Module 3

FISCAL FEDERALISM AND EQUALIZATION

USAID FROM THE AMERICAN PEOPLE

The Asia Foundation

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WHAT THIS MODULE WILL COVER

1. What is the role of equalization in a federal system?
2. What are the different fiscal transfers in Myanmar?
3. How do equalizing elements of the fiscal transfer system work in Myanmar? How does equalization work in other contexts?
4. Should equalization reflect different needs to promote equity?

TERMS IN THIS MODULE

EQUALITY: The condition of being equal, especially in status, rights, and opportunities.

EQUITY: The quality of being fair and impartial: justice according to natural law.

EQUALIZATION PAYMENTS: Payments made from the federal government to subnational governments with the objective of balancing differences in available revenue or in the cost of providing services.

FISCAL INEQUITY: The unequal treatment of equals across jurisdictions due to differences in Net Fiscal Benefits.

NET FISCAL BENEFITS: The difference between per capita benefits received and per capita taxes paid.

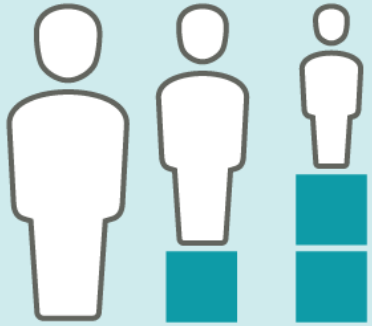
REVENUE SHARING: The dispensing of a portion of federal tax revenue to state and local governments.

EQUITY AND EQUALITY

EQUALITY

Equality is the condition of being equal, especially in status, rights, and opportunities.

EQUITY

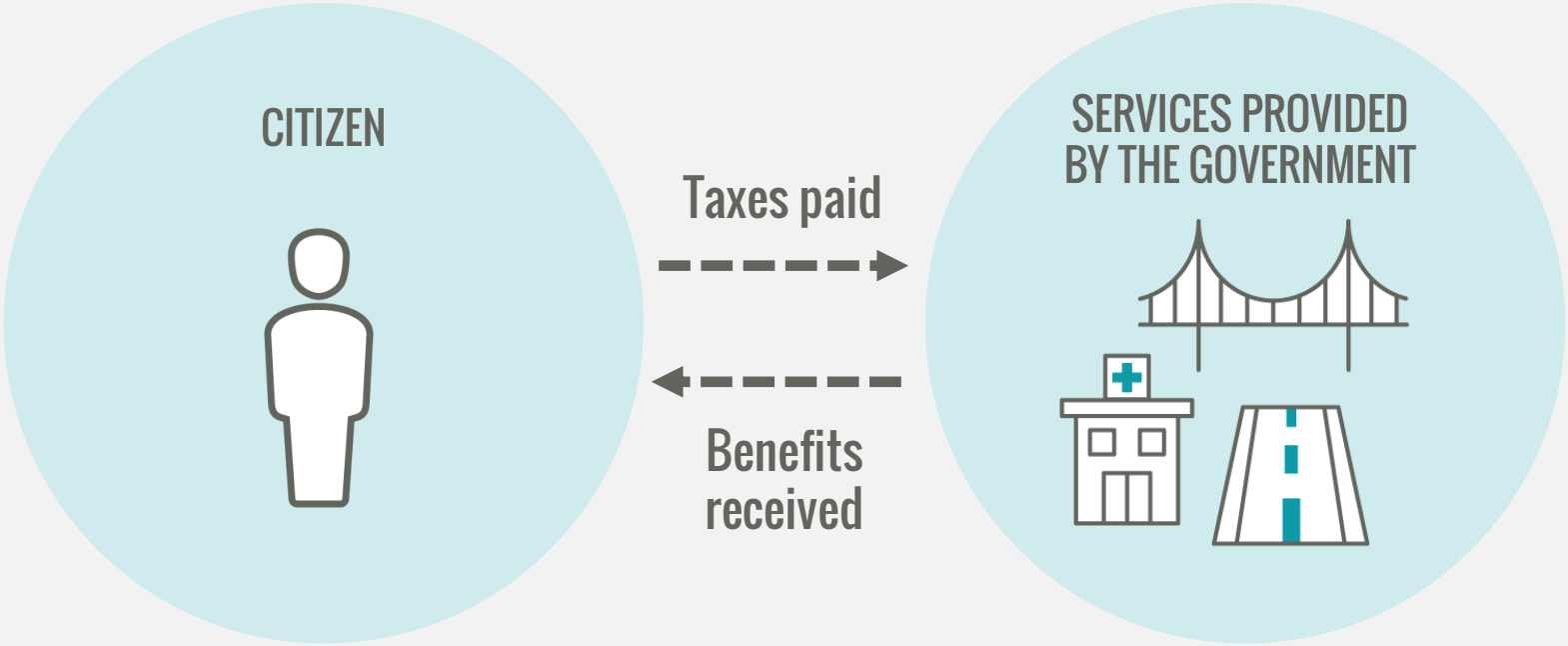


Equity is the quality of being fair and impartial; justice according to natural law.

NET FISCAL BENEFITS (NFB)

NFB = BENEFITS RECEIVED - TAXES PAID

Net Fiscal Benefits (NFBs) are essentially the difference between per capita benefits received and per capita taxes paid.



DIFFERENCES IN NET FISCAL BENEFITS

- States with below average income provide below average level of benefits per capita
- Net fiscal benefits will be lower for residents of states with below average incomes than those in states with above average incomes
- This is called **fiscal inequity**

EQUALIZATION

- It is the role of equalization payments to compensate for fiscal disparities in a federation—to equalize net fiscal benefits.
- Differences in net fiscal benefits across states can arise from differences in:
  - State tax capacities
  - The cost of providing state public services
  - The need for particular public services within the state
- Equalization grants can eliminate these differences in net fiscal benefits across states.
  - Based on relative tax capacity and on relative need for and cost of providing state public services.
- Objective is to enable states to be able to provide reasonably comparable levels of public services at reasonably comparable tax rates.

EQUALIZATION

EQUALIZING FOR DIFFERENCES IN 'NEEDS'

Formula based on needs indicators such as:

- Population size
- GDP per capita
- Poverty rate
- Demographics
- Population density

EQUALIZING FOR DIFFERENCES IN TAX CAPACITIES

Formula based on equalization of per capita tax revenues:

- All sources, including natural resources

Various standards:

- National average
- Top state
- Representative group of states

Net versus gross schemes.

THREE EXAMPLES OF EQUALIZATION

AUSTRALIA

Equalization in Australia is on a “needs” basis, administered by the Commonwealth Grants Commission. In Australia, expenditures are highly decentralized while tax revenue collection is highly centralized.

CANADA

Equalization in Canada is based on the Representative Tax System (RTS), designed to raise fiscal capacities in provinces with below average fiscal capacities to the national average. Referred to as a “gross” scheme. Canada is highly decentralized in terms of expenditure responsibilities and tax powers, including natural resources.

GERMANY

Equalization in Germany is centered on the major taxes and operates as a “net” scheme. Collection of the major taxes is centralized with explicit revenue sharing arrangements on a fully equalized derivation basis. Revenue rich states are equalized down to the national average; revenue deficient states are equalized up. These arrangements are constitutionalized.

EXERCISE

Step 1 Review terms and slides on equity, equality and equalization.

Step 2 **GROUP DISCUSSION** - 10 minutes
Why is equalization needed in Myanmar?
What can be the benefits of equalization?

Step 3 **PRESENTATION BY GROUPS** - 10 minutes
Nominate a speaker to present back in plenary.

TYPES OF GRANTS AND TRANSFER

REVENUE SHARING TRANSFERS

SPECIFIC PURPOSE GRANTS

- Lump sum

COST-SHARING ARRANGEMENTS

- Matching grants tied to health, education and social assistance programs delivered by states
- Infrastructure development
- Green technology development

BLOCK GRANTS

- Transfers to states in support of expenditures in key areas
  - Equal per capita
  - Per capita “needs” based

TAX REVENUE SHARING & EQUALIZATION

Devolution of tax powers to state governments, e.g., personal income tax, corporate income tax, sales tax

- State control of tax base and rate structure
- Potential for fiscal disparities across states

Centralized tax collection, defined share returned to states on derivation basis
(proportion of revenues collected in a state are returned to the state)

- Common definition of different taxes
- Complementary equalization payments required

Centralized tax collection, equal per person distribution to states

- Per capita revenues equalized to national average standard
- Common definition of different taxes

GENERAL GRANT

GENERAL GRANT:

A revenue based transfer based on need and fiscal capacity. Formula based since 2015-2016.

DISTRIBUTION FORMULA (WEIGHTING):

Land area
Population
Poverty rate

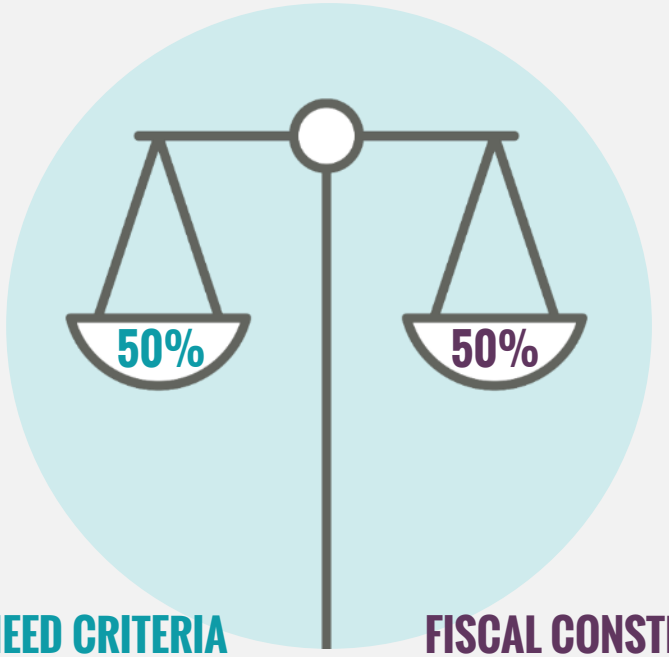
NEED CRITERIA

Tax collection per capita
% Urban population
GDP per capita

FISCAL CONSTRAINT

CURRENT FISCAL ARRANGEMENTS IN MYANMAR

DISTRIBUTION FORMULA (WEIGHTING):



GENERAL GRANT

- Previously for "deficit financing"
- Since 2015-16, formula based, but only applied to incremental amounts
  - Grant Pool defined in Union budget, to be divided among States/Regions
  - Needs-related criteria
  - Fiscal constraint-related criteria
  - Net of revenue sharing provisions
- Criteria used:
  - Needs-related
    - State/Region Population
    - State/Region Poverty index
    - State/Region land area
  - Fiscal constraint-related
    - State/Region per capita GDP
    - State/Region urban population as a percentage of total state population
    - State/Region per capita tax collection (actual)
- Equal weighting

DISTRIBUTION OF GENERAL GRANT

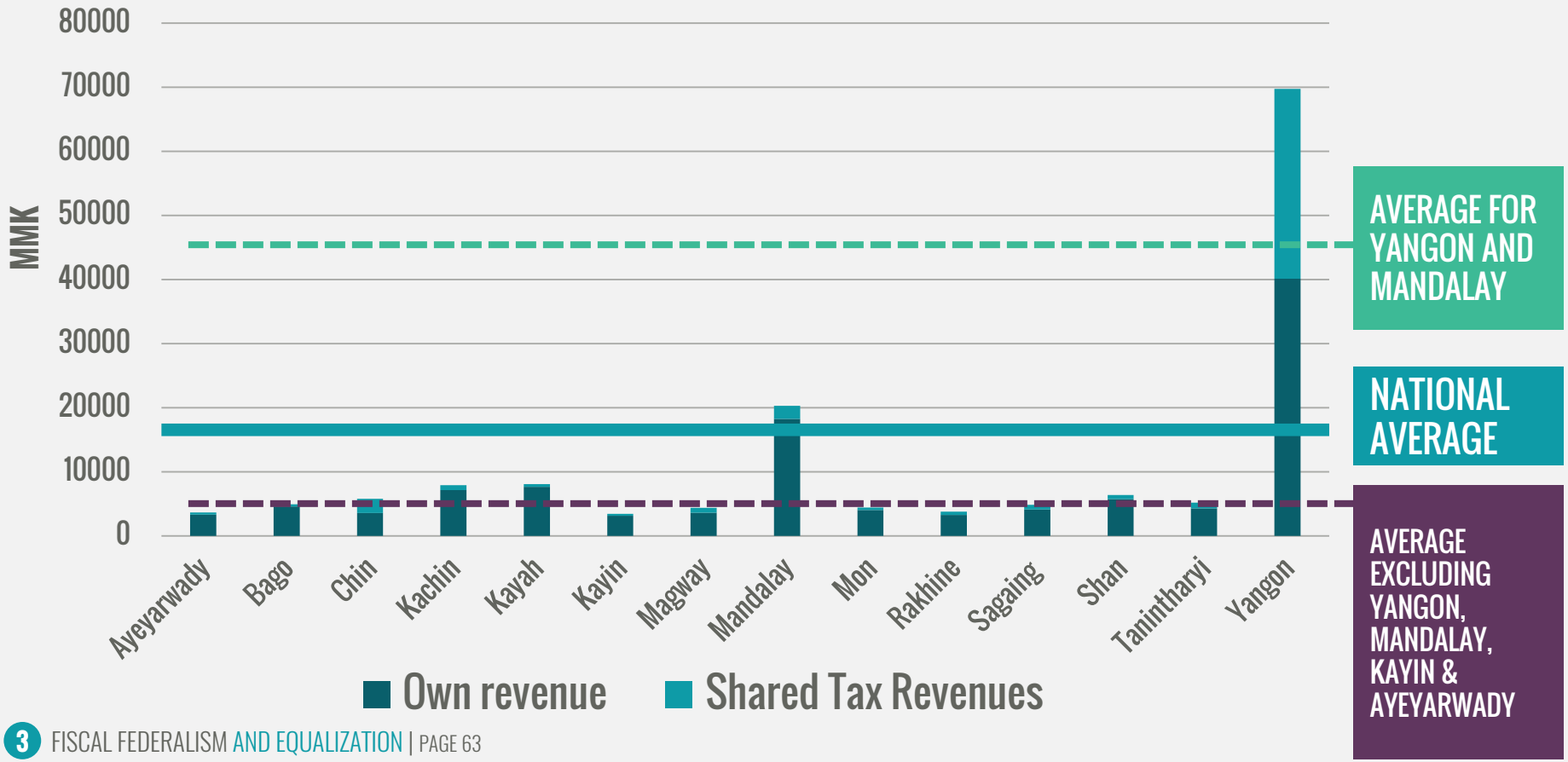
- Previously, general grant transfers were conceived as 'deficit financing'
  - Annual State and Region government budget submissions were reviewed by the Union government and a determination was made of the amount by which projected deficits would be offset for each State and Region.
- Since 2015/16, the formula-based approach is being phased in
  - Criteria used in 2015/16
  - State/Region population, poverty index, and per capita GDP.
- Additional criteria added in 2016/17
  - State/region land area, urban population as a percentage of total population, and per capita tax collection.
- Formula applied only to annual increments to grant pool.

DISTRIBUTION OF GENERAL GRANT

- Very wide variance of per capita revenues between states/regions.
  - Not justified by any corresponding variance in relative 'need' or 'fiscal capacity'.
- Some states/regions which have similar population and poverty index often enjoy very different levels of revenue/expenditure.
- Some states/regions with higher population and poverty index enjoy much lower revenue/expenditure levels.
- No correlation of revenue/expenditure levels with the two principal 'need' indicators.
- Huge per capita total revenue disparities across states/regions.

EQUALIZING FOR STATE/REGION PER CAPITA REVENUE DISPARITIES

FY 2016/2017

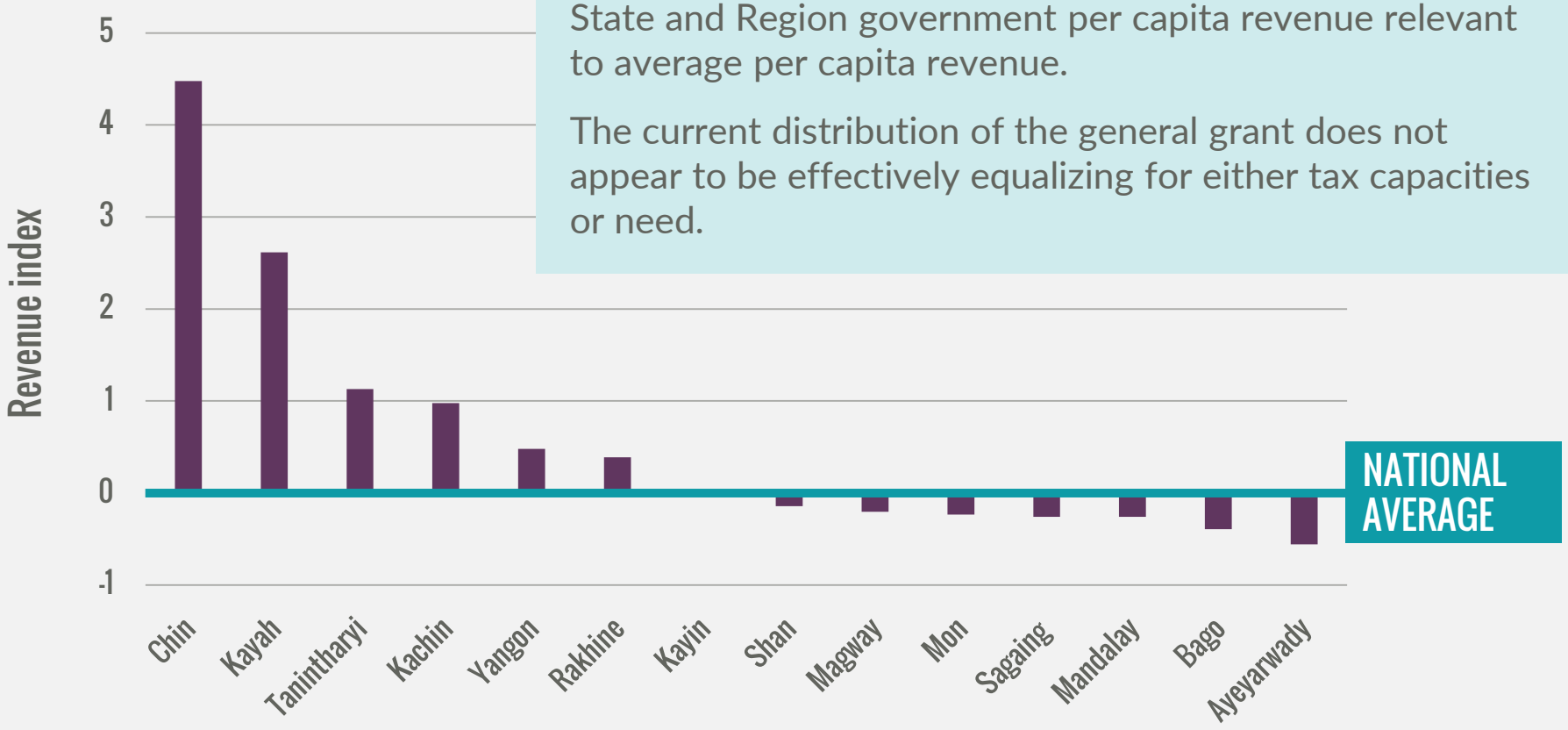


STATE/REGION PER CAPITA REVENUE INDEX

FY 2016/2017

State and Region government per capita revenue relevant to average per capita revenue.

The current distribution of the general grant does not appear to be effectively equalizing for either tax capacities or need.



Index: Total per capita revenue divided by average per capita revenue

SUMMARY OF KEY ISSUES

- The role of equalization in a federal system is to enable sub-national levels of government to provide reasonably comparable levels of public services given reasonably comparable levels of taxation.
- The different fiscal transfers in Myanmar are the Community Development Fund, shared taxes (commercial and special goods taxes, income tax and stamp duty), and the general grant.
- Because revenue sharing in Myanmar is on a derivation basis, this results in further fiscal disparity across States/Regions.
- In principle, the general grant could be designed to equalize for fiscal disparities, but in practice it does not: fiscal disparity remains across States/Regions in Myanmar.

EXERCISE

Step 1 Review section on grants and transfers.

Step 2 **GROUP DISCUSSION** - 15 minutes
Should an equalization system take from the revenue rich states and give to the revenue poor states?

Step 3 **PRESENTATION BY GROUPS** - 10 minutes
Nominate a speaker to present back in plenary.