84</sup>**



Source: FY 2012-13 and FY 2013-14 Budget Estimates and Revised Estimates as published in Gazette

**Figure 5: Union aid to states/regions FY 2012-13 to FY 2013-14**



Source: FY 2012-13 to FY 2014-15 Budget Estimates as published in Gazette

### 3.3 Channel 3: Allocating subnational development funds

Since 2011 Myanmar has introduced a number of overlapping committees and subnational development funds broadly aimed at poverty alleviation and local development through increased discretionary resources and “bottom-up” planning.

<sup>84</sup> In 2012-13 Yangon has a particularly large supplementary (Revised Estimate) which doubled its expenditures, contributing to the apparent anomaly of a declining budget from 2012-14.



This process began in 2011 with a list of eight priorities set by the President in an address made to the Poverty Alleviation Central Committee.<sup>85</sup> To support these policy priorities, committees were formed starting from the Union level through working committees down to village tract level. However, these committees have had limited roles in programming subsequent funds that have been directed to subnational development.

Since then, there has been a remarkable proliferation of committees at the township level to manage development planning and implementation.<sup>86</sup> The basic administrative organ is the Township Management Committee (TMC), headed by the GAD Township Administrator, with the other members being the officers of government departments present locally. The Township Development Affairs Committee (TDAC) consists of a respected community member as chair, the GAD deputy township administrator, the rural development, livestock and fisheries department deputy, the secretary of the development affairs office (formerly known as Municipal Organization), and representatives from social, business, and academic sectors.<sup>87</sup> Finally, Township Development Support Committees (TDSC) were formed to contribute to development planning, although without direct control over resources. These comprise the Assistant Township Administrator from GAD, the chair from the Township Development Affairs Committee and six selected sector representatives from social sectors, business associations, laborers, and farmers.<sup>88</sup>

These three committees and the Township Farmland Management Committee meet once or twice a month to discuss needs across the eight development priorities set out by the President. The TMC is the decision maker while the TDSC takes an advisory role between the TMC and the public.<sup>89</sup> There are also Ward/Village Tract Management Committees and Ward/Village Tract Development Support Committees, the latter with five to seven elected members depending on the size of the ward or

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<sup>85</sup> The eight priorities were (1) Development of agricultural production sector; (2) Development of Livestock Breeding and Fish and Meat Production; (3) Development of rural productivity and cottage industries; (4) Development of micro saving and credit enterprises; (5) Development of rural cooperative tasks; (6) Development of rural socio-economy; (7) Development of rural energy; (8) Environmental Conservation: Chairman of Rural Development and Poverty Alleviation Central Committee President U Thein Sein addresses the central committee meeting (1/2011), 20 June 2011, [<http://www.president-office.gov.mm/en/?q=issues/rural-urban/id-1845>]

<sup>86</sup> For a thorough presentation of township and district level committees' memberships and roles, see Kyi Pyar Chit Saw and Matthew Arnold, *The General Administration Department: An Overview of Myanmar's Administrative Backbone*, Annex 2.

<sup>87</sup> For more discussion of the Township Development Affairs Office see Jared Bissinger, *Subnational Governments and Business in Myanmar* (Yangon: The Asia Foundation/Centre for Economic and Social Development, February 2014), 13-15.

<sup>88</sup> Union of Myanmar, President Office Order No. (27/2013), Art.4.

<sup>89</sup> Interview, Region TDSC Chairman (March 2014).

village tract.<sup>90</sup> The process for filling these posts has been unclear, and in many cases existing officials may effectively nominate them.<sup>91</sup>

### *Union Government Funds: The Poverty Reduction Fund*

The principle subnational development fund provided by the Union Government is known as the Poverty Reduction Fund (PRF).<sup>92</sup> The Poverty Reduction Fund was a presidential initiative to address rural development and poverty, and began in FY 2012-13 with one billion kyats allocated to each state and region. Chin State, due to its extreme poverty rates and remote condition, was subsequently allocated an additional two billion kyats the same year. As this first round of the poverty reduction fund was distributed as an equal share for each state/region it resulted in widely varying entitlements on a per capita or poverty basis.<sup>93</sup> Within states and regions, the one billion kyats were generally divided equally among the townships, resulting in differing entitlements per township as well. This equal shares approach raised concerns among some local representatives:

The development of regions and states are unequal with different needs and different poverty rates and so allocating poverty reduction funds equally to all states and regions would not be the most appropriate solution to tackle the poverty.<sup>94</sup>

The funds were both budgeted and executed under the General Administration Department, because state and region government institutions were newly formed and considered unable to manage these funds.<sup>95</sup> The second round of poverty reduction funds for FY 2013-14 – also one billion kyat per state and region – were budgeted and transferred directly (via drawing rights) to the state/region “administrative organization” budget category, and not the Home Ministry’s budget line. This is the newly created budget category for the state and region government’s executive institutions, and in theory could provide for more fiscal autonomy over the use of the funds. However, execution of the state/region administrative organization’s budget is still the GAD Executive Secretary’s responsibility, and therefore under the GAD’s influence. The township committees, particularly the Township Development Support Committee, are meant to provide input to project selection and monitoring.

For the 2014-15 budget, the fund no longer provides an equal share for all 14 regions and states. The overall budget has been increased dramatically to 50 billion Kyat, and

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<sup>90</sup> Union of Myanmar, President Office Order No. (27/2013), Art.6.

<sup>91</sup> Field research on township administration, personal communication.

<sup>92</sup> This has been translated in some cases as Poverty Eradication Fund.

<sup>93</sup> Nixon et al., *State and Region Governments in Myanmar*, 45.

<sup>94</sup> Interview, State Minister (December 2013).

<sup>95</sup> Interview, Union Line Ministry Staff (February 2014).

some regions and states are receiving much higher amounts while others remain at one billion kyats. For example, Shan State received four billion kyats and Rakhine and Kachin received fifteen billion kyats each, while the other states and regions (see Table 2 below). These large amounts are aimed at areas with particularly high reconstruction needs due to conflict, or remoteness.<sup>96</sup>

The process for allocating funds to each township is also now decided by the state and region government. Some states and regions have kept to an equal shares principle, while one region described using a classification of townships into two groups based on poverty rate and population. In one state, the quota for each township is decided based on the size of the projects, and some of the funds have been given as small loans.<sup>97</sup> The repeated changes to the procedures for distribution and use of these funds have led to some concerns over the monitoring and auditing:

There have been many policy changes and the auditor could not keep up with it because the rules and regulations used by auditors are outdated. It is not updated to keep up with the changes in the budget such as poverty reduction funds.<sup>98</sup>

There are several other discretionary funds from the Union Government delivered via different channels. Both the Departments of Rural Development and the Ministry of Border Affairs have some funds available for use at state/region level and below. In addition, at township level the GAD has discretionary use of a commission or rebate on collected motor vehicle license fees – in busier townships such as Myeik in Tanintharyi, this can be a substantial amount.<sup>99</sup>

#### *The Constituency Development Fund*

The Constituency Development Fund (CDF) aims to provide budget for local development by allocating a fixed amount in each township for projects selected under the guidance of the national and state/region *hluttaw* representatives. *Pyidaungsu Hluttaw* Speaker Thura U Shwe Mann introduced the concept of a CDF in April 2013. Apparently this idea was inspired during a visit to India in December 2011. The CDF was realized by promulgation of the “Procedures of controlling and using of Development Fund, Order No. (82/2013)”: by the *Pyidaungsu Hluttaw* on 15

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<sup>96</sup> Interview, State Finance Director (May 2014). The exact distribution was hard to discern at the time of writing because this assistance is aggregated with other aid to the states and regions in the Union budget document, and the individual state and region budget estimates had not yet been collated.

<sup>97</sup> Interview, State Minister (May 2014).

<sup>98</sup> Interview, State Finance Minister (December 2014).

<sup>99</sup> Interview, Township Administrator (March 2014).

November 2013, whereby representatives were also given the right to open joint bank accounts for each township.<sup>100</sup>

The plan calls for the distribution of 33 billion kyats resulting from cuts to the Union budget equally to all 330 townships, resulting in an allocation of 100 million per township.<sup>101</sup> Representatives from the two houses of the *Pyidaungsu* and region/state *hluttaws* are allowed to select township development activities in their constituencies to a maximum of five million kyats per project.<sup>102</sup> Priorities for these projects are to be water supply, renovations of rural roads and bridges, renovation of school buildings, renovation of buildings related to health and other township needs.<sup>103</sup> The implementation of CDF projects is to be done by Township Development Implementation Bodies consisting of the four *hluttaw* representatives from the township.

The fund has been controversial. Initially the President refused to sign the law and sent it back to the *Pyidaungsu Hluttaw* with comments that the law was unconstitutional due to its granting the *hluttaw* executive power to implement development activities. However, the *hluttaw* proceeded to promulgate Order No. 83/2013 and No. 86/2013 with minor amendments. International experience suggests that constituency funds – including in Pakistan, India, and the Philippines – can breach separation of powers and weaken legislative oversight, weaken government capacity to plan and monitor, undermine equity when the program allocates funds equally across constituencies, and encourage patronage.<sup>104</sup> MPs themselves were divided, and academics and international organizations raised concerns.<sup>105</sup> On the other hand, local *hluttaw* members indicated that these funds would allow development activities to be better aligned with local needs.<sup>106</sup>

In February 2014, Minister for Finance U Win Shein and Union Auditor General U Thein Htike explained the government's concerns over the program, and the *Pyidaungsu*

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<sup>100</sup> Procedures of controlling and using of Development Fund, Order No. (82/2013), Pyidaungsu Hluttaw, 15<sup>th</sup> November 2013, Art.7.

<sup>101</sup> "Hluttaw to release procedures to spend K.33 billion development fund", *Myanmar Freedom*, (7 October 2013).

<sup>102</sup> Procedures of controlling and using of Development Fund, Order No. (82/2013), Pyidaungsu Hluttaw, 15<sup>th</sup> November 2013, Art.8a.

<sup>103</sup> Procedures of controlling and using of Development Fund, Order No. (82/2013), Pyidaungsu Hluttaw, 15<sup>th</sup> November 2013, Art.7k.

<sup>104</sup> Albert van Zyl, *What Is Wrong with the Constituency Development Funds?*, Budget Brief (International Budget Partnership, 2010).

<sup>105</sup> Thomas Kean, "Vote-buying fears over MP funds plan", *Myanmar Times*, (15 December 2013), [<http://www.mmmtimes.com/index.php/national-news/9057-vote-buying-fears-over-mp-funds-plan.html>].

<sup>106</sup> Interview, Region *Hluttaw* Members (January 2014).

*Hluttaw* agreed to changes to better align it with government financial procedures.<sup>107</sup> The CDF is now budgeted as current expenditure and revenue under the state/region *hluttaw* budget.<sup>108</sup>

#### *Donor Provided Funds: Community Driven Development*

In 2013 the World Bank and the Myanmar government launched the six year Myanmar National Community Driven Development project (NCDD) with an 80 million USD grant, supplemented by 6.3 million USD of government support, over the life of the project. The development objective of NCDD is to enable poor rural communities to benefit from improved access to and use of basic infrastructure and services through a people-centered approach, and to enhance the government's capacity to respond promptly and effectively to crisis or emergency.<sup>109</sup> The project is currently planned to expand to 15 poor and remote townships (i.e. one township per state/region plus the union territory). Township selection takes place using participatory methods starting at the village tract, township and state/region level, and the first phase is currently under implementation in three townships. Each village tract receives an average block grant of 27,000 USD per year for three years, and these grants are in three bands according to village tract size.

The institutional arrangements for NCDD have three levels: (1) the Union level, (2) township level and (3) village tract and village level.<sup>110</sup> At the village tract level, newly formed Village Tract Project Support committees consist of the Village Tract Development Support Committee and Village Project Support Committee leaders, and are responsible for subproject selection. A finance sub-committee is formed at the village tract level to manage the block grants for village tract and village level along with other subcommittees for monitoring and procurement. The township level is responsible for coordinating with the Rural Development Department, and certifying the sub-projects that are proposed by village and village tract meetings do not duplicate existing government efforts. As in most community driven development programs, this process is facilitated by partner NGOs, currently the International Rescue Committee and Mercy Corps.

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<sup>107</sup> Ei Ei Toe Lwin, "MPs agree to amend constituency funding program", *Myanmar Times*, 8 February 2014: [<http://www.mmmtimes.com/index.php/national-news/9490-mps-agree-to-amend-constituency-funding-program.html>].

<sup>108</sup> Interview, Region Budget Director (March 2014).

<sup>109</sup> Myanmar National Community Driven Development Project, World Bank [<http://www.worldbank.org/projects/P132500/myanmar-national-community-driven-development-project?lang=en>]

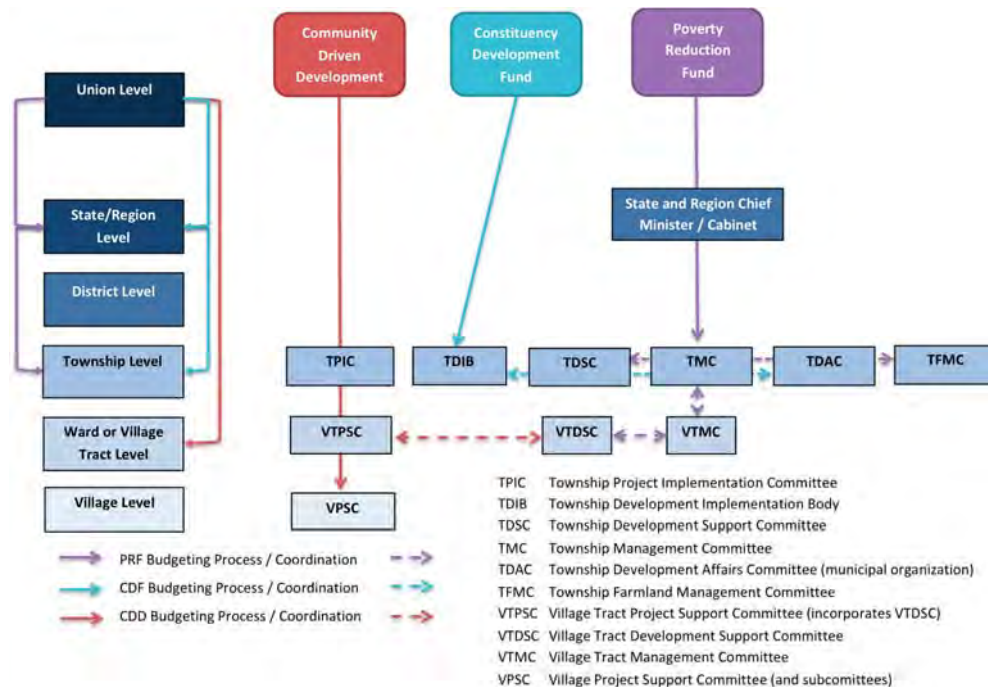
<sup>110</sup> National Community Driven Development, Operational Manuel Part IV, Government of the Republic of the Union of Myanmar, 2013, Government of the Republic of the Union of Myanmar, 3.

There are a number of other donor provided local infrastructure programs including a proposed 22 million USD community block grant implemented by the Asian Development Bank for several states and regions, and a large national local infrastructure investment program of about 220 million USD support by Japan.<sup>111</sup> However, the latter primarily draws on Union ministries to select and implement its 79 subprojects. The UNDP-UNCDF has also been exploring the possibility of a township level development fund. As noted above, the Department of Rural Development itself also has a local development budget outside the NCDD framework, and is seeking ways to increase community involvement in their programming.

*Implications and challenges*

The introduction of these important sources of funding for development initiatives clearly provide new opportunities for local governments and administrations to implement development activities that would have been impossible otherwise. However, the different fund structures and modalities, and the proliferating committee structures that have grown up to ensure local participation in their targeting, present challenges of their own. Both the funds and the committees have overlapping objectives and mandates, which makes coordination difficult and risks poor targeting of resources.

**Figure 6: Selected local capital development funds and their budgeting arrangements**



<sup>111</sup> Donor representatives, personal communication with authors.

Given the different funding and management procedures, duplication of effort in some sectors or areas could occur, while others go underfunded. At the same time, the complex and varied allocation procedures mean that the overall effect of these flows on the horizontal distribution of resources across the country may be difficult to discern. Some funds are distributed nationwide and equally shared, while others are aimed at particular areas or allocated on a more *ad hoc* or targeted basis. Indeed, one recent attempt to document “fiscal space” at the level of several sample townships found it virtually impossible to quantify systematically the various resources available.<sup>112</sup> As a result, while individual funds may succeed relative to their own objectives, the impact on the subnational fiscal system as a whole – and particularly horizontal fiscal balance – is very unclear. In short, at a time when Myanmar should be aiming for greater budget integration, there is actually considerable budget fragmentation occurring. There is a need to consider ways to better integrate both the ordinary state and region budgets and the various sources of development funds. The next subsection introduces potential elements of such a transfer system.

**Table 2: Devolved government local development funds by state/region, FY 2014-15**

State/Region	# of Townships	Estimated Population *	Poverty Reduction Fund (Millions)	Constituency Fund (Millions)	Total (Millions)	Per Capita (Kyat)
Ayeyarwaddy	26	7,179,000	1,000.00	2,600.00	3,600	501
Bago	28	5,428,103	1,000.00	2,800.00	3,800	700
Chin	9	514,994	5,000.00	900.00	5,900	11456
Kachin	18	1,510,618	15,000.00	1,800.00	16,800	11121
Kayah	7	316,714	1,000.00	700.00	1,700	5368
Kayin	7	1,623,989	2,000.00	700.00	2,700	1663
Magway	25	4,858,203	1,000.00	2,500.00	3,500	720
Mandalay	31	7,090,579	1,000.00	3,100.00	4,100	578
Mon	10	2,626,104	1,000.00	1,000.00	2,000	762
Rakhine	17	3,264,231	15,000.00	1,700.00	16,700	5116
Sagaing	37	5,836,529	1,000.00	3,700.00	4,700	805
Shan	55	5,076,654	4,000.00	5,500.00	9,500	1871
Tanintharyi	10	1,539,734	1,000.00	1,000.00	2,000	1299
Yangon	45	6,492,478	1,000.00	4,500.00	5,500	847

Sources: Myanmar Information Management Unit Township Lists, Interviews with MoF staff, and Constituency Fund legislation

\* Population estimates are averages of 2011 MIMU population estimates and 2011 Myanmar Statistical Yearbook and are intended to be indicative only.

<sup>112</sup> UNCDF, *Local Fiscal Space in Myanmar*, unpublished draft (April 2014).

### 3.4 Towards a state/region transfer system

Both the aid from the Union government for state/region departments and the various subnational development funds described above are effectively fiscal transfers, since substantial local discretion over their use exists at state/region levels or below. Also as described, both the Union aid to the state/region budget and the development funds have weaknesses in their allocation systems: the former through its deficit-based budgeting process, and the latter through their collectively overlapping objectives and mandates.

Alongside the process of sectoral deconcentration already described, Myanmar should also consider moving towards a system of transfers that works to meet the objectives of the government for those devolved activities defined in Schedule Two. The immediate priorities in Myanmar are to start to move from the current system of budgeting for state/region transfers to one that rationalizes (1) the vertical balance of resources between central and subnational levels; (2) the horizontal balance across the country; and (3) the incentives for own source revenue collection, while (4) not overwhelming fiscal or implementation capacity in weak or small states. Strengthening revenue capacity is essential for subnational governments to avoid being a “spending agent” for the center, and to develop more permanent balance between revenues with expenditure assignments, discretion, autonomy and accountability.<sup>113</sup> An additional objective of the system may be to enhance the coordination of the ordinary and development/capital sides of the budget.

The most appropriate way to accomplish these objectives is to carefully develop a formula-based system for transfers for some, if not all, state and region level resources and development funds. In Cambodia, comparison of the horizontal imbalance among communes, which receive a formula-based allocation, and provinces, which undertake a budget process similar to that in Myanmar, confirms that “basic formula-driven approaches that take some account of capacities and needs will lead to more efficient and fairer outcomes than will bargaining between subnational administrations and officials of the central government.”<sup>114</sup>

The transparency created by this process can be politically useful as well. In Tanzania, one reason for the introduction of a formula-based transfer system was to clarify to members of parliament the criteria for distribution of revenues among local governments.<sup>115</sup> A formula-based budget for subnational allocation sets a hard budget constraint at the beginning of the fiscal year, and can be used to limit local governments from turning to large requests for end-of-year assistance from the

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<sup>113</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 22.

<sup>114</sup> Niazi, *Deconcentration and Decentralization Reforms in Cambodia*, 51.

<sup>115</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 9.



central government which undermine the predictability of the national budget. Without such a constraint, local governments may induce bailouts or defaults such as Brazil and Argentina experienced in the mid-1990s.<sup>116</sup> Transfers can therefore support fiscal controls such as the government's goal of maintaining GDP-based deficit targets. It may also help support alignment with future public financial management reforms such as the introduction of a single treasury account or more results-based budgeting models.

The development of such a transfer system involves several steps. The first and most important is to consider carefully the objectives of the system as a whole, and of the individual transfers that are to make it up. Some of the most common objectives of transfers potentially relevant to Myanmar are as follows:

- Improving vertical fiscal balance (ensuring sufficient resources for subnational responsibilities);
- Improving horizontal fiscal balance (equalization);
- Compensating localities for spillovers of benefits to neighboring areas;
- Pursuing national priorities and services with some locally provided component, such as health and education;
- Sharing revenues from specific sources such as natural resources according to political agreements;
- Encouraging certain kinds of local government performance, for example revenue mobilization or good financial management.

Each of these objectives may be best served by different transfer designs. One key element of transfer design is whether the transfer is conditional or unconditional. Conditional transfers are “earmarked” for specific purposes according to sector or expenditure class. Unconditional transfers can be used at the discretion of the local government and better serve purposes such as compensating for horizontal imbalances or inequalities, promoting local autonomy or revenue sharing from natural resources. In addition, transfers are increasingly being designed that incorporate a performance-based component, by which the amount transferred varies according to local governments performance in a given area – for example financial management, revenue mobilization or development outcomes.<sup>117</sup>

The best starting point for designing a state/region transfer system for Myanmar would be those responsibilities *already* under the control of state/region government, or the development aims of the funds described in the previous subsection. Certainly there is a need for more clarity on the scope of subnational responsibilities, and this can be developed through a similar process of functional analysis to that described in the section on sectoral deconcentration above. The current system does not

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<sup>116</sup> Ibid., 24.

<sup>117</sup> For a thorough explanation of performance-based grant design principles see UNCDF, *Performance-Based Grant Systems: Concepts and International Experience*, (New York: UNCDF, n.d.).

effectively address some key objectives, particularly horizontal equity or wealth-sharing, but Myanmar already has a solid set of objectives upon which to develop its system of inter-governmental finance in a more rational direction without starting afresh. To guide consideration of transfer designs, some common subnational expenditures and appropriate funding sources are presented in Table 3.

**Table 3: Matching expenditure responsibilities with appropriate financing<sup>118</sup>**

Expenditure	Examples	Appropriate Financing
Locally determined services or infrastructure that has identifiable user group (excludable) and no spillovers or equity implications	Local utilities, recreational facilities	User fees
Locally determined services and infrastructure that have some local spillovers	Local parks, minor roads, refuse collection	Local taxes and transfers (unconditional)
Local services that have spillovers to other jurisdictions	District roads, disease control	Local taxes and transfers (conditional or unconditional)
Local provision of nationally-determined priority programs	Public health care and education	Central transfers (conditional)
Local spending on nationally-determined programs for promoting equity (national spillover)	Social welfare, public education, resource sharing	Central transfers (conditional, unconditional, or revenue sharing)
Local capital/infrastructure development with long-term benefits	Highway, transport, telecommunications	Local borrowing, transfers (conditional or unconditional) and revenue for debt servicing

In general, transfer system design should consider objectives in the following order. The first is to achieve vertical fiscal balance by bridging the difference between expenditure responsibilities and revenue raising powers. The second is to ensure provision of national or regional functions where under-provision might take place without assistance. Finally, equalization must address horizontal imbalances that remain after the first two parts of the transfer system are designed.<sup>119</sup>

Transfer systems fall into four broad types based on whether transfers are conditional or unconditional and their focus on recurrent or development spending. These are presented in Table 4 in order of increasing complexity and decreasing decentralization from left to right. The more conditionality, the more complex the system and the lower the degree of autonomy or decentralization granted to lower administrative levels. Simpler and more unconditional systems support more local autonomy, and

<sup>118</sup> Adapted from Steffensen, *Fiscal Decentralization and Sector Funding Principles and Practices*.

<sup>119</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*.

might be more conducive to further decentralization in the future, an important consideration in light of the uncertainty over Myanmar’s long-term decentralization path.

**Table 4: Basic grant options for subnational fiscal transfer systems**

Budget Element	Transfer System Elements			
Recurrent Budget	Single Unconditional Block Grant	Unconditional Block Grant	Conditional Sector Grants	Conditional Sector Grants
Development Budget		Unconditional Block Grant	Unconditional Block Grant	Conditional Sector Grants
	<i>Less complex / More decentralized</i>		<i>More complex / Less decentralized</i>	

With the overall system in mind, the design of individual transfers can take place. There are four steps to this process:

1. Clearly and simply define the objectives of the transfer;
2. Select the appropriate transfer mechanisms (conditional, unconditional, matching, performance-based);
3. Determine the basis for determining the transfer pool (the total amount available according to a defined share of revenues, reimbursement of costs, estimation of needs).
4. Determine how the pool is divided among the subnational units (the formula).

Each of these steps is explained in more detail in Annex 2, but it should be kept in mind that transfer design is a complex activity and requires adequate technical support. It also causes transition issues:

often, a particularly difficult issue arises when the system of distributing intergovernmental transfers among local governments is dramatically changed, as for example from a negotiated system to a formula-based system. This change will almost certainly produce local governments who make big gains from the new formula transfers, and others who face big revenue losses.<sup>120</sup>

Fortunately, one advantage of introducing formula-based transfers is that their impact on budget outcomes can be *simulated* before any implementation needs to take place.

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<sup>120</sup> Ibid., 31.

Appropriate measures can then be designed to deal with transitional issues such as the reallocation of existing resources between territories.

In the case of Myanmar's transfer system to states and regions, some significant decisions are (1) whether to treat the ordinary state and region budget on a conditional basis or unconditional basis; and (2) how to integrate the various development funds with each other and with the recurrent budget; (3) how to encourage own-source revenue generation; and (4) how to encourage coordination with the separate channel of deconcentrated sectoral services.

A tentative proposal for state and region transfers might therefore include:

- an unconditional block grant for those ordinary functions assigned to state/region level, possibly with a matching or small performance-based component aimed at improving planning and revenue performance relative to local capacity and conflict sensitivities; and
- an additional unconditional grant aggregating the Poverty Reduction Fund and, if politically feasible, the Constituency Development Fund, with rules for coordination with deconcentrated sector services;
- a possible general purpose grant for equalization, compensation or derivation based on natural resource revenues (see Box 5).

**Box 5: Natural resource wealth: the “fourth channel”?**<sup>121</sup>

“Myanmar’s government has announced a commitment to both greater transparency in natural resource sectors and to further fiscal decentralization. There has also been increasing discussion of sharing natural resource revenues in the contexts of economic restructuring, constitutional reform, and the peace process. However, there is not yet consensus on what is to be shared, between which entities, how, or why.

The government has established a working group to improve public financial management and Myanmar has submitted a candidacy request to the Extractive Industries Transparency Initiative (EITI)...Significant sources of uncertainty include: the composition, extent and distribution of the resource endowment; informal extraction and payments; contested areas and parallel administration by non-state groups; the role of military-owned companies; and a lack of routine, disaggregated reporting for formal revenues from the extractive sector.”

In Myanmar, important parts of the architecture needed for such a fiscal system are already moving into place. While budget proposals are currently compiled based on individual departments’ revenue and expenditure, there is no serious technical barrier of which we are aware to prevent the state and region taking full discretion over the allocation of funds within its assigned responsibilities. The most complex changes will, like the proposed deconcentration reforms, involve alterations to the budget cycle to

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<sup>121</sup> Excerpt from Thet Aung Lynn and Mari Oye, *Natural Resources and Subnational Governments in Myanmar*, ii.

allow more for budget ceilings to be issued to states and regions, and for state/region governments to review and modify the budget.<sup>122</sup> These reforms are complex and require coordinated efforts at both central and subnational levels, and across different parts of government. The final part of the paper emphasizes that the country will need stronger and more formalized coordinating institutions and reform processes if these smaller pieces are to later converge and support a coherent long-term vision for effective central-subnational relations in Myanmar.

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<sup>122</sup> Interviews, State/Region *hluttaw* members (January – March 2014); Bart Robertson, *Overview of the Myanmar Budget* (Yangon: Action Aid, April 2014), 15.

## FOUR: Managing Myanmar's Fiscal Decentralization

This report proposes starting an incremental fiscal decentralization reform strategy with three reform tracks, corresponding to the major existing channels of subnational resource flows to states and regions and smaller units below.<sup>123</sup> The outlines of the initial reforms in each track were introduced in the previous section of this report and are reviewed here. The implementation of such a strategy requires the Union government to provide a framework to guide reforms, and strong coordinating policy institutions and processes, considered in the final sections of this report.

### 4.1 The three track strategy

The first track consists of a framework for sectoral deconcentration. This framework begins with systematic analysis and adjustment of functional assignments followed by the introduction of sectoral budget norms where needed to improve subnational budget allocations *within* major Union line ministries. This process run in parallel with changes to budget preparation and presentation to allow ceilings and final allocations to state/region departments to be transparent within the Union budget.

The second and third tracks involve rationalizing the preparation of state/region budgets through the development of a more integrated transfer system. Separate transfers can be designed, simulated, and potentially piloted for current state/region responsibilities in the ordinary budget, and to integrate subnational development funds that are currently distributed in ways that are not best suited to their objectives. There may be need for a parallel discussion over a general purpose grant to meet goals related to the distribution of natural resource wealth.

There is an argument that the contingent risk of a decentralization reform is at least equal to the share of public expenditure being decentralized.<sup>124</sup> This three track approach limits some of the fiduciary and capacity risks of rapid decentralization by supporting a more gradual process of deconcentration in major sectors, but also provides some of the rapid and democratic benefits of decentralization through devolution by dramatically boosting the autonomy of state/region government through the second and third tracks.

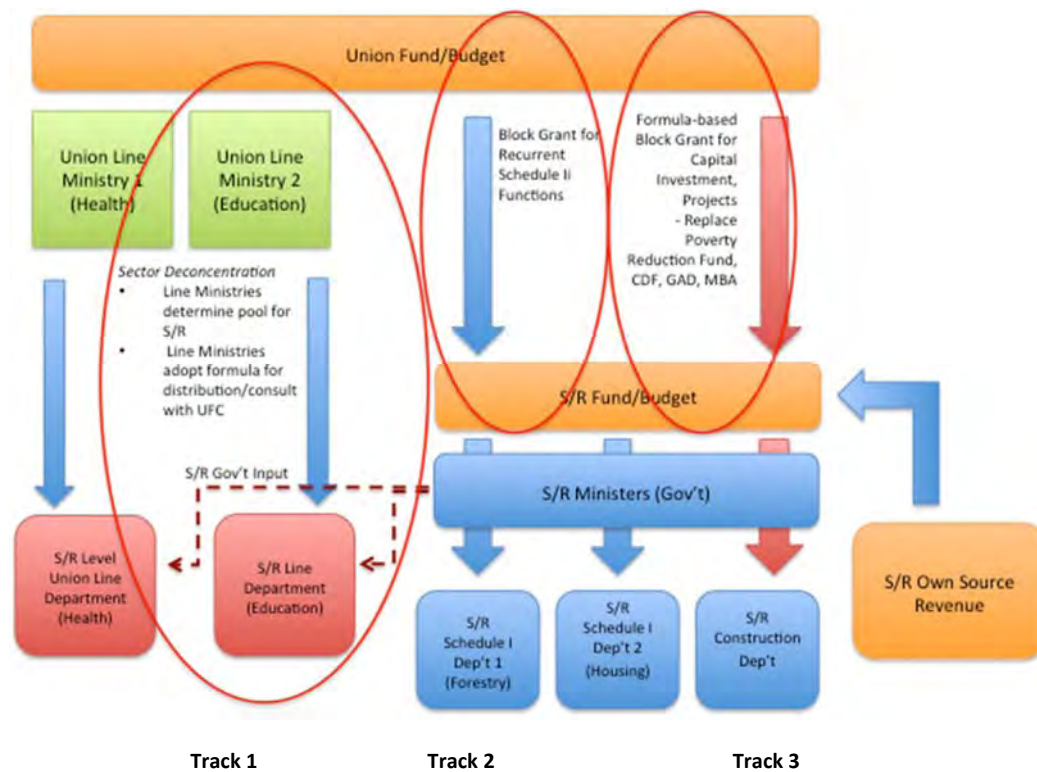
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<sup>123</sup> These proposals benefitted from personal communication with Jamie Boex and comments from Robert Ebel on earlier work, particularly regarding reform of Egypt's similarly hybrid system of vertical and horizontal decentralization. See Jamie Boex, *Democratization in Egypt: The Potential Role of Decentralization*, Policy Brief (Washington, DC: Urban Institute, February 2011); Jorge Martinez-Vazquez and Andrey Timofeev, *Decentralizing Egypt: Not Just Another Economic Reform*, International Studies Program Working Paper (Atlanta, GA: Andrew Young School of Policy Studies, December 2008); Khaled Z. Amin and Robert D. Ebel, *Egyptian Intergovernmental Relations and Fiscal Decentralization*, Egypt Public Expenditure Review (Washington, DC: World Bank, January 2006).

<sup>124</sup> Bahl and Martinez-Vazquez, *Sequencing Fiscal Decentralization*, 37.

Many of the principles for determining the appropriate vertical and horizontal distribution of resources between levels and across territorial units are similar for both deconcentration and devolution reforms. However, the latter introduces more local autonomy and democratic accountability. For example, deconcentration reforms can be seen as similar to a kind of conditional transfer *within* a ministry. Certainly both sets of reforms require similar adjustments to national fiscal procedures for budget preparation to allow ceilings to be released early enough for subnational planning. These include preparation of medium-term financial frameworks and budgets, as well as a revised annual budget calendar and guidelines.

**Figure 7: Three reform tracks**



Reforms in each track must also be able to interact and support the others. For example, in Cambodia early phases of decentralization focused on capital investment funds at various levels. This situation is similar in some ways to Myanmar's, where efforts to move forward with subnational development funds threaten to outpace a more holistic view of the system linking the central and local levels for improved services. However, the Myanmar state has more capacity than Cambodia's did at the start of its transition, and the country is not as aid dependent, so shaping the entire reform agenda around local development funds ignores the capacity that already exists:

decentralisation is not just about local participatory planning, but also about getting basic services to people. To do that, meaningful fiscal decentralisation is of the greatest importance.<sup>125</sup>

Many activities being pursued with subnational development funds overlap substantially with responsibilities of major sectors that are still Union responsibilities: these funds are used to build or support schools, clinics, and rural development. Reforms to budgeting that better coordinate these local projects with sector ministry plans or strengthen ministry coordination with state/region government *before* the budget is passed will strengthen the efforts of both sides. They may also lay the ground for adopting a more devolved system in the future, in which local governments have increased discretion over sector responsibilities.

Finally, these tracks may converge over time. As the second part of this report emphasized, the long-term scope of devolved government in Myanmar is unclear. Additional responsibilities may be devolved to state/region government over time, and/or elected local governments may be introduced at lower administrative levels. A three track approach allows for the planning and financial management capacities of these local governments and administrations to be built, even as the future extent of devolved government or even federalism remains unclear. An important reminder here is that these reforms must be undertaken with great care in areas where governance authority over public services is still contested.

Coordinating, integrating, or eventually even completely combining these three tracks, is a massive policy initiative, but there is currently no clear policy home for this activity within the Myanmar government. While some piecemeal reforms have been driven out of the President's Office, they have not been closely coordinated with the planning and budgeting institutions in the Ministry of Finance and Revenue and Planning and Economic Development. At the same time, the Financial Commission has remained largely a forum for compiling budget proposals, rather than setting fiscal policy between Union and state/region government. And there has been little interaction between the ongoing fiscal decentralization reforms and the broader policy discussions over the constitution, natural resource wealth, and the peace process.

#### **4.2 Institutions and processes for successful fiscal decentralization**

Myanmar's political and reform environment presents great opportunities because there are strong incentives for reform to succeed. But there is an urgent need for a national policy coordination capacity that so far is not being exercised consistently due to a focus on piecemeal and rapid reforms such as an increased state/region budget share. Decentralization can demonstrate benefits quickly – such as local development

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<sup>125</sup> Pak Kimchoeun, *Fiscal Decentralisation in Cambodia*, 3.



projects and new staff in sector departments – but it is not a “quick win” reform. It requires a consistent and clear effort to establish objectives, coordinate many stakeholders, and develop and implement overarching policies. Some of the necessary components of Myanmar’s longer-term fiscal decentralization strategy are outlined in Annex 4.

Many institutional models have been adopted to manage decentralization reform. In some countries, a Ministry of Local Government or similar institution may have this responsibility. However, a common issue is that such institutions tend to be able to act on administrative and even some political decentralization, but have little influence over fiscal matters, which are dominated by Ministries of Finance. Egypt had a Ministry of Local Development prior to the recent uprisings, but it was unable to gain traction on fiscal decentralization proposals developed there. In Afghanistan, a Directorate for Local Government introduced ambitious policy documents on local governance, but the Ministry of Finance retained a tightly centralized budget, preventing the kind of reforms advocated in this paper.

One solution to this problem is to lead reform from an inter-ministerial task force, as was adopted in the early 2000s in Kenya to manage a national decentralization program. Other countries focus on “developing special-purpose, somewhat more ‘neutral,’ and high-level mechanisms to oversee and coordinate decentralization.”<sup>126</sup> The mechanism needs to balance the requirements of political decision-making and sound technical analysis and policy development. As decentralization is a cross-cutting issue that influences public financial management of all kinds, it needs participation of all key budgetary institutions. Such an institution may take the form of temporary or more lasting institutions such as a national commission, usually based in or around the Prime Minister or President’s Office.

Whatever the structure for driving policy, the existence of some form of Finance Commission or fiscal forum to define the inter-governmental fiscal system is crucial. As with the political level, these institutions take many forms, either permanent or intermittent, and independent or government-led. Lessons gathered across many countries with such institutions suggest that they should be permanent bodies with a limited membership; but include the Minister of Finance, Minister of Interior or equivalent, representatives of local governments, and more independent advisory members from academia, civil society and the private sector.<sup>127</sup>

**Box 6: Selected decentralization policy coordination mechanisms**

**Ethiopia:** Regional Affairs Department in the Office of the Prime Minister.

<sup>126</sup> Smoke, “Strategic Fiscal Decentralization in Developing Countries,” 103.

<sup>127</sup> Steffensen, *Fiscal Decentralization and Sector Funding Principles and Practices*, 33; Roy Kelly, unpublished presentation, Duke University (August 2008).

**Uganda:** Decentralization Secretariat reporting to the Permanent Secretary for Local Government, but staff are not civil servants. Local Government Finance Commission is independent and reports to the President, influencing local revenue and transfer design.

**Cambodia:** Subnational Democratic Development Program is designed and managed by a permanent inter-ministerial National Commission on Democratic Development (NCDD) chaired by the Minister of Interior. The NCDD has its own budget, supporting secretariat, and subcommittees on functions and resources, fiscal and financial affairs, and personnel of subnational administrations.<sup>128</sup>

**India:** An independent advisory body with 5 members periodically constituted every five years to focus on central-state level allocations of revenues and grants. Subnational (state) level finance commissions were introduced in the 1990s.

**Canada:** Provinces meet periodically in intergovernmental “first ministers” forum.

**South Africa:** Permanent autonomous and independent financial and fiscal commission including provincial and local representatives, with full-time secretariat.

It would be unwise for this paper to provide comprehensive recommendations on a specific decentralization policy management arrangement for Myanmar. However, two general observations might be made. First, given Myanmar’s context of political decentralization leading administrative and fiscal dimensions and its pending high-level questions about the constitution, the peace process, and natural resources, it is likely that a higher level political body such as a national commission or secretariat is more suited than a Local Government or Home Affairs Ministry-led model.

Second, once again Myanmar has some important building blocks in place. There is an existing constitutional Financial Commission that meets annually to consider the budget. However, the constitution actually allows for a potentially more significant policy-making role for the Financial Commission: namely to “carry out the duties assigned by the *Pyidaungsu Hluttaw* through the promulgation of law for the emergence of a substantial financial system.”<sup>129</sup> The Financial Commission already includes some key central and subnational players – the Vice Presidents, the Auditor-General, the Minister of Finance and the Chief Ministers of the states and regions.

In addition to a higher-level body to guide policy with wider participation, the Finance Commission could to be given – in law in accordance with the constitution – a defined policy role in designing precisely the fiscal frameworks for deconcentration and devolution introduced in this paper. Essentially the Financial Commission needs to move from being a forum for inter-governmental bargaining to a policy setting body. To do so would require substantial investment in a technical secretariat, and preferably legislative requirements for it to consult widely both within and beyond government on policy decisions it makes.

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<sup>128</sup> Niazi, *Deconcentration and Decentralization Reforms in Cambodia*, 12.

<sup>129</sup> *Constitution of the Republic of the Union of Myanmar*, Art. 230.

This paper has stressed throughout that Myanmar can strengthen its decentralization process in an incremental way, while also working towards resolution of a longer-term vision. In this sense, these policy coordination institutions do not need to start by determining everything, as in the textbook model presented in the introduction. In fact,

Developing a process to build consensus about the appropriate extent, form, and pace of fiscal decentralization is at least as important as – and initially often more important than – defining an ‘end product’ system that conforms to the normative decentralization model. This is particularly critical in highly centralized countries where there is no unified vision of decentralization ... Such a process, if properly structured, representative of the key stakeholders, led by a trusted or neutral agency, broadly perceived as fair, and adequately empowered, can help define a realistic starting point for fiscal decentralization.<sup>130</sup>

The most important recommendations of this paper, therefore, are not just about a specific decentralization proposal, but rather the need to form coordinating institutions and a policy process to manage these evolving fiscal decentralization reforms. There are many ways to approach decentralization, and with the pace and uncertainty of Myanmar’s transition, a much more dramatic process is a possibility. Regardless of the path taken, the analysis in this paper is intended to contribute to a more informed discussion about how best to fulfil the hopes of all Myanmar’s peoples, no matter where they live, for a more developed and peaceful country.

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<sup>130</sup> Smoke, “Strategic Fiscal Decentralization in Developing Countries,” 107.

## **Annex 1: Political, administrative and fiscal dimensions of decentralization**

**Political decentralisation** involves the transfer of decision-making power and accountability to local levels. It often involves some form of *devolution*—the transfer of responsibilities to local governments that have been granted significant autonomy. In “democratic decentralization” these local governments are accountable to local populations through elections and/or other means.

**Administrative decentralization** focuses on distributing managerial responsibilities (for example, for delivering a given public service) among different levels of government or administration. It may also take the relatively modest form of *deconcentration* in which officials at lower levels are given more authority or discretion, but remain accountable to their chiefs at the centre. Decentralization could also be combined with the devolution of executive authority to local governments. *Delegation* is the shifting of functions to semi- or wholly-independent organizations outside the core government sector (for example to independent authorities, or in *privatization*, to private firms).

**Fiscal decentralization** describes the way in which the expenditure responsibilities are assigned and corresponding resources are provided. These resources may be provided by deconcentrating control over central funds to lower levels, or devolving to local government, a more comprehensive system of planning and budgeting supported by assignment of local revenues, central-local transfers, and possibly local borrowing.

Excerpted from Nixon et al., *State and Region Governments in Myanmar*.

## Annex 2: Designing transfer schemes

### 1. Define the purpose of each scheme

Considering the system objectives, the purpose of this specific transfer scheme should be defined. It is probably easiest to limit the objectives of a given scheme to preserve simplicity and transparency: Will this scheme focus on providing general purpose funds for local service-delivery or development, support national policy objectives, or equalize conditions among different parts of the country?

### 2. Define the transfer mechanisms or windows

Depending on the purposes of the transfer, several design choices need to be made. The first is what conditions will be attached to the transfer. These might require that the transfer is to be used for a specific sector (health, education), purpose (local roads), or expenditure category (recurrent or capital). On the other hand, the grant may be unconditional or general purpose, for use at the discretion of the local unit. Each type of transfer has advantages and disadvantages.

#### **Advantages and disadvantages of conditional and unconditional transfers**

*Conditional transfers* can support specific national policy goals or standards of service, stimulate service delivery in priority areas, or compensate local areas for spillovers. On the other hand they can be complicated and expensive to administer, and may distort local priorities and confuse accountability for the delivery of services.

*Unconditional transfers* build up local autonomy and planning capacity, can strengthen local accountability and political decentralization, and are relatively simple to administer. However, they may crowd out local spending on local services, and require good local financial management.

In general, conditional grants should be used when a policy objective cannot be met by other means, and it is good to consider an exit strategy to phase them out in favour of less conditional mechanisms. There should be a balance between conditional and more discretionary funds in the local budget.

Second, the transfer may be delivered as a lump sum or in some matching form that varies depending on local expenditures for the same purpose. If it is matching, the grant should be defined as open-ended or with a fixed ceiling. In addition, transfers are increasingly being designed that incorporate a performance-based component, by which the amount transferred varies according to local governments performance in a given area – for example financial management, revenue mobilization or development outcomes. Such performance-based systems require careful

consideration in order to incentivize and support capacity for good performance without punishing disadvantaged jurisdictions.<sup>131</sup>

### 3. *Determine how the transfer pool is established (vertical allocation)*

The transfer “pool” is the total amount of resources to be transferred to lower levels through the scheme, before considering how it is to be divided up. This pool may be determined in a number of ways.

- The pool may be determined on an *ad hoc* basis or be defined by a program, for example through donor local development funds.
- The pool may be a defined share of the total national budget or revenues, or some portion of a specific revenue stream.
- It may be based on the reimbursement of the expenditures of local governments, most common for conditional transfers.
- In more unusual cases the pool may be based on estimating the expenditure needs of local government (for example to meet a standard level of service delivery). As it must be based on expenditure and revenue estimates this process can be complicated.

The determination of the pool of resources should be related to its purpose. For example an equalization transfer pool focused on justly distributing natural resource revenue would be a portion of that specific revenue stream, a broader socio-economic equalization pool might be a portion of the national budget, and an equalization grant aimed at promoting national service standards might be determined on a reimbursement basis. In general, *ad hoc* transfers are the least decentralizing form, as they tend to rely on political negotiations at the centre and can be unpredictable and undermine local planning and budgeting.

### 4. *Determine how the pool is divided among subnational units (horizontal allocation)*

Once the mechanism and pool are determined, it remains to establish the allocation or division of the resources among the eligible subnational units. This division can be determined in four or five broad ways, also according to the purposes of the transfer:

- Often the division of the pool is determined through an *ad hoc* or case-by-case process through political negotiations or executive order. When transfers form part of a development assistance program it will usually have its own pre-determined allocation criteria, often a standard grant amount.

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<sup>131</sup> For a thorough presentation of performance-based grant design principles see UNCDF, *Performance-Based Grant Systems: Concepts and International Experience*.

- The division may be based on the “derivation”, or origin of the funds. In this case some proportion of a given revenue stream is directed back to where it was collected.
- It may be based on the conditional reimbursement of expenditures for a specific purpose by each local government.
- It may be based on an objective formula-based allocation using objective and verifiable allocation factors that are assigned differing weights. Sometimes performance criteria are included in these allocation factors, so that transfers reward good local government performance.

*Ad hoc* or politically negotiated transfers are common, but often have problems with their lack of transparency, participation and objectivity leading to perceptions of bias. As a result they often rely too much on the “equal-shares” principle to avoid controversy. The recent distribution of poverty reduction development grants in Myanmar is an example: giving 1 billion Kyat per state/region appears fair, but does not reflect the relative expenditure needs of each state and region. Further adjustments (for example giving an additional 2 billion Kyat to Chin State) may appear arbitrary and are still not directly related to defined needs. On the other hand, some *ad hoc* planning may be needed in the case of exceptional or large capital investments.

The derivation principle is often used to ensure local governments are assured that a portion of the financial resources raised there are available for their use. Such a principle is particularly important in political agreements over natural resource revenues or in sharing out nationally collected taxes. The transfer does not have to be of all resources, as some resources may be reserved for national purposes or to make equalizing transfers to less advantaged regions.

Reimbursement transfers are distributed according to the expenditure of the local government on a particular service – for example teachers’ salaries. They aim to ensure national policy goals are pursued or services delivered at a national standard. Possible problems are that an open-ended commitment will discourage local revenue collection for the same service, and this can be addressed by capping the grant pool or defining a matching ratio, by which the grant is based on the level of local revenues used. With matching grants, care must be taken to avoid distorting or crowding out other preferred forms of local spending, or to support the wealthiest regions more than poorer ones.

Formula-based transfers have the advantages of transparency, clear linkage to the objectives of the transfer, and flexibility. Since they are objectively determined, the impact of different allocation factors and weights can be modeled in advance, and can be adjusted over time – many countries evaluate the weights and allocations used through a regular institutional process. Formula-based transfers can be shaped to serve a range of objectives including equalization, support for national policy goals, local development, and incentivizing improved performance.

## **Annex 3: Schedules Two and Five of the Myanmar Constitution**

### **Region or State Legislative List (Schedule Two)**

#### **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 centres, 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**

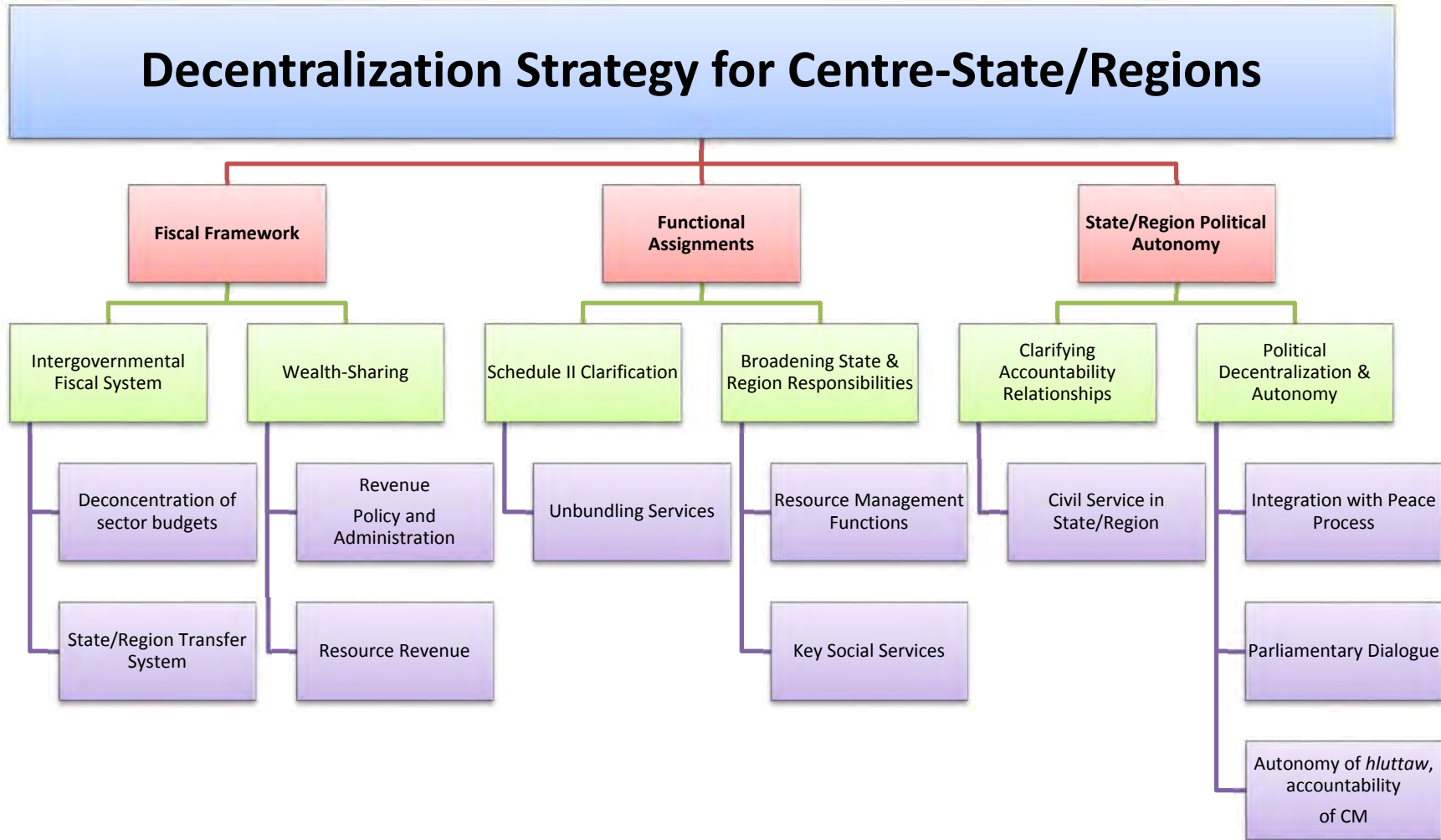
- (a) Development matters;
- (b) Town and housing development; and
- (c) Honorary certificates and awards.

## **Taxes and Fees Collected by Region or States (Schedule Five)**

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 hardwoods;
  - b. Taxes collected on firewood, charcoal, rattan, bamboo, birdnests, catch, 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.

Annex 4: Elements for Myanmar's Decentralization Strategy



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**The Asia Foundation**

No. 21, Bo Yar Zar Street  
14 Ward, Kyauk Kone  
Yankin Township  
Yangon, Myanmar



No. 27, Pyay Road, 6 1/2 Mile  
Hlaing Township  
Yangon, Myanmar