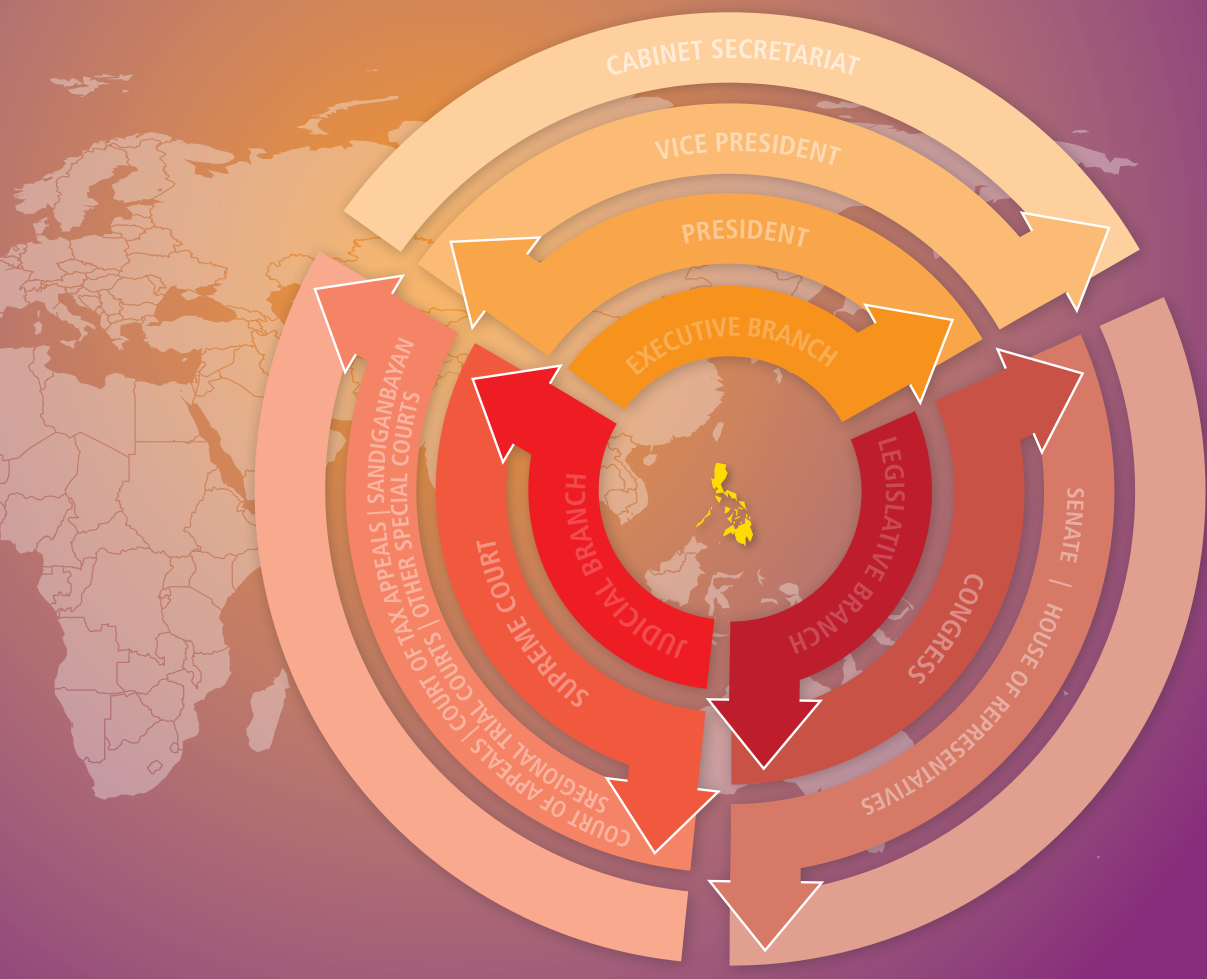
THE GLOBAL
URBAN ECONOMIC
DIALOGUE SERIES

FISCAL DECENTRALIZATION
IN THE PHILIPPINES



UN HABITAT
FOR A BETTER URBAN FUTURE

FISCAL DECENTRALIZATION
IN THE PHILIPPINES

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FOREWORD

Urbanization is one of the most powerful, irreversible forces in the world. It is estimated that 93 percent of the future urban population growth will occur in the cities of Asia and Africa, and to a lesser extent, Latin America and the Caribbean.

We live in a new urban era with most of humanity now living in towns and cities.

Global poverty is moving into cities, mostly in developing countries, in a process we call the *urbanisation of poverty*.

The world's slums are growing and growing as are the global urban populations. Indeed, this is one of the greatest challenges we face in the new millennium.

The persistent problems of poverty and slums are in large part due to weak urban economies. Urban economic development is fundamental to UN-HABITAT's mandate. Cities act as engines of national economic development. Strong urban economies are essential for poverty reduction and the provision of adequate housing, infrastructure, education, health, safety, and basic services.

The *Global Urban Economic Dialogue* series presented here is a platform for all sectors of the society to address urban economic development and particularly its contribution to addressing housing issues. This work carries many new ideas, solutions and innovative best practices from some of the world's leading urban thinkers and practitioners from international organisations, national governments, local authorities, the private sector, and civil society.

This series also gives us an interesting insight and deeper understanding of the wide range of urban economic development and human settlements development issues. It will serve UN member States well in their quest for better policies and strategies to address increasing global challenges in these areas

Joan Clos
Under-Secretary-General
of the United Nations,
Executive Director, UN-HABITAT

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CHAPTER 1 **INTRODUCTION**

Many developing countries, the Philippines included, have embarked on a major shift in policy and approach to development by decentralizing and devolving central government powers, functions and responsibilities to local government units.[1] In 1991, the Philippine Congress enacted the Local Government Code, which devolved to local government units the great responsibility of providing the local populace with a range of basic public goods and services.

The Philippines has a presidential unitary government system. The national government has three independent branches, namely, the executive, the legislature, and the judiciary. The executive is headed by a popularly elected president. The executive branch is functionally organized into sectoral departments, each headed by a cabinet secretary appointed by the president. The legislature, or Congress, is bicameral and is composed of the Senate and the House of Representatives. Senators are nationally elected while representatives are elected by legislative districts. The judiciary is composed of the Supreme Court and the lower courts. As of 2011. the political subdivisions are the 80 provinces, 138 cities, 1, 496 municipalities, and 41, 945 barangays. They are collectively referred to as local government units. The barangay is the lowest tier of local governance. A group of barangays comprise a municipality. The more urbanized and developed barangays comprise a city. There are two types of cities: (a) highly urbanized, which is independent of the province, and (b) component cities (smaller cities). A cluster of municipalities or municipalities and component cities, comprise a province. Each local government is headed by directly elected officials, namely, a chief executive and a legislative body called "sanggunians.". Figure 1 shows the three co-equal branches of government in the Philippines. Figure 2 shows the structure or layers of local government units in the country.

1 *In the Philippines, these comprise provinces, cities and municipalities. In other countries, these local government units are commonly known as sub-national governments or sub-national units. Throughout this paper, I retain the conventional term used in the Philippines, namely "local government units" (LGUs).*

Figure 1. Three Branches of the Philippine Government

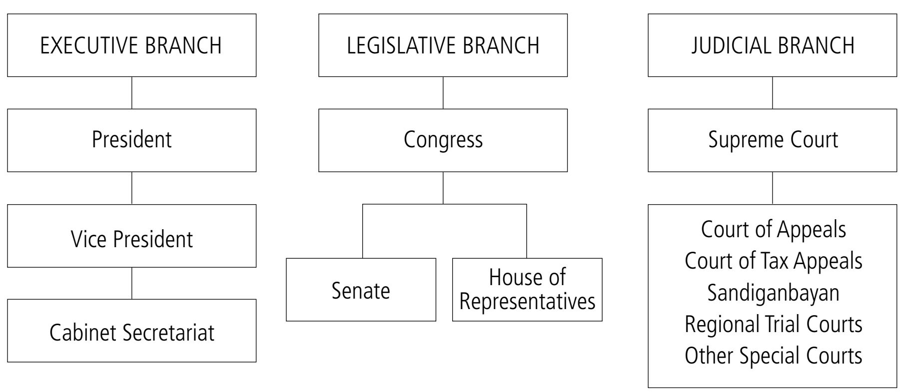
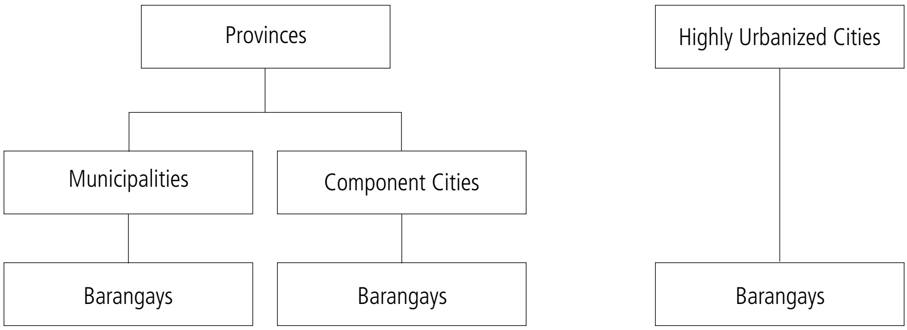


Figure 2. Philippine Local Government Units



The 1991 Local Government Code (Republic Act 7160) provided local government units with powers to tax and levy various fees and charges, and to borrow from the financial markets in order to raise revenues for financing local development. A key element of fiscal decentralization is the inter-governmental fiscal transfer called the 'internal revenue allotment,' which is a block grant to local government units based on a formula designed by the Philippine Congress.

This is a ground-breaking legislation because it has decentralized and devolved significant power and authority to local government units, unleashing tremendous opportunities for self-development at the local level[2]. In the period preceding its enactment into law, the central (national) government exerted control over virtually all aspects of local governance. The 1991 Local Government Code endows local government units with fiscal autonomy and accountability to the local population, which constitute a major departure from firm direction and control by the national government.

Local political scientists have enthusiastically observed that "decentralization has been the single most significant political reform after the fall of the Marcos dictatorship in 1986" (Tayao 2010)[3]. Brillantes and Tiu Sonco II (2010) saw decentralization as reframing "the discourse of governance when local governments begun to play a key role in governance in a country long steeped with a history of excessive centralization and dominance by the center, the latest of which was the domination by the Marcos dictatorship". These political scientists called attention to the substantial changes made in the politico-administrative system of the Philippines. They viewed the Code as a force, which redefined the "notion of governance by providing the enabling framework for local government-business partnerships, and also local government-NGO partnerships, including opening the door to direct people participation in governance".

Objective of the Report

The objective of this report is to determine to what extent fiscal decentralization has empowered local government units in the Philippines to efficiently discharge the greater responsibility over governance, public service delivery and local development mandated to them by the 1991 Local Government Code. More specifically, it provides a descriptive analysis of fiscal decentralization in the

2 The Philippines has political decentralization because powers are devolved to political leaders who are directly elected by or accountable to the population as opposed to de-concentration or administrative decentralization where power is devolved to appointees of the national government.

3 Tayao, Edmund (2010), "Decentralization in the Philippines: Impact on Politics and Governance," unpublished paper, December 09.

Philippines. It focuses on local government fiscal policies and inter-governmental fiscal transfer and identifies local finance policy reform issues, which policy makers should address to enable local government units to improve their local revenue-raising effort.[4] The inability to raise adequate local revenues is at the core of the problem of local government units in delivering local public services. A reason behind this is the inadequate taxing powers assigned to local government units, resulting in a vertical fiscal imbalance, which occurs when the central government retains control over major sources of tax revenues.

The intergovernmental fiscal transfer called the internal revenue allotment (IRA) significantly supplements or covers the inadequacy in local revenue collection. The allocation or distribution formula for the internal revenue allotment stands a close review and improvement even as it has become the most important source of revenue for many local government units, especially the poorer municipalities. The irony is that the internal revenue allotment may have had a disincentive effect on local effort to raise revenues, making many local government units dependent on it for funding local development and services. The distribution formula for the IRA should be improved but Philippine local government units must exert effort to raise local revenues because failure to do so results in inefficient local service delivery and diminished accountability. The IRA received by local government units has not been adequate enough to finance comprehensive service delivery and local development programs.

A case can also be made about the need for local government units to improve local public expenditure management. Under-spending on vital local public goods and services affects the level of welfare of households and negates the advantages given to decentralized regimes of better local service delivery arising from closer matching of public services with local preferences and greater efficiency in the provision of public goods. A recent paper by Llanto and Quimba (2010) provides some empirical evidence that there has not been a significant improvement in the delivery of health and education services despite devolution[5]. Their empirical analysis seems to indicate that decentralization has not resulted in an improvement in the delivery of local services, contrary to the popular notion, which tends to be based on anecdotal evidence.

The report is organized as follows. To provide context to the discussion, Section 2 provides a brief review of the concept of fiscal decentralization and its elements based on recent literature. Section 3 discusses the tax-expenditure assignment at the local level. It first discusses the structure and composition of local tax revenues, fees and charges and then describes the pattern of local government spending with focus on health and education, major expenditure items for which data are more readily available. A key finding is the presence of an inefficient tax-expenditure assignment, which has constrained the envisaged development of local areas by local people utilizing local resources. This confirms earlier findings of Manasan (2007) who found a mismatch between revenue resources and expenditure needs of the various levels of local government.

An issue overlooked by many local researchers is the need for local government units to exert more effort to improve local expenditure management. The findings of Llanto and Quimba (2010) show that many LGUs have been under-spending, which point outs out the need for more efficient local expenditure management. The key message of this section is the importance of providing

4 In the Philippines, sub-national governments are called "local government units" (LGUs), which are comprised of provinces, municipalities, cities and "barangays." Barangays are the smallest political unit headed by a local elective officer called "barangay captain." Municipalities and cities are comprised of several barangays , respectively.

5 Llanto, Gilberto M. and Francis Quimba (2010), "Decentralization and Local Service Delivery," paper prepared for the Local Government Foundation, unpublished.

local government units with ample power and authority to raise the necessary revenues to finance local development but at the same time, local government units must exert utmost effort in improving local public expenditure management. It is commonplace to hear in various forums in the country complaints about the inadequacy of local resources to address various development challenges. Llanto and Quimba (2010) indicate that there is room for improving service delivery even under a regime of constrained resources.

Section 4 analyzes intergovernmental fiscal transfers, basically the major block fiscal grant called the "Internal Revenue Allotment (IRA)." The IRA is the single biggest revenue item for many LGUs and the section points out outstanding issues affecting the efficacy of this fiscal tool for helping with local development. Popular discourse on this topic inevitably gravitates around suggestions to increase the IRA from its current share of 40% of national internal revenue taxes to 50 percent and even 60 percent with apparent disregard about the implications of the suggestion to the financing of the country's overall national development agenda. There is a need for an in-depth research and analysis of the Philippine experience with intergovernmental fiscal transfers, which cover both conditional and unconditional fiscal grants. The biggest part of the fiscal transfers is composed of the internal revenue allotment. The current discourse and proposals to increase the amount of the IRA, and at the same time change the formula for its distribution has to be enlightened by findings of systematic research and study that has yet to be undertaken. Policy makers cannot simply rely on the narrow metric of politics to decide on this significant issue. There is a crying need to produce an evidence-based policy recommendation on how to improve the use of this important fiscal tool.

Section 5 summarizes the status of local government units' access to development capital and identifies areas for policy reform. It looks at the outstanding constraints to access to the capital markets and official development assistance and sketches pathways to reform[6]. The final section pulls together the findings in preceding sections, and draws some conclusions and policy recommendations.

6 *The major issues on access to capital markets were first presented and analyzed in Llanto, Gilberto M., and others (1998), Local Government Units' Access to the Private Capital Markets, Makati City: Philippine Institute for Development Studies. Some of those issues have been resolved, many others have remained outstanding.*

CHAPTER 2 THE CONCEPT AND ELEMENTS OF FISCAL DECENTRALIZATION[7]

Oates decentralization theorem

A working definition of decentralization is that by Faguet (2005) who defines it as "the devolution by central, (that is, national) government of specific functions, with all of the administrative, political and economic attributes that these entail, to democratic local (i.e. municipal) governments which are independent of the center within a legally delimited geographic and functional domain". A common denominator behind policy makers' decision to decentralize and devolve is the belief that this paradigm shift can improve the allocation problem in the economy, improve productive efficiency and bring about better cost recovery. In the last two decades, decentralization has been at "the center stage of policy experiments in a large number of developing and transition economies in Latin America, Africa and Asia" (Bardhan 2003, page 1) for a number of reasons. For example, a motivation for decentralization in Latin America was the disenchantment with military rule and dictatorships, which has created a political culture that places a premium on decentralized decision making to prevent a return to the past. In China, decentralization was seen as a means for social cohesion, faster economic growth and preservation of communist party rule (Shah, 1997).

In the Philippines, the enactment into law of the Local Government Code in October 10, 1991, which decentralized and and devolved vast powers to local government units, introduced a significant shift in the policy and institutional framework for development. In their review of Philippine decentralization, local scholars (Brillantes and Tiu, 2010; Tayao, 2010) noted that the Philippine political and administrative system has been dominated by the central government since the time of the Spanish colonization. A long history of centralization meant that policies, programs, funding, allocation of resources, etc were controlled and implemented by the central government situated in Manila (somewhat derisively called "imperial Manila"). Thus, 1991 Local Government Code (Republic Act No. 7160) was a critical break point in the country's political and administrative framework. In his reading of recent Philippine political history, Tayao (2010) called decentralization as "single most significant political reform after the fall of the Marcos dictatorship in 1986."

The thinking behind this is that greater involvement of LGUs or sub-national units in service provision, including the provision of basic infrastructure such as local roads, farm-to-market roads, communal irrigation facilities, among others, will result in better service delivery and accountability, provide opportunities for people participation in development, and create an enabling environment for local private sector investments.

Proponents of decentralization claim that it has provided a framework for responsive and accountable local governance. According to Bird (1993) it has given local constituents what they want and are willing to pay for, and the

7 *The brief review of literature partly draws from Gilberto M. Llanto, "Decentralization, Local Finance Reforms and New Challenges: The Philippines," a paper presented at the Third Symposium on Decentralization and Local Finance at the Institute for Comparative Studies in Local Governance (COSLOG), National Graduate Institute for Policy Studies, Tokyo, Japan on March 10, 2009.*

opportunity for greater local responsiveness and political participation. It has demonstrated a potential to lead to more appropriate and better-utilized facilities, lower costs per unit of service and improved operations and maintenance (Klugman 1994)[8]. Devolution is based on the subsidiarity principle and rests on the view that it results in improved efficiency in the delivery of public services, and hence a more efficient allocation of resources in the economy (Dabla-Norris 2006)[9]. This perspective draws from the classic distinction given by Musgrave about the different tasks of government in an economy: allocation (which is better done by local governments), stabilization and redistribution (which are better done by central government).

These views echo the *decentralization theorem* (Oates,1972, page 55), which maintains that "each public service should be provided by the jurisdiction having control over the minimum geographical area that would internalize benefits and costs of such provision." Oates (1993) later observes that decentralization is a mechanism to make policy more responsive to local needs and to involve the local populace in processes of democratic governance[10]. The economic case for decentralization is the enhancement of efficiency that it introduces because locally provided public goods, which are more responsive to local taste and preferences are superior to centrally determined goods. Decentralization provides for "tailoring levels of consumption to the preferences of smaller, more homogeneous groups" (Wallis and Oates 1988, page 5). Decentralization has laid down the foundation of a new, major "institutional framework" for the provision of a range of benefits to local constituents and the harnessing of local energy for local development, which could make governments to be "more responsive and efficient;" at the same time decentralization offers a practical avenue for "diffusing social and political tensions and ensuring local cultural and political autonomy" (Bardhan 2003, page 1).

Joumard and Kongsrud (2003) add that it can strengthen the democratic process, allow governments to tailor the supply of public goods to local preferences and introduce some competition across jurisdictions, thus raising public sector efficiency. At the same time, it must be recognized that it can entail efficiency losses, and make it difficult to implement redistributive policies and complicate macroeconomic management (ibid). A contrarian view is that "decentralization may increase the participation of people at the local level but sometimes it is only a small privileged elite group who get to participate" (Conyers 1990, page 18) quoted by Oates (1993). Faguet (2005) pointing out that there is little agreement concerning the effects of decentralization in the empirical literature, says that pessimists argue local governments are too susceptible to elite capture, and too lacking in technical, human and financial resources, to produce a heterogeneous range of public services that are both reasonably efficient and responsive to local demand.

For political decentralization to be effective, it should be accompanied by fiscal decentralization. Many years ago in a paper prepared for the World Bank Annual Conference on Development Economics, Tanzi (1996) observed that decentralization of fiscal activities can improve the allocation of public spending by making it more consistent with local preferences. Oates (1996) cites the potential contribution of decentralization in enhancing allocative efficiency by providing a menu of local outputs that reflects the

8 *However, according to Klugman (1994) greater efficiency need not necessarily accompany decentralization, given the risk of loss of economies of scale, duplication and overlap.*

9 *Shah (2004) points out that the principle of subsidiarity was introduced by the Maastricht Treaty for assignment of responsibilities among members of the European Union. According to this principle, taxing, spending and regulatory functions should be exercised by the lowest levels of government unless a convincing case can be made for assigning the same to higher levels of government.*

10 *While a discussion of the opposing views may be interesting, this paper will not dwell on it because it is outside the scope and objectives of the paper.*

varying wishes and conditions in local areas[11]. Furthermore, it can provide "political glue for countries with regional ethnic diversity" (Tanzi 1996, page 295)[12]. Fiscal decentralization is not always seen as conferring unmitigated benefits to the local populace. Fiscal decentralization is not without its share of controversy. Oates (2006) mentions some analysis that "reveals its dark side, especially in practice" and that "raises some serious questions about its capacity to provide an unambiguously positive contribution to an improved performance of the public sector" (pages 2-3). Smoke (2001) alludes to potential macroeconomic dangers and growth retarding effects of fiscal decentralization, indicating however that most of the evidence is anecdotal and relevant only under particular uncommon circumstances or focused on correctable rather than inherent problems.

This is not the place to expound on this interesting facet of fiscal decentralization as pointed out by Oates and others but certainly it poses a challenge to fiscal decentralization analysts. Suffice it to say at this point that there is a need for more research and the production of comparative information on the extent to which and the conditions under which the alleged benefits and disadvantages of fiscal decentralization have been realized (Smoke 2001).[13]

The decentralization theorem argues that sub-national governments can more efficiently provide public services to identifiable recipients up to the point at which the value placed on the marginal amount of services for which recipients are willing to pay is just equal to the benefit they receive (Ebel and Yilmaz, 2002; Oates 1972, 2006)[14] To implement this, sub-national (local) governments must be given the authority to exercise "own source" taxation at the margin and be in a financial position to do so. This is the essence of fiscal decentralization (Ebel and Yilmaz 2002).

Following Smoke (2001), the key elements that should be included in a good fiscal decentralization program are as follows: (a) an adequate enabling environment; (b) assignment of an appropriate set of functions to local governments; (c) assignment of an appropriate set of local own-source revenues to local governments; (d) the establishment of an adequate intergovernmental fiscal transfer system; and (d) the establishment of adequate access of local governments to development capital.

An adequate enabling policy environment

To begin with an enabling policy environment for fiscal decentralization, which is clearly stated in constitutional mandate or law, defining some minimum level of autonomy, rights and responsibilities for local governments is important. The return of democratic governance in the Philippines after the 1986 People Power Revolution following a long period of martial rule in the 70s and 80s has provided an enabling environment for decentralization. The series of freely elected democratic governments since then have continued to recognize that it is good for a functioning democracy to allow local leaders and people to have the power and responsibility of deciding what goods and services to

11 *Oates, Wallace (1996), "Comment on 'Conflicts and Dilemmas of Decentralization' by Rudolf Hommes," in Bruno, Michael and Boris Pleskovic, editors, Annual World Bank Conference on Development Economics, Washington, D.C.: The World Bank, pages 351-353.*

12 *Tanzi, Vito (1996), "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects," in Bruno, Michael and Boris Pleskovic, editors, Annual World Bank Conference on Development Economics, Washington, D.C.: The World Bank, pages 295-316.*

13 *Smoke, Paul (2001) "Fiscal Decentralization in Developing Countries: A Review of Current Concepts and Practice," Democracy, Governance and Human Rights Programme Paper Number 2, United Nations Research Institute for Social Development, February. Professor Smoke declares that anecdotal evidence and case studies provide some insights but there is a need for more policy experimentation and systematic research to understand the prospects for fiscal decentralization in developing countries.*

14 *Robert D. Ebel, Robert and Serdar Yilmaz (2002), "On the Measurement and Impact of Fiscal Decentralization," Policy Research Working Paper 2809, The World Bank, March; Oates, Wallace (2006), "On the Theory and Practice of Fiscal Decentralization," IFIR Working Paper No. 2006-05, May; Oates, Wallace E. 1972. Fiscal Federalism. New York: Harcourt Brace Jovanovich*

produce and finance. The enactment into law of the 1991 Local Government Code signals a major departure from the traditionally centrist approach to governance and development in developing countries, which view the problem of development as one requiring the presence of a strong central government that will lay down policy directions and allocate resources accordingly. It may be recalled that before the above-mentioned period of martial rule, there were a series of policy reforms leading toward local autonomy.

Atienza (2006) related the quest for decentralization and autonomy in a recent study[15]. The 1991 Local Government Code may be a radical piece of legislation but it is not the first decentralization law in the country and it passed after five years of debate in Congress (Uchimura and Suzuki 2009)[16]. Guevara (2004) recounted that in 1959 the Local Autonomy Act (Republic Act 2264) was passed to grant fiscal and regulatory powers to local governments. In 1967, the Decentralization Act (Republic Act 5185) increased the financial resources and powers of local governments. The 1973 Constitution of the Philippines mandated that the state "shall guarantee and promote the autonomy of local governments to ensure their fullest development as self-reliant communities." Martial rule stymied those reform efforts. The 1991 Local Government Code, then, "institutionalized a systematic allocation of powers and responsibility between the national and local governments" (Guevara 2004, page 1)[17]. The 1991 Local Government Code was a landmark legislation that gave rise to a major shift in local governance (Manasan 2007). The Code consolidated and amended the Local Government Code of 1983, the Local Tax Code (Presidential Decree 231), and the Real Property Tax Code (Presidential Decree 464).

In the Philippines, the 1991 Local Government Code devolved to local government units the responsibility of delivering local and basic public services and raising local or own-source revenues for financing their expenditure assignment. Under the Local Government Code, local government units have autonomy in deciding on the composition of local spending, taxing and borrowing that they would need to meet local development objectives. Thus, local government units are now responsible for the following areas: land use planning, agricultural extension and research, community-based forestry, solid waste disposal system, environmental management, pollution control, primary health care, hospital care, social welfare services, local buildings and structures, public parks, municipal services and enterprises such as public markets and abattoirs, local roads and bridges, health facilities, housing, communal irrigation, water supply, drainage, sewerage, flood control and inter-municipal telecommunications.

The Local Government Code also transferred to local government units certain regulatory functions. The fiscal transfers to local governments were likewise increased, with 40% of internally generated taxes allocated to local governments through the Internal Revenue Allotment (IRA). In addition, the Code encouraged the local government units to explore alternative sources of revenue by exercising their corporate powers in partnership with the private sector. An innovation introduced by the Code is the provision of a framework for active participation of non-governmental organizations and civil society in local governance[18]. Indeed, the new

15 Atienza, Maria Ela (2006), "Local Governments and Devolution in the Philippines," in Noel Morada and Teresa Encarnacion, editors, Philippine Politics and Governance: An Introduction, Department of Political Science, University of the Philippines.

16 Uchimura, Hiroko and Yurika Suzuki (2009), "Measuring Fiscal Decentralization in the Philippines," IDE Discussion Paper No. 209, Institute of Developing Economies, July.

17 Guevara, Milwida (2004), "The Fiscal Decentralization Process in the Philippines: Lessons from Experience," http://www.econ.hit-u.ac.jp/~kokyo/APPPsympo04/PDF-papers-nov/guevara-i2004-revised2.pdf, date accessed August 29, 2011.

18 For a detailed discussion, see Brillantes, Alex, Gilberto M. Llanto, James Alm and Gaudioso Sosmena (2009), "Decentralization and Devolution in the Philippines: Status, Triumphs, Tests and Directions," Report submitted to the Department of the Interior and Local Government, unpublished paper, April 29 institutional framework for local development has generated an enthusiastic response on the part of local government units (LGUs) to deliver better public services to local citizens. It has promoted local autonomy by devolving expenditure responsibilities and vested greater taxing powers on local government units[19].

The succeeding sections of this paper first outline the current status of (a) the tax-expenditure assignment, (b) the intergovernmental fiscal transfer (IRA), and (c) the access of local government units to development capital through borrowing, and then highlight outstanding issues or problems which should be addressed by policy makers.

19 The paper does not discuss the Organic Act of Muslim Mindanao, which transfers to the regional government of the Autonomous Region of Muslim Mindanao all powers, functions, and responsibilities heretofore being exercised by the central government except (a) foreign affairs, (b) national defense, (c) postal service, (d) fiscal and monetary policy, (e) administration of justice, (f) quarantine, (g) citizenship, naturalization and immigration, (h) general auditing, civil service and elections, (i) foreign trade, (j) maritime, land and air transportation and communications that affect areas outside the ARMM, and (k) patents, trademarks, trade names and copyrights. For a discussion see Manasan (2005).

CHAPTER 3 **TAX-EXPENDITURE ASSIGNMENT**

A principal challenge faced by LGUs is finding the means to raise adequate financing for local development. The LGUs are a heterogeneous group with varying administrative, financial and technical capacities. There is also great variation in the level of local development with the few highly urbanized cities enjoying bigger and more buoyant tax bases. The rest of the LGUs are composed of smaller cities and municipalities with weaker local economies. Provinces are also a heterogeneous lot with great variation in economic, administrative, financial, and technical capacities. The rising expectations of the local populace for more and better quality public services has to be matched by the ability of local government units to find substantial funding and to have better and more efficient implementation of programs and project for local development. The 1991 Local Government Code assigned taxing and spending powers to local government units. It is an acknowledged principle that matching expenditure and tax assignments is desirable because this will enable the local governments to shape the supply of public goods according to local preferences and willingness to pay (Jourmard and Kongsrud 2003)[20].

To assess the fiscal performance of the LGUs, time series data covering pre-decentralization period (1989-1991) up to the present were tabulated[21] Income data were obtained from the Statement of Income and Expenses (SIE) while expenditure data were from the SAAOB (previously called Schedule of Appropriations and Expenditures) from the Commission on Audit's Annual Financial Reports for Local Government Units for the years 1989 to 2009.

Local government tax revenues: trend and composition, 1989-2009

Table 1 summarizes the various taxes that are assigned to local government units by the Local Government Code. The Code has empowered local government units to set local tax rates and collect own-source revenues. Only cities and provinces can levy the real property tax. The former shares the proceeds with their barangays while provinces share the proceeds with the municipalities and barangays. Both provinces and cities are also authorized to impose a tax on the transfer of real property, sand, gravel, and other quarry resources; amusement places; franchises; professionals; delivery vans and trucks; and idle lands. On the other hand, municipalities and cities, but not provinces, are allowed to levy the community tax and the local business tax (i.e.,turnover tax levied on the gross receipts of businesses/traders)[22].

The main sources of local incomes are the IRA, property tax, the business tax, and service and business income from various local economic enterprises. However, Section 133 of the Code also provides a detailed list of taxes,

20 Joumard, Isabelle and Per Mathis Kongsrud. 2003. "Fiscal relations across government levels." Economics Department Working Papers No. 375, Organization for Economic Cooperation and Development, December 10.

21 Sources: Commission on Audit's Annual Financial Reports for Local Government Units

22 The first tier of government is the central government which operates through departments (ministries). The second tier of government is composed of local government units (LGUs) and one autonomous region, the ARMM. In general, the local government structure is composed of three layers. Provinces comprise the first layer. In turn, the province is divided into municipalities and component cities, each of which is further subdivided into barangays, the smallest political unit. At the same time, independent cities (or highly urbanized cities) exist at the same level as the provinces, i.e., they share the same functions and authorities. Independent cities are divided directly into barangays (Manasan 2005).

which are revenue-productive but which only the central government can impose. These include the individual and corporate income taxes, customs duties, value-added tax, and the excise taxes on alcoholic beverages, tobacco products and petroleum products.

Table 1. Tax assignment in cities, provinces and municipalities

Tax base	Cities	Provinces	Municipalities	Barangays
Transfer of real property	X	X		
Business of printing and publication	X	X		
Franchise	X	X		
Sand, gravel and other quarry resources	X	X	*	*
Amusement places	X	X	*	
Professionals	X	X		
Real property	X	X	*	*
Delivery vans and trucks	X	X		
Idle lands	X	X		
Business	X		X	X
Community tax	X		X	*

*shares in the proceeds of levy of province

Local generated revenues are basically the tax revenues and non-tax revenues obtained from regulatory fees, service charge, income from local enterprises and other receipts. The share of local own source revenues and non-tax revenues to total LGU income was at 62 percent in 1989, decreasing over time. In 2009, it stood at 33 percent. As IRA's share in the total LGU income increased through the years, tax revenues and non-tax revenues' share decreased. Please see Table 2 and Figure 3. From 38 percent in 1989 Tax Revenues shares dropped to 29 percent in 1992, and to 22 percent by 2009. As for the Non-Tax Revenues, from 24 percent in 1989 it was down to 13 percent in 1992. By 2002 Non-Tax Revenue was at its lowest at 7.5 percent, then slowly picked up and was 11 percent by 2009.

Tax Revenues includes *Property Tax, Business Tax and Licenses* and *Other Taxes*. Property Tax is composed of real property tax, property transfer tax, real property tax on idle lands, special assessment tax and special education tax. Under *Property Tax*, the major one is the real property tax. Provinces can levy a real property tax not exceeding 1% of the assessed value of the real property. For cities, the real property tax rate should not exceed 2% of the assessed value of the real property. The Local Government Code defines the maximum assessment level for each type of real property (Box 1). The assessment level varies from local government to local government based on local ordinances passed by the legislative body ("*sanggunian*").

Box 1. Assessment level by type of land

Assessment level on lands	% (maximum under Local Government Code)
Residential	20%
Commercial	50%
Industrial	50%
Mineral	50%
Timberland	20%

The Local Government Code defines "assessed value" (AV) as the fair market value of the real property multiplied by the assessment level. It is synonymous to taxable value. The assessment level is the percentage applied to the fair market value to determine the taxable value of the property. On the other hand, "fair market value" is defined by the Local Government Code as fair market value" as the price at which a property may be sold by a seller who is not compelled to sell and bought by a buyer who is not compelled to buy. The real property tax (RPT) is computed as follows:

RPT = AV x rate.

Buyers of real property pay a one-time property transfer tax when title to a real property passes on to them. The special education tax is an additional 1% tax on the assessed value of real property in addition to the basic real property tax. A special assessment tax on real property may be levied to address a local development goal[23]. On the other hand, the real property tax on idle lands has generally not been implemented by local government units due to political constraints.

Business tax and licenses, or taxes on goods and services in other years, includes business tax, franchise tax, occupation tax, printing and publication taxes, tax on fishing vessels and tax on delivery trucks and vans among others. Under the category of *Other Taxes* are community tax, amusement tax, tax on sand and gravel and other quarry products, etc. *Non-Tax Revenues* on the other hand consists of *Service Income, Business Income*, *Other Income and Capital Revenues*. *Service Income* is classified as Government Services and Operating and Service Income in earlier years, and Service Income + Permits and Licenses in later years. *Business Income* includes income from local economic enterprises or LEES such as markets, slaughterhouses, waterworks and transportation systems, and hospital fees among others. *Other Income* consists of LGU Shares from National Wealth, Economic Zones, EVAT and Tobacco Exise Tax, and other miscellaneous income. *Capital Revenues* are mainly income from the sale of assets but in later years it also included receipts from the sale of confiscated goods and properties, disposed assets, securities and gains from foreign exchange.

The Property Tax has been the largest contributor when it comes to own-source revenues with a share of 22 percent in 1989, followed by Business Taxes and Licenses and Business Income both at 10 percent but later years especially after devolution, show that IRA has become a dominant source. Please see Figure 4. The local government units depended more on the IRA and this has eroded the effort of local government units to collect own-source revenues. For many local government units, it is much easier to just rely on the IRA transfer than it is to collect real property taxes and business taxes[24].

23 Recently Quezon City, one of the largest highly urbanized cities imposed a special levy of 0.5 percent on residential lots with an assessed value of Pesos 100,000.00 (approximately US$2, 325.00 at the current exchange rate of Pesos 1 to US$ 1) to finance the construction of housing for informal settlers in the city..

24 The disincentive effect of IRA is discussed in succeeding paragraph below.

In general, there is a general downward trend in the contribution of total local tax and non-tax revenues to LGU income. By 2009 Property Tax is only at 11 percent of total LGU income while Business tax dropped to 9.6 percent from its level of 10.5 in 1990 before the 1991 Code. Other Taxes and Capital Revenue also went down from 4 percent and 6 percent in 1989 to 2 percent and 1 percent in 2009 respectively. Business Tax, Service Income and Other Income did not change that much through the years. It is important to note that this general situation is true for provinces and municipalities but not for cities as indicated below.

Figure 3: Total Income, all LGUs, 1989-2009

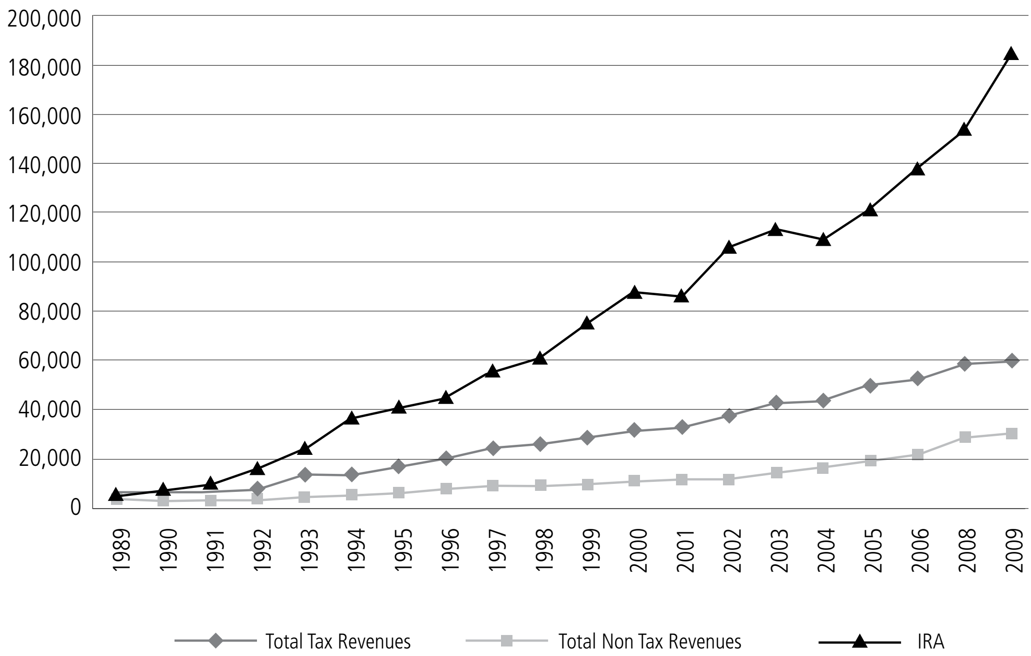


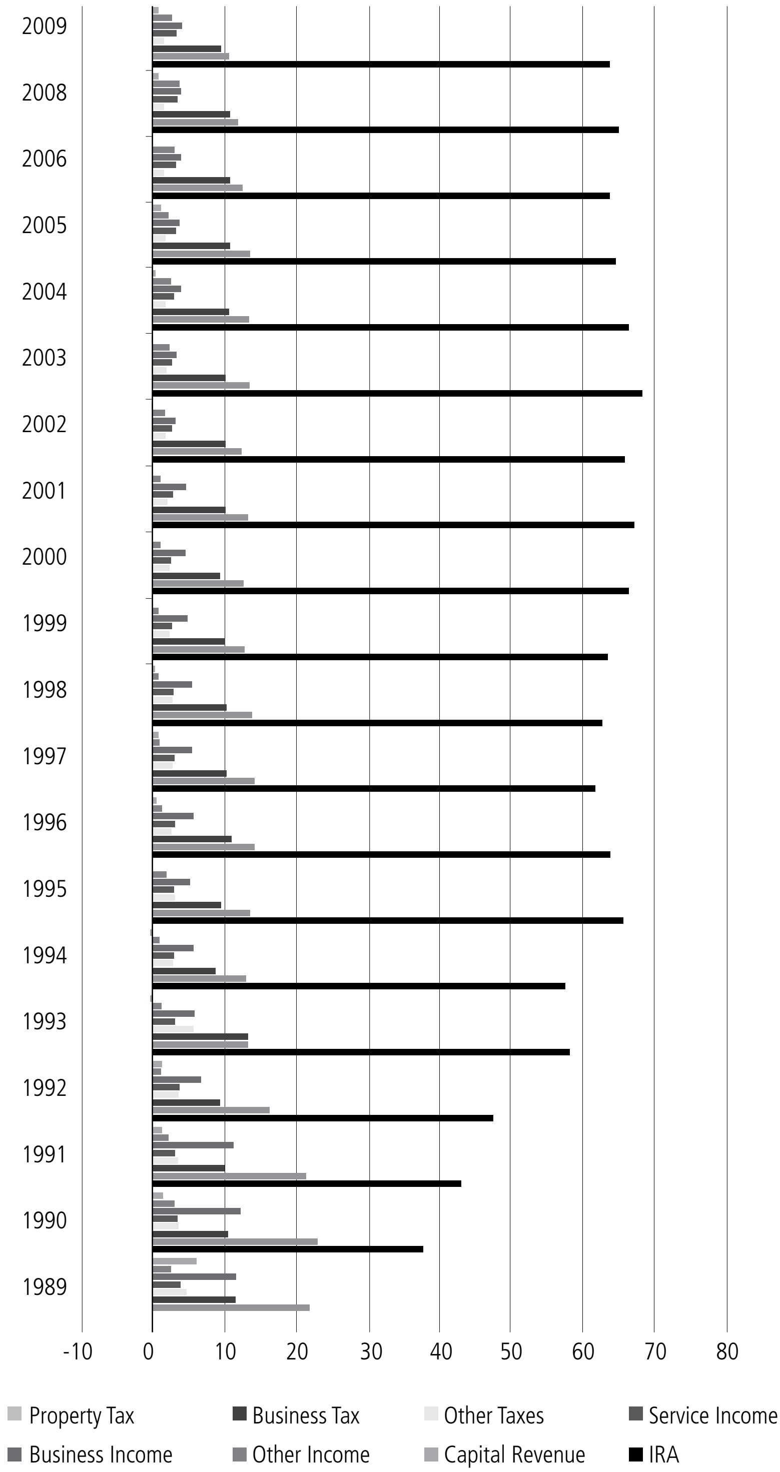
Table 2. Distribution of Local Income, All LGUs, 1989-2009 (in million pesos)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2008	2009
Property Tax	21.9	22.9	21.4	16.3	13.3	13.0	13.6	14.2	14.2	13.9	12.8	12.7	13.4	12.4	13.4	13.4	13.6	12.5	11.8	10.7
Business Tax	11.5	10.5	10.0	9.3	13.3	8.8	9.5	10.9	10.3	10.3	10.0	9.4	10.1	10.0	10.0	10.7	10.8	10.8	10.9	9.6
Other Taxes[1]	4.7	3.6	3.5	3.5	5.7	2.8	3.2	2.7	2.7	2.8	2.4	2.4	2.0	1.7	1.9	1.7	1.7	1.6	1.6	1.5
TOTAL TAX REVENUES	38.1	37.0	34.8	29.1	32.3	24.7	26.3	27.8	27.2	27.1	25.1	24.4	25.5	24.1	25.3	25.8	26.1	24.9	24.3	21.8
Service Income[2]	4.0	3.4	3.1	3.8	3.1	3.0	2.9	3.2	3.0	2.8	2.7	2.6	2.8	2.6	2.7	3.0	3.3	3.3	3.5	3.3
Business Income[3]	11.6	12.2	11.3	6.7	5.8	5.7	5.2	5.7	5.4	5.5	4.8	4.6	4.7	3.2	3.2	3.9	3.8	3.9	3.9	4.1
Other Income	2.6	3.0	2.2	1.1	1.2	1.0	1.8	1.2	1.0	0.9	0.8	1.2	1.1	1.7	2.3	2.5	2.1	3.0	3.7	2.7
Capital Revenue	6.1	1.3	1.2	1.2	0.1	0.0	0.1	0.4	0.7	0.3	0.1	0.1	0.2	0.0	0.0	0.3	1.0	0.0	0.8	0.8
TOTAL NON TAX REVENUES	24.2	20.0	17.7	12.7	10.2	9.7	10.0	10.5	10.1	9.4	8.4	8.5	8.7	7.5	8.3	9.7	10.2	10.1	11.9	10.9
IRA	37.7	43.0	47.4	58.1	57.5	65.6	63.7	61.7	62.6	63.5	66.5	67.2	65.8	68.3	66.4	64.5	63.7	64.9	63.8	67.3
TOTAL LOCAL INCOME	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: Annual Financial Reports 1989-2009

1 - Includes Shares from National Wealth, Economic Zones, EVAT and Tobacco Exise Tax, PAGCOR/PCSO
2 - Includes regulatory fees and permits and licenses
3 - Includes receipts from local enterprises such as markets, slaughterhouse, transportation system, waterworks system, and hospital fees

Figure 4: Distribution of Total Income, all LGUs, 1989-2009 (%)



Figures 5 and 6 compare the source of income of LGUs before (1990) the passage of the 1991 Code and after several years (2009). The broad taxing powers benefited more the cities than provinces and municipalities. They have been dominant in all types of local taxes and the internal revenue allotment. The cities have also the advantage of getting higher amounts of IRA individually because there are fewer of them to divide the pie, so to speak. This has motivated municipalities to of getting higher amounts of IRA individually because there are fewer of them to divide the pie, so to speak. This has motivated municipalities to convince legislators to pass special laws converting them into cities.

Figure 5: Distribution of Income by type of LGU, 1990

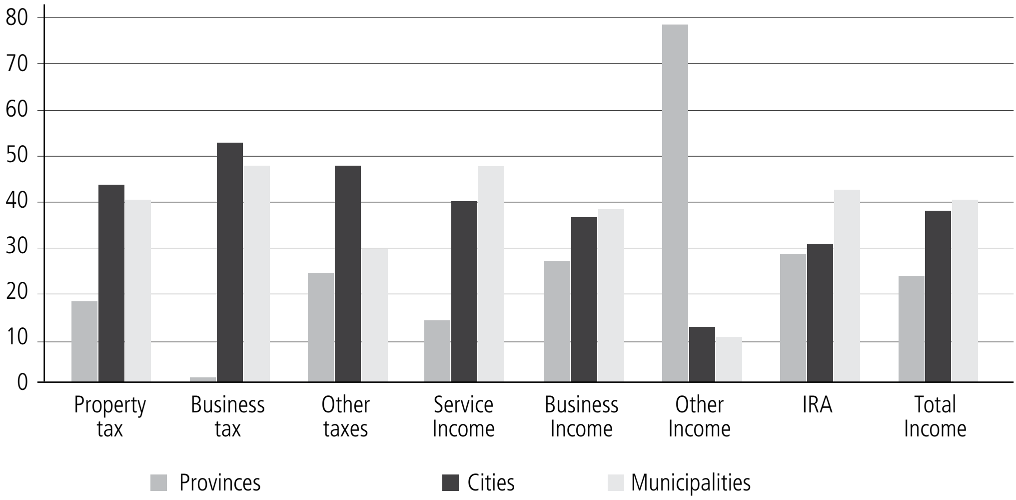
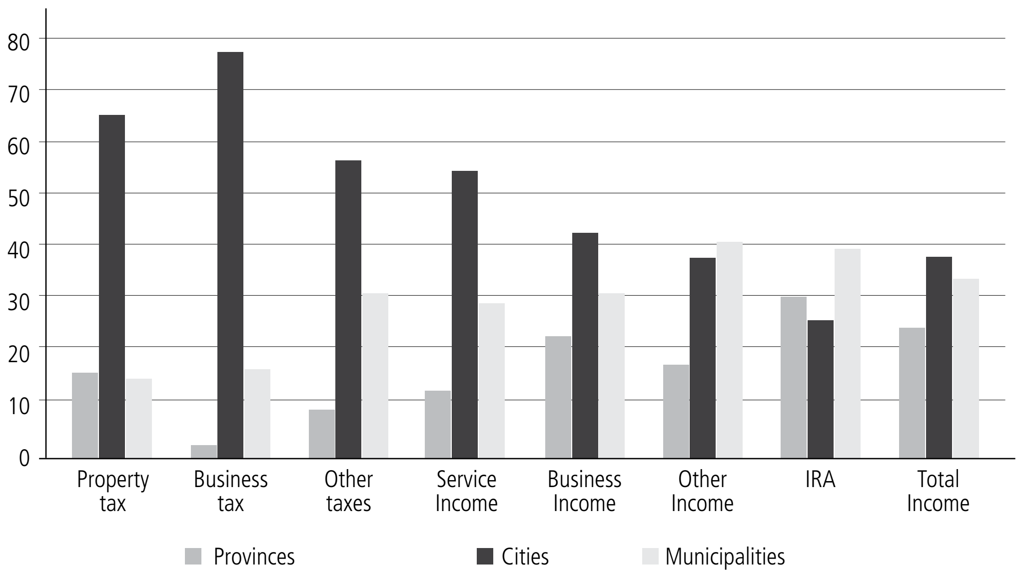


Figure 6: Distribution of Income by type of LGU, 2009



An examination of revenue figures over the period 1989-2009 indicates a significant decline in the share of provinces and municipalities in total LGU own-source revenue. This contrasts with the continuous increase in the share of cities in total LGU own-source revenue. An outstanding problem faced by provinces and municipalities is how to raise substantial revenues when they do not have very productive tax bases to begin with. The 1991 Code have put certain limits on their taxing powers. Cities are more fortunate because they have broader taxing powers than municipalities and provinces. Please see Table 1 above.

Because of an inefficient tax assignment, it is only the cities, which have the capacity to raise the needed revenues. As Manasan (2007) has observed the distribution of own-source revenues is in favor of cities, and partly in favor of municipalities away from provinces[25]. The cities have larger tax bases and consequently, buoyant revenue sources but the majority of local government units, that is, the municipalities have weaker tax bases and thus, do not raise sufficient own-source revenues. They have remained dependent on fiscal transfers, principally the internal revenue allotment (IRA) for funding local development activities.

The dominance of IRA as revenue source is very obvious. Provinces and municipalities are most dependent on IRA. In an extreme case, the IRA allocations sometimes account for 95 percent of local revenues and, in at least one case, 114 percent of total expenditures (ADB 2005)[26]. The dependence on IRA results in weaker local fiscal autonomy, which creates opportunities for greater control by the central government, contrary to the envisaged situation of local governments able to respond to local needs and to match local outputs with local preferences. To wean themselves away from central government control local government units should strive for greater fiscal autonomy by working to significantly improve own-source revenues. Improving the collection of real property and local business taxes is an important step to boost local fiscal autonomy.

Limits on sub-national government discretion to determine tax rates and tax bases significantly reduce local fiscal autonomy (Joumard and Kongsrud 2003).

Various researchers such as Manasan, Cuenca, Uchimura and Suzuki, Capuno, and Llanto, among others have noted the inefficiency in tax assignment to local government units in the Philippines. Manasan (2005) provides a good summary[27] as shown in Box 2.

25 Manasan, Rosario (2007), "Decentralization and Financing of Regional Development," in Balisacan, Arsenio and Hal Hill, editors, The Dynamics of Regional Development: The Philippines in East Asia, Quezon City: Ateneo de Manila University Press.

26 Asian Development Bank (2005), Decentralization in the Philippines: Strengthening Local Government Financing & Resource Management in the Short Term, Mandaluyong City: Asian Development Bank

27 Manasan, Rosario G. 2005. "Local Public Finance in the Philippines: lessons in autonomy and accountability." Philippine Journal of Development. Second Semester 2005, Vol. XXXII No. 2: 32-102.

Box 2. An assessment of tax assignment to local government units

- The Philippine tax assignment appears to be largely consistent with the traditional view of tax assignment.
- It scores low on the autonomy criterion because (a) the Code fixes the tax rate of some of the taxes that are assigned to LGUs; (b) the Code sets limits (floors and ceilings) on the tax rates that LGUs may impose and maximum allowable rates are rather low; (c) in terms of real property assessment levels, the Code sets maximum assessment rates for different classes of property; (d) the Code mandates that tax rates can only be adjusted once in five years and by no more than 10 percent.

- Future Code amendments should consider giving LGUs greater discretion in setting tax rates by raising the maximum allowable tax rates.
- There is a need to move away from tax rates that are not indexed to inflation.
- There is a need to simplify the structure of local business tax because different categories of firms are subject to different rate schedules.
- There is a need to improve the tax administration machinery of local governments, e.g., employ certified public accountants to improve tax audit capability; use automation to improve revenue performance, etc.
- There is a need to revise the schedule of market values for real property purposes because many provinces and cities have done a general revision of such schedules only once since 1991.
- There is a need for many LGUs to revise their tax codes since only a few have made revision since 1992 even if some tax rates are not indexed to inflation.

There are current legislative bills to modify the taxing powers of LGUs, e.g., Senate Bill 1458, which recommends transferring the mandate to tax sand, gravel, and other quarry resources to cities and municipalities. House Bill 1607 seeks to give additional sources of revenue to provinces by requiring component cities to share their collection from real property taxes with the provinces. These proposals should be carefully examined in view of the inequities in tax assignments and the IRA allocation formula.

LOCAL GOVERNMENT EXPENDITURES: TREND AND COMPOSITION, 1989-2003[28]

Table 3 and Figure 7 show that local governments spent most of their resources on *General Public Services. General Public Services* (GPS) include the essential requirements to run the government such as the executive and legislative services, treasury, assessment, budgeting and auditing services, property and supply administration, and information services. GPS is highest in the late 80s thru early 90s, reaching its peak at 49 percent in 1992. In 1993 it dropped to 40 percent and maintained this level in the following years.

The second largest local government expense is on *Economic Services* with a share of 35 percent in 1989 which steadily declined through the years, with only 22 percent share to total LGU expenditures by 2003.
Economic Services refers to activities directed towards the promotion and enhancement and the attainment of desired economic growth. Included in this category are agricultural, veterinary and natural resource services, architectural and engineering services, operation of local enterprises such as markets, slaughter house, transportation and waterworks among others, cooperative programs, livelihood projects and other economic development programs.

Rounding up the major components of LGU expenditure are education and health services and housing and community development. *Education, Culture, Sports and Manpower Development* covers expenditures for the support of schools and education facilities, planning and manpower development, sports, cultural preservation and enrichment. *Health Services* pertains to expenditures for national health programs including medical, dental and nutrition services. *Housing and Community Development* includes expenditures for the

28 The period covered does not include the following years: 2004-2009 because of noise in the latter years. There is a need to review the Schedule of Appropriation, Allotment, Obligation and Balances (SAAOB) for local government units especially in view of the recent shift to the New Government Accounting System (NGAS).

provision of housing and sanitary services, promotion of community development, slum clearance, zoning and pollution control.

Education, Culture, Sports and Manpower Development experienced a rise and fall trend starting with an 8 percent share in total expenditure in 1988, dropping to 4 percent in 1991 and then back at 8 percent in 1992. A steady decline followed until it reached its lowest point in 2002 at 5 percent. Though *Health Services* also experienced a decline from 1988 to 1992, it posted a 7 percent increase from 4 percent in 1992 to 11 percent in 1993. Share of *Housing and Community Development* in the total expenditure did not change that much posted a 5 percent share in1988

Figures 8, 9 and 10 indicate how the different type of LGUs allocated their budgets. All of them allocate a bigger portion of their budgets to general public services. Expenditure for economic services follows as the second biggest item of expense. There is a need to review local public expenditure management for more efficient allocation of resources. It seems that there is a relatively small allocation of investment in human capital (education, health and nutrition) and infrastructure relative to other expenditure items. General public services are basically for general administration needed for the daily routine of running a local government. A recent paper by Llanto and Quimba (2010) hypothesizes that local governments have under-spent for health and education. While the common view is that local governments are so cash-strapped that they do not have the funds for better service delivery, it may be that a more efficient expenditure management may be able to address the lack of service delivery among the local population.

Figure 7: Distribution of LGU Expenditures, All LGUs 1988-2003

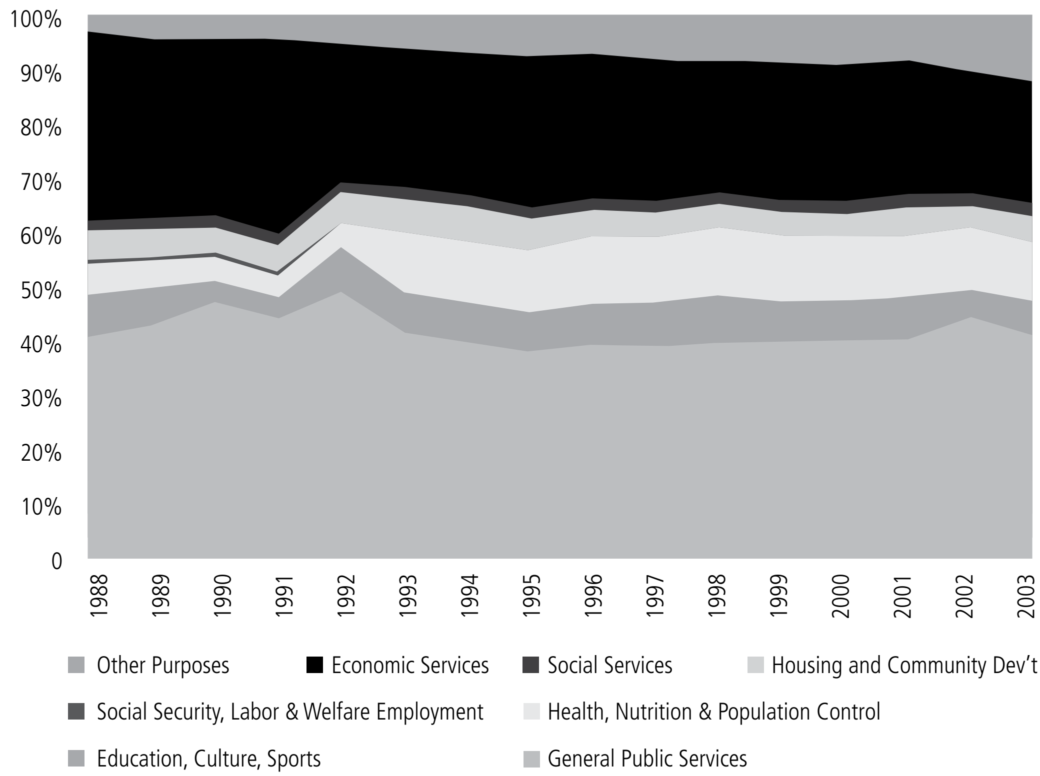


Table 3. Distribution of LGU Expenditures, All LGUs, 1988-2003

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
GRAND TOTAL	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
GENERAL PUBLIC SERVICES	40.88	43.19	47.32	44.53	49.32	41.77	40.02	38.36	39.44	39.20	39.87	39.93	40.41	40.66	44.42	41.25
EDUCATION,CULTURE, SPORTS	8.01	6.78	3.94	3.58	8.09	7.35	7.11	7.16	7.54	8.06	8.59	7.45	7.35	7.59	5.24	6.30
HEALTH, NUTRITION & POPULATION CONTROL	5.53	4.94	4.55	4.19	4.34	11.15	11.60	11.41	12.43	12.18	12.66	12.22	11.58	11.43	11.43	10.85
SOCIAL SECURITY, LABOR & WELFARE EMPLOYMENT	0.74	0.64	0.71	0.70	0.12	0.03	0.08	0.07	0.07	0.08	0.05	0.03	0.04	0.02	0.03	0.02
HOUSING & COMMUNITY DEV'T	5.37	5.31	4.58	4.83	5.76	5.96	6.12	5.78	4.84	4.35	4.23	4.39	4.28	5.11	3.92	4.79
SOCIAL SERVICES	1.67	1.95	2.21	2.13	1.66	2.32	2.15	2.06	2.19	2.18	2.22	2.19	2.34	2.45	2.29	2.42
ECONOMIC SERVICES	34.96	32.84	32.24	35.76	25.49	25.48	26.29	27.62	26.60	25.95	24.09	25.19	25.04	24.56	22.30	22.36
OTHER PURPOSES	2.83	4.36	4.45	4.27	5.22	5.95	6.63	7.52	6.89	8.01	8.28	8.60	8.96	8.19	10.37	12.01

Figure 8: Distribution of Total Expenditures - All Provinces, 1988-2003

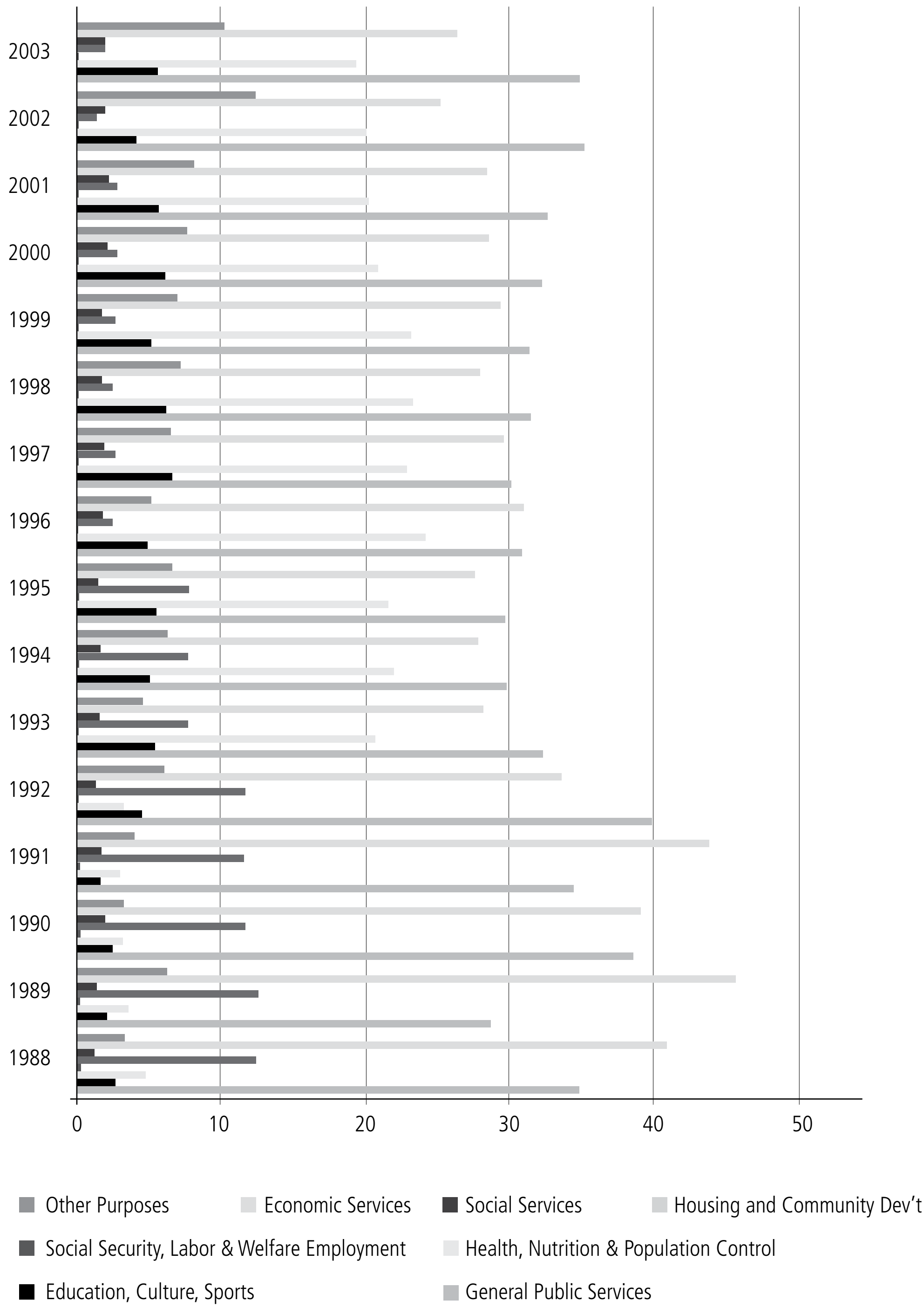


Figure 9: Distribution of Total Expenditures - All Municipalities, 1988-2003

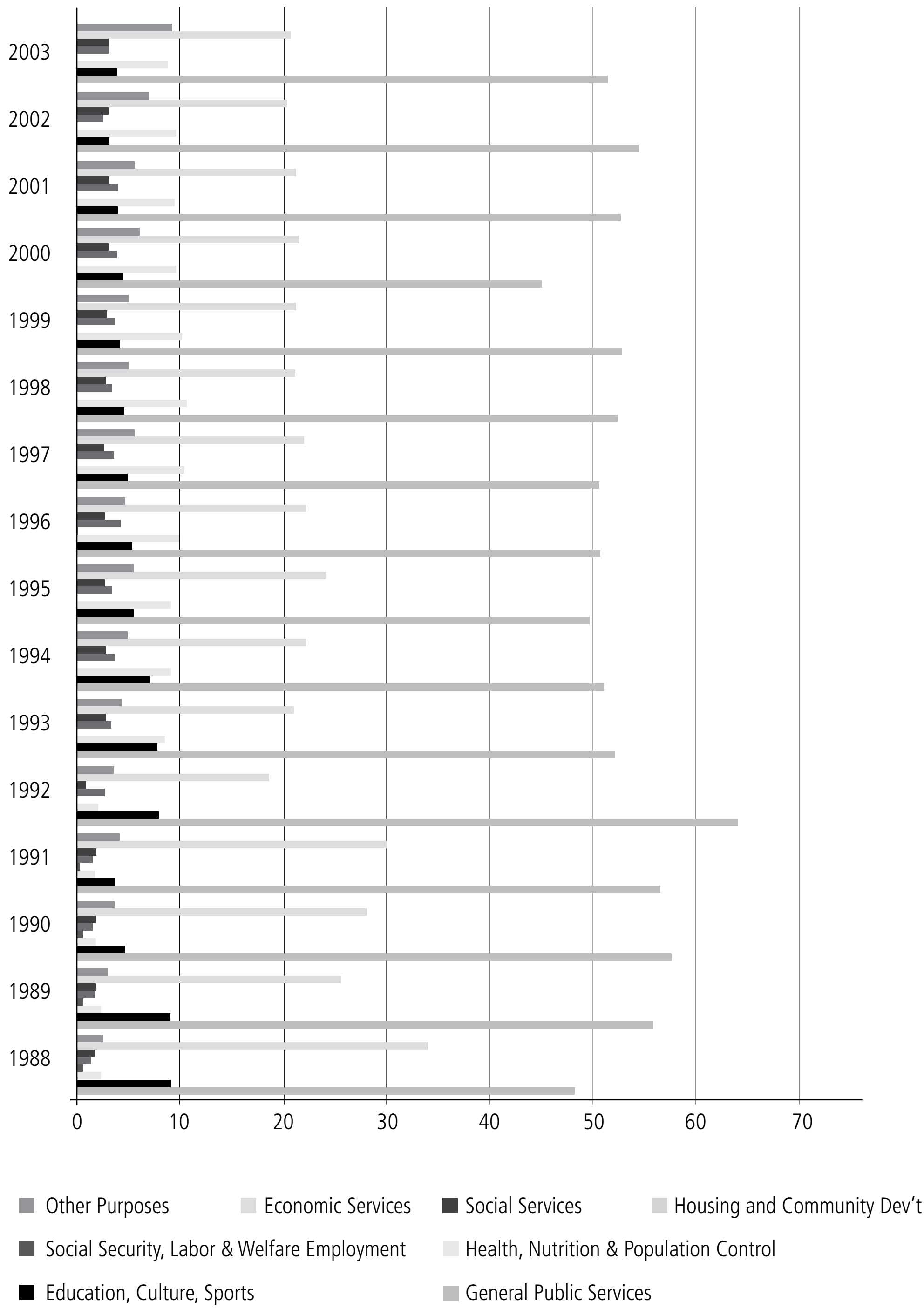
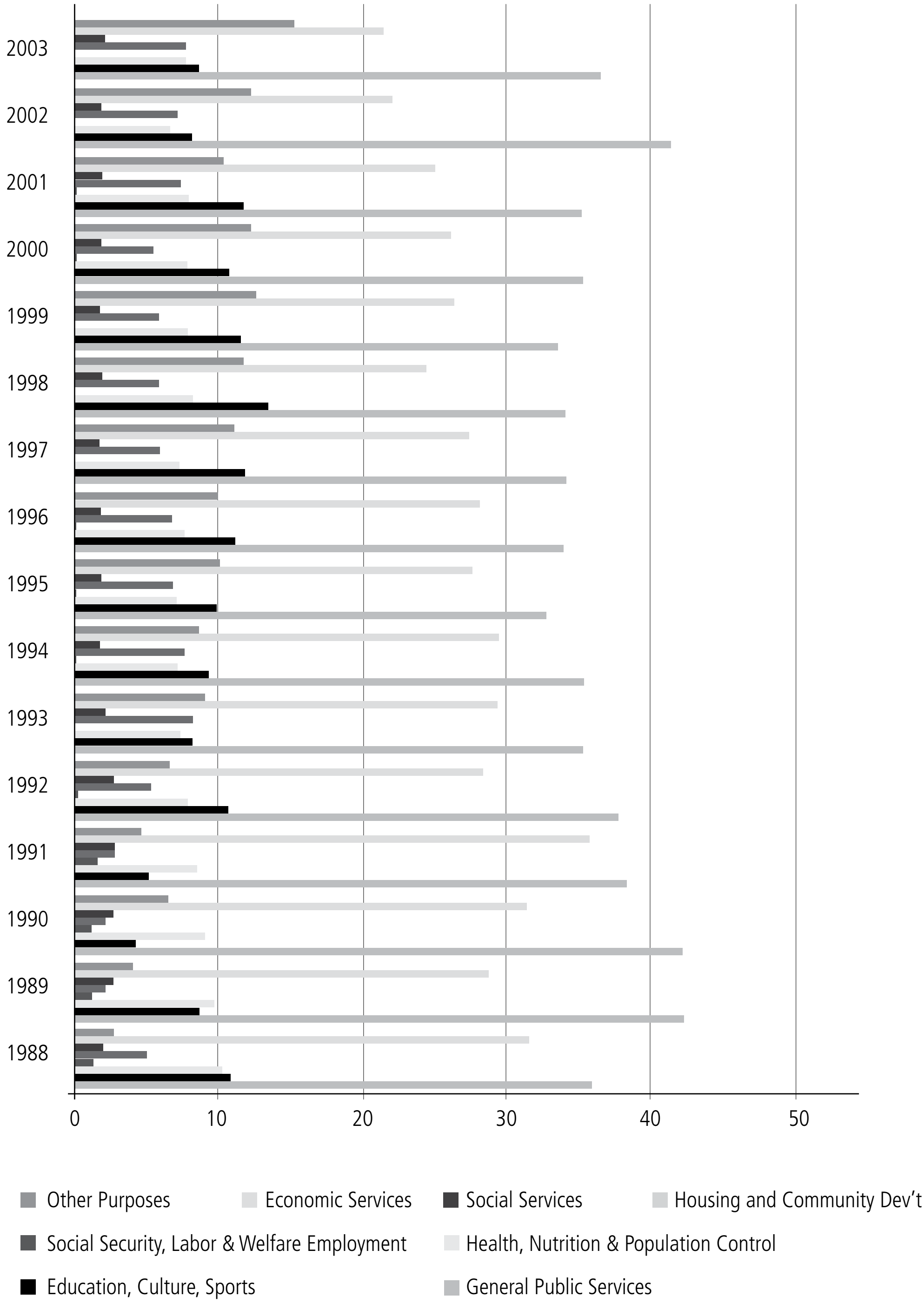


Figure 10: Distribution of Total Expenditures - All Cities, 1988-2003



A joint study by the Asian Development Bank and the World Bank in 2005 pronounced that overall the devolution of expenditure responsibilities to LGUs is consistent with the principle of subsidiarity (ADB 2005)[29]. The report also noted that few devolved activities have spillover benefits outside LGU territorial jurisdictions and that the Code allowed LGUs to regroup into larger cooperative units when they deem appropriate. As proof, it cited several cases of inter-LGU cooperation in coastal resource management, solid waste management, water supply development and distribution, and construction of inter-municipal roads. Metropolitan arrangements have also appeared in several places. Loehr and Manasan (1999) find that the devolution of expenditure responsibilities to LGUs is generally consistent with the decentralization theorem. The devolved activities are those "that can be provided at lower levels of government . . . and few of them have benefits that spill over outside the territorial jurisdiction of the LGUs with exception of those related to environmental management" (Manasan 2005, page 37)[30].

During the period after the enactment of the Local Government Code, there seems to be a marked increase in LGU spending as more resources had been made available to LGUs. A JICA study (2008) notes that the top three service areas where improvement with devolution was noted in sample provinces, cities and municipalities are: 1) social welfare; 2) health and nutrition; and 3) agriculture and fisheries. Undoubtedly the changes brought about the passage of the 1991 Local Government Code have resulted in an increase in LGU spending.

On the other hand, whether there has been an overall improvement of public service delivery, governance and local development now that these functions are with local government units is an empirical question. There has been an improvement in public service delivery but perhaps not in a significant way for all local government units. Llanto and Quimba (2010) report recent findings of a survey conducted by the Philippine Institute for Development Studies, namely that:

- For health, despite more than 10 years after devolving this function to local government units, there is still an overlap in the provision of services by LGUs and the national government. LGUs still have not fully built capacity to provide better health care services. Finally, LGUs and the central government's Department (Ministry) of Health have not clearly identified cost-sharing and assignment of functions regarding delivery of health service.
- For education, the School Based Management approach which centers on giving the authority to school principals and involving parents and other stakeholders in school decisions is a good start for proper phasing and right-sizing of functions yet to be devolved. However, there is need for clear and proper delineation of functions, capacities and funds between local and national offices.
- For LGUs to better manage their own water resources there is a need for a clear delineation of powers, functions, and responsibilities, institutional development, and source of financing.

Pending better data and the conduct of more systematic and in-depth studies, there seems to be at best only anecdotal evidence supporting claims of improvement in service delivery in several local government units.

For example, Klugman (1994) reports a Philippine study by Jimenez and others (1988) that for given levels of enrolment and quality, schools which rely more heavily on local funding are more efficient. There is a lower cost of delivery of education services. They also find that students at

29 Asian Development Bank (2005), Decentralization in the Philippines: Strengthening Local Government Financing & Resource Management in the Short Term, Mandaluyong City: Asian Development Bank

30 An exception is education (Manasan, 2005).

schools which relied more heavily upon local funding had better ‘achievement scores’. A special education fund, a surcharge on taxes on real property is administered by the local school board composed of the school principal, local government representative and parents. The ADB (2005) noted a growing number of examples of excellence in service delivery, which seem to indicate that well-performing local governments may be distinguished by their ability to access resources more effectively, and manage them more transparently and accountably. According to Brillantes and Tiu Sonco, since its establishment in 1994, Galing Pook has received over 3000 nominations. Close to 250 programs coming submitted by some 152 local governments have been awarded. These initiatives range from the protection of the environment, delivery of health and sanitation, agricultural and educational services, local economic development, culture and tourism and livelihood generation. Table 4 shows the number of Galing Pook awards given since 1994.

Table 4. Number of Awardees per Award Category (1994 – 2009)31

Rank	Award Category	No. of Awardees
1	Environmental Protection	51
2	Local Economic Development	40
3	Health and Sanitation	34
4	Local Administration and Management	24
5	Sustainable Agriculture	21
6	Livelihood/Income Generation	19
7	Culture and Tourism	14
8	Local Governance	14
9	Social Welfare and Development	14
10	Public Infrastructure	12
11	Socialized Housing	12
12	Education	10
13	Peace and Security	10
14	Integrated Area Development	8
15	Multi-sectoral Cooperation	7
16	Disaster Management	6
17	Child and Welfare Protection	5
18	Gender Sensitivity	5
19	Inter-LGU Cooperation	5
20	Protective Services	5
21	Power and Telecommunication Program	4
22	Information Technology	3
23	Water Supply	3
24	Capability Building	2
25	Justice System	2
26	Population	2
27	Advocacy	1
28	Sports Development	1

Source: Galing Pook Foundation 2010.

31 Table prepared by Giana Aira Barata and Joebert Sayson, undergraduate students under the guidance of Prof. Jose Tiu Sonco II.

There is a need to have a closer look at the expenditure assignment of local government units. An ADB (2005) report indicates that surveys done to assess satisfaction with public services point to mixed results on local government performance in the Philippines. Local areas continue to suffer from a myriad of problems — uncertain access to potable water and electricity, declining literacy rates, environmental degradation, rising unemployment rates, lack of low-cost housing, and unreliable police and fire department services. There is a need to invest in infrastructure and social services. Recent studies have also pointed out the mixed results on local government performance in the country (e.g., Capuno, 2007 and Brillantes, Llanto, Alm and Sosmena, 2009).

The examination of the expenditure assignment of local government units indicates a room for improvement. Section 17 (b) of the 1991 Code provides an explicit and clear expenditure assignment across levels of government with the exception of environment and natural resources management. However, the following section 17 (c) allows national (central) government agencies to continue with the implementation of devolved public works and infrastructure projects, and other programs and services. The national government has also issued Executive Order 53, which empowers national government agencies to manage and control all foreign-assisted and nationally funded projects, even if those projects may involve devolved activities.

In addition, Section 17 (f) allows the national government to or the next higher LGU level to "provide or augment the basic services and facilities assigned to a lower level of local government unit when such services or facilities are not made available, of if made available, are inadequate to meet the requirements of its inhabitants.[32]" Loehr and Manasan (1999) observed that national government agencies have exploited Section 17 (f) and Executive Order 53 to implement projects involving devolved activities on the justification that those projects support national objectives.

Section 17(c) and Section 17 (f) of the 1991 Code have provided the opportunity for central government line agencies to continue to implement devolved public works and infrastructure projects and other facilities, programs and services. Funding is made available under (a) the central government budget provided under the Annual General Appropriations Act, (b) special laws, (c) executive orders and (d) foreign sources such as official development assistance (ODA).

In sum, how should one characterize the current status of tax-expenditure assignment? In general, local own-source revenues are inadequate and cannot effectively cover the LGUs expenditure assignment. The experience in the almost twenty year period after the enactment of the law shows a significant mismatch in the tax-expenditure assignment33. Uchimura and Suzuki (2009) succinctly declare the issue as a case of expanding local expenditure responsibility while the local fiscal capacity is not strengthened. There is an obvious need for an appropriate matching of tax and expenditure assignments if local governments are to efficiently deliver public services.

The 1991 Code looked at fiscal transfers as instruments to close the fiscal gap. As shown in the following section, there is much room for improvement in the distribution formula for the internal revenue allotment.

Total LGU expenditure is consistently larger than the total local income and revenues (except 2002) as depicted in Figure 11. Income generated from local taxes and other operating income are not enough to finance all of the local government activities and to implement

32 See Manasan (2007) for an extended explanation.

33 The 1991 Local Government Code was enacted into law on October 1991.

its programs and projects. The gap between total expenditure and total local income widens as the years go by. In 1989 total income is more than half of the total expenditures but by the mid-90s it is only about a third. It is the substantial amount of the IRA that made it possible for local government units to cover their expenditure needs (Figure 12). Without the fiscal transfer, local development would have been at a standstill.

Looking at the three types of LGUs, before the passage of the 1991 Code, IRA made up for the shortfall of local tax and non-tax revenues for cities and municipalities but not for provinces (Figure 13). The 1991 Code provided for a huge share of local government units in the national internal revenue taxes. The IRA was increased to 40 percent thus, enabling the local government units to finance all their local expenditure requirements although the provinces still face funding constraints (Figure 14). The other figures (15 and 16) re-enforce the observation made here that were it not for a substantial increase in the IRA, local government units would have faced a huge funding constraint. The inefficient tax-expenditure assignment has to be supported by the internal revenue allotment.

Figure 11: Local Income vs. Total Expenditure - All LGUs, 1988-2003

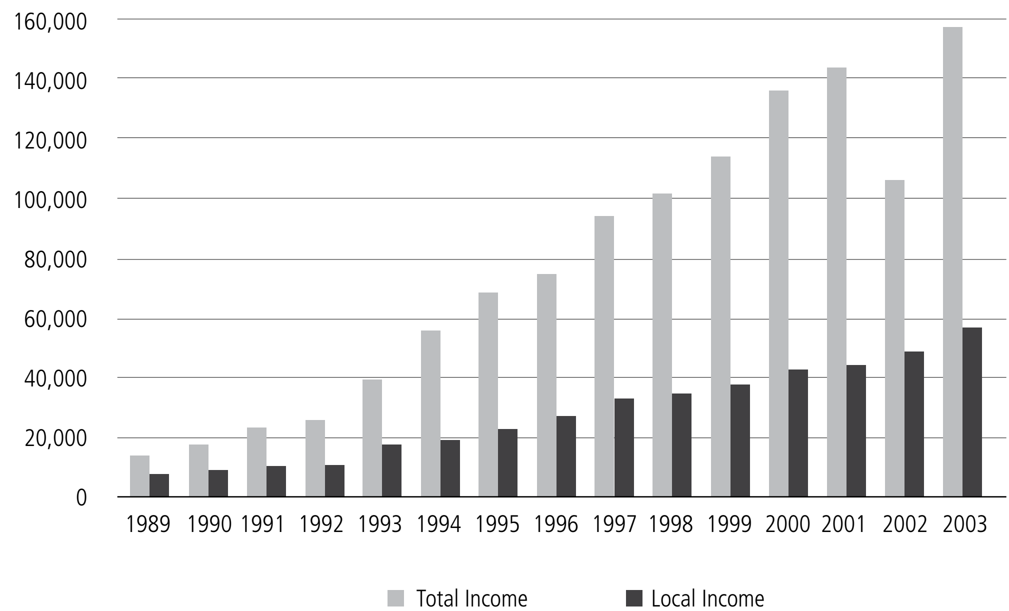


Figure 12: Total Income with IRA vs. Total Expenditure - All LGUs, 1989-2003

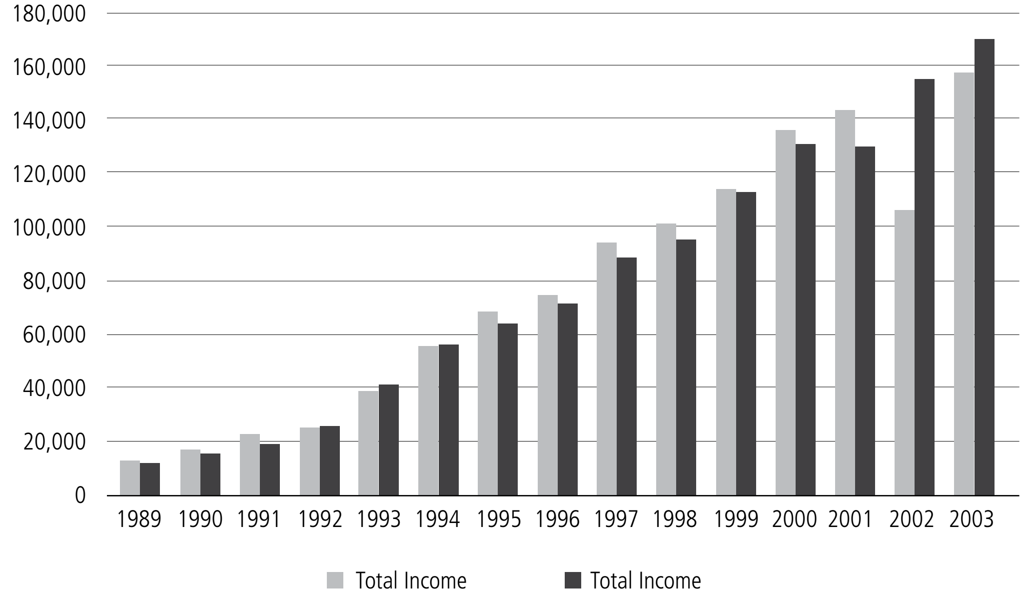


Figure 13: Total Income with IRA vs. Total Expenditure - by Type of LGU, 1990

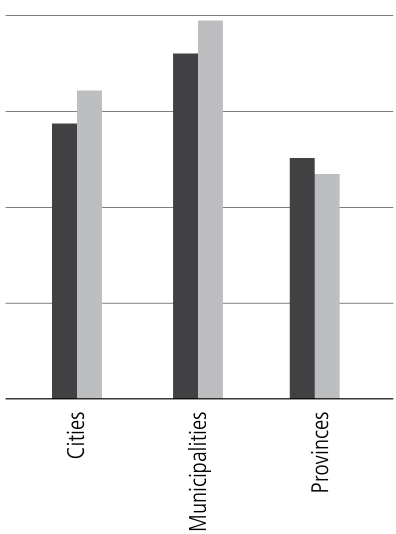


Figure 14: Total Income with IRA vs. Total Expenditure - by Type of LGU, 1990

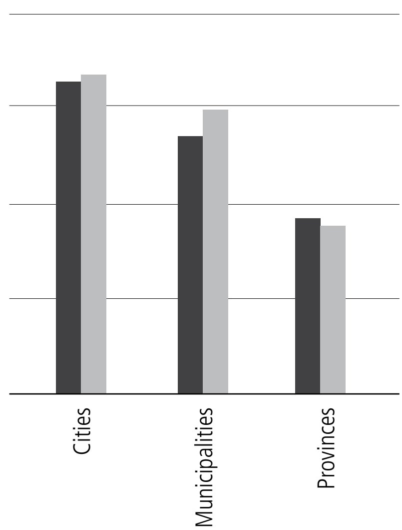


Figure 15: Local Income vs. Total Expenditures, by type of LGU, 1990

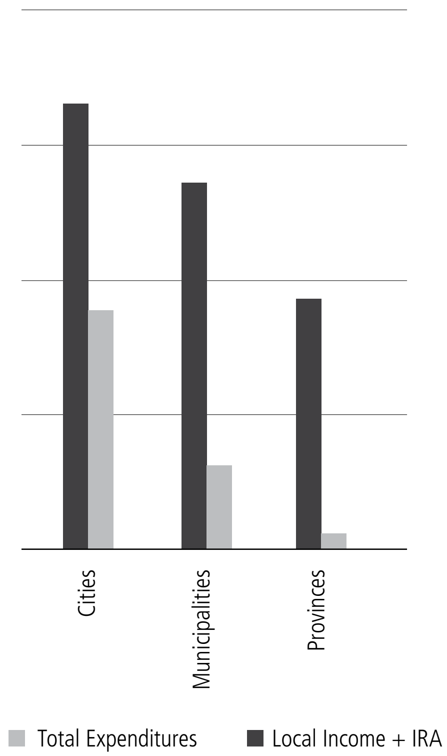
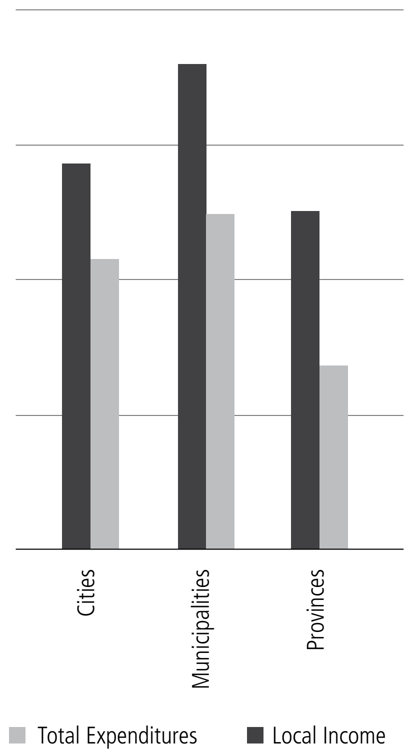


Figure 16: Local Income vs. Total Expenditures, by type of LGU, 2003



CHAPTER 4 INTERGOVERNMENTAL FISCAL TRANSFERS

Intergovernmental transfers are traditionally viewed as instruments to close the vertical fiscal gap between revenue and expenditure at the local level that naturally arise in a decentralized government. However, this simplistic notion fails to take account of the other uses of transfers such as a tool for horizontal fiscal equalization and for the attainment of national objectives.[34] By and large, intergovernmental transfers are a necessary complement to decentralization – as it serves as a powerful instrument to realize the benefits from decentralization, while minimizing without undermining national objectives of efficiency and equity.

Instruments of intergovernmental fiscal transfers

There are two main types of intergovernmental transfers or grants, namely, general-purpose (unconditional) and specific-purpose (conditional) transfers.[35] General-purpose transfers are general budget support given to local governments with the simple objective of enhancing overall welfare, while preserving local autonomy. In contrast, specific-purpose transfers are conditional grants aimed at targeting specific types of expenditure (input-based conditionality) or attaining specific results in service delivery (output-based conditionality). Both types of transfers may either be mandatory or discretionary in nature.

Between the two types of conditional grants, output-based conditionality is thought to achieve the grantors' objectives and uphold local autonomy at the same time, while input-based conditionality is deemed to promote the culture of opportunism and rent-seeking (Shah 2007). Conditional grants may or may not be matched by local funds (cost-sharing).

Designing fiscal transfers

Regardless of form, intergovernmental transfers should be determined in a systematic manner. However, there is a no "one-size-fits-all" pattern of transfers that is universally appropriate. Bird (2001) lists three critical aspects of intergovernmental transfer design: (1) role of conditionality and matching grants; (2) distributable pool; and (3) basis for distributing transfers.

The form of intergovernmental transfer that is most appropriate to use depends largely on its effects on grant objectives and its impact on local government behavior. The grant objective should be unambiguously and accurately defined, and should have singular focus to guide grant design: design follows objective.

If the main objective is to close the vertical fiscal gap, that is, the difference between own-source revenues and expenditures, then unconditional (formula-based) transfers seem proper but only as a last resort because such transfers weaken accountability (Shah 2007). Accountability warrants that local governments at least raise some revenues to fund expenditures which have been devolved to them.

In Shah (2007)'s opinion, it is crucial to pull the stops to the sources of the vertical fiscal gap through a combination of policies such as the reassignment of tax and expenditure

34 See Boadway and Shah (2007) for a complete discussion of the role of transfers.

35 The succeeding discussion on the instruments of intergovernmental transfers is taken mainly from Boadway (2007).

responsibilities, tax decentralization, and tax-base sharing. In the latter case, local governments levy supplementary rates on a national tax base.

Yet again, unconditional (formula-based) transfers can also be used to equalize fiscal capacities (that is, the ability to raise own-source revenues) to an explicit standard across jurisdictions as Shah (2007) has expounded.

To the extent that the goal is to compensate for expenditure need differentials that stem from differences in demographics, age distribution, and poverty incidence across jurisdictions, the equalization payment should be in the form of conditional non-matching transfers. The equalization transfers should partly compensate only intrinsic deficiencies in fiscal capacity and need, discounting differences in costs that emanate from conscious policy choices or differences in the efficiency in resource utilization (Bird 2001).

When the central government prioritizes certain service areas, and requires that minimum national standards for quality, access, and level of services be met, it is appropriate to make transfers conditional on output results. Conditional output-based non-matching transfers foster innovative and competitive ways to service delivery, without undermining local autonomy and budget flexibility. Service areas that generate externalities or spillovers are better handled by conditional open-ended matching transfers, which place no limit on the funds provided. Infrastructure deficiencies are best dealt by using capital grants with matching local funds. Conditional matching transfers promote local ownership of the program.

The total pool of resources for distribution should be determined in a predictable yet flexible manner to help local governments effectively plan their expenditure program. A transfer mechanism should be able to provide medium-term projections of funding availability, which could be adjusted to accommodate unanticipated changes in the fiscal condition of local governments. Bird (2001) favors transferring a fixed percentage of central taxes or current revenues that is adjustable every few years to local governments.[36]

The distributable pool should be allocated according to a formula that is simple and transparent. The formula should incorporate objective measures that are not easily manipulated and should be disseminated widely to help garner acceptability and support. In principle, the formula for general-purpose transfers should include measures of fiscal *capacity* and *needs* – that is, any preferred degree of fiscal equalization could be built into the formula.[37]

Fiscal capacity is estimated using either macroeconomic variables [38] such as gross domestic product and factor income, or the representative tax system approach,[39] which uses measures of potential revenue-raising capacity and not actual revenues. Most developed and transition economies have equalization components in their formulas, while only a few developing countries include specific capacity measures in their formulas due to data constraints and weak local autonomy with respect to local taxes. Expenditure needs are either determined in an *ad hoc* fashion using simple measures or estimated using the representative expenditure system approach[40].

Canada uses arbitrary measures of population, location, urbanization, and social assistance, among others (Shah 1994) to quantify needs, while Australia determines fiscal need using the representative

36 Another way of determining the distributable pool is through a system where governments at the same level establish a common fund, which are distributed among them. This system of revenue pooling is practiced in Germany, the Russian Federation, and other countries.

37 In contrast, conditional matching transfers contain indicators specific to the financed projects and activities.

38 In general, macroeconomic indicators do not reflect the ability of local governments to raise revenues from own sources (Boadway 2007). Moreover, the availability of accurate and timely data at the local level proves problematic.

39 The representative tax system approach measures fiscal capacity by the revenue that the local government could raise if it employs all of the standard sources at the nationwide average intensity of use.

40 The representative expenditure system approach determines what each local government would have spent if it had national average fiscal capacity but actual need factors.

expenditure system approach as part of its fiscal equalization program.

Clearly, *ad hoc* or discretionary transfers are not advisable. In Canada and Germany, both the resource pool and its distribution are based on a formula, as opposed to the arbitrary determination of the distributable resource pool by the central government through an act of parliament in Australia and Switzerland (Shah 2007).

As a general rule, there is room for both general-purpose and specific-purpose transfers (Smart 2007). General-purpose transfers may incorporate fiscal equalization: transfers should be inversely proportional to fiscal capacity and vary directly with fiscal need factors. However, only a handful of countries choose to implement a comprehensive fiscal equalization program, despite the general consensus in the academic literature that it enables local governments to provide a standard package of public services with a standard level of taxes on the bases at its disposal. Most countries only opt for a fiscal capacity equalization program due to its relative transparency and achievability. Fiscal need equalization, though important, necessitates using subjective judgments and inexact analytical methods. Rather than implement it as part of a comprehensive fiscal equalization program, fiscal needs compensation is better achieved through conditional output-based non-matching transfers for merit goods, as practiced in many industrial countries (Boadway and Shah 2007).

The point made by Boadway and Shah (2007) on the basic tasks in transfer design about making local governments fully accountable to their citizens for the actions they undertake – at least at the margin of decision-making is crucial. The basic challenge in transfer design is thus how to provide local governments with sufficient fiscal transfers or block grants to carry out responsibilities devolved to them without generating perverse incentives to local government behavior. There is good case for matching transfers with local contributions or counterpart funding to create a sense of ownership and thus, encourage accountability of local governments. Moreover, a well-designed transfer system should be able to accord budgetary flexibility and autonomy in setting priorities to local governments.

Philippine internal revenue allotment

Fiscal decentralization leads to the transfer of responsibility for delivery of certain public goods to local government units, which typically may not be adequately covered by local revenues (Bird and Rodriguez, 1999)[41]. The enactment of the 1991 Local Government Code has resulted in a remarkable increase in the size and composition of central government transfers to local government units. The local governments in the Philippines heavily relies on the internal revenue allotment (IRA) or central government transfers to LGUs, to close the vertical fiscal gap. Figure 17 shows how the internal revenue allotment (the intergovernmental fiscal transfer) is transferred from the central government to the local government units.

41 *Source: Department of Budget and Management website (http://www.dbm.gov.ph/ira.php)*

Figure 17. Release Procedure of the Internal Revenue Allotment99

Bureau of Internal Revenue submits to Department of Budget and Management (DBM) certification of collections made and 40% share of LGUs.

↓

DBM verifies with Bureau of Treasury the collections remitted and computes the share of LGUs based on formula as provided under Section 285 of RA No. 7160, the Local Government Code.

↓

DBM Central Office (CO) programs the amount and releases the allotment comprehensively to the DBM Regional Office (RO) at the start of the year.

↓

DBM CO issues the Notice of Cash Allocation (NCA) monthly for deposit with the Government Servicing Banks of DBM ROs. Subsequently, the DBM RO issues the funding check for credit of IRA share to the individual bank account of the LGUs.

The Local Government Code of 1991 was revolutionary in its impact on decentralization. It assigned greater responsibilities for service provision to local governments and also entitled them to receive 40 percent of national internal revenue taxes. The internal revenue allotment is distributed on the basis of a formula. Prior to the 1991 Code, the share in national internal revenue taxes was 20 percent. The total amount of the internal revenue allotment is based on the collection of national internal revenue taxes in the third year preceding the current one at a rate of 40 percent.

42 *Bird, Richard M. and Edgard R. Rodriguez (1999), "Decentralization and Poverty Alleviation: International Experience and the Case of the Philippines," Public Administration and Development, No. 19, pages 299-319.*

Philippine intergovernmental fiscal transfers are of three types: (a) the internal revenue allotment (IRA), a formula-based grant, (b) and a share in national wealth and (c) *ad-hoc* conditional grants. Table 5 shows these three types of transfers

Table 5 . Fiscal transfers to local government units

Fiscal transfers	Before the Code	After the Code
Revenue share	Internal revenue allotment	Internal revenue allotment
	Specific tax allotment	Share in national wealth
	LGU revenue stabilization fund	Share in tobacco excise tax
	Budgetary aid to LGUs	
	Barangay development fund	
Grants	Calamity fund	Calamity fund
	Municipal development fund	Municipal development fund
	Countryside development fund	Local government empowerment fund
		Countryside development fund
		DECS school building program

I focus on the internal revenue allotment, which comprise the biggest and most important type of fiscal transfers. The other types of fiscal transfers (a) share in national wealth and (b) conditional grants will only be mentioned in passing and will not be discussed in detail[43].

43 *These should be studied in the near future for their allocative effects, among others.*

The share in national wealth comes from mining taxes, royalty from mineral reservation, forestry charges, energy resources production and tobacco excise tax and does not accrue to all LGUs. Conditional grants come from (i) lump sum allocations under the central government budget, (ii) allocations made by central government sector agencies from their own budgets and (iii) lump sum and/or line item appropriations for pork barrel funds of legislators. The problem with conditional grants is that they become available depending on the fiscal position of the central government and/ or political objectives of legislators and the central government. For example, the Local Government Service Equalization Fund (LGSEF) created by Executive Order 48 of 1998 during the Estrada administration was funded from the aggregate IRA share of LGUs. The money for LGSEF was carved out of the IRA, which diminished block grant to LGUs. The government later discontinued the LGSEF. Through the congressional insertions or pork barrel, the legislator substitutes his own preferences to those of the local government units, which have their own preferences. Because of the information advantage, the LGUs would have a better idea of what programs, projects and activities that would lead to higher local welfare. In this light, congressional discretionary funds and the enjoinment to spend those funds according to the wish and whim of legislators would be welfare-reducing.

Table 6 shows the relative shares of different local government units in the IRA before and after the Code.

Table 6. Percentage Shares of LGUs in the Internal Revenue Allotment

Type of LGU	Before the Code	After the Code
Provinces	27.0	23
Cities	22.5	23
Municipalities	40.5	34
Barangays	10.0	20
Total	100.0	100

As Table 6 shows, the biggest gainers in terms of relative share from the internal revenue allotment are the barangays. Provinces and municipalities have lower shares after the passage of the 1991 Code. The cities gained the most because of an increase in IRA allotment but also because there are fewer cities than provinces and municipalities. This has created an incentive among municipalities to troop to Congress to convince legislators to pass a law converting them into cities. Thus, even those municipalities, which do not qualify to become cities have begun to pull legislative strings for the favor.

The distribution of the IRA to individual local government units follows the weighted formula shown in Table 7.

Table 7 Distribution Formula for the Internal Revenue Allotment

Factors	Before the Code, % weight	After the Code, % weight
Population	70	50
Land area	20	25
Equal sharing	10	25
Total	100	100

The internal revenue allotment is the single biggest dominant source of local revenues for local government units. As shown in Table 7 above, as of latest data available, the IRA accounts for 67 percent of total local income. For provinces, it is as much as 82 percent of local income and 78 percent for municipalities. In contrast around 47 percent of local income for cities comes from the internal revenue share. Clearly, the IRA is skewed toward the cities, which ironically have the bigger and more buoyant local tax bases. Thus, the combination of bigger and more buoyant tax bases and a relatively larger share of the IRA result in greater fiscal autonomy for cities than for the other types of local governments. It is no wonder that cities can provide better services to the local populace than other local governments.

Provinces and municipalities are much more dependent on IRA than cities. In any case local governments, which continue to depend on IRA as a significant source of revenue, tend to have weak fiscal autonomy. In addition, any change or fluctuation in the size of the IRA can pose a danger to local revenue stability as pointed out by Manasan (2007) and Uchimura and Suzuki (2009). The amount of the IRA for distribution to local governments depends on the fiscal position of the national government. Weak collection of national internal revenue taxes by the national government can lead to a reduction in the size of the IRA. In times of fiscal stress felt at the national level, there could be delays in the release of the internal revenue allotment (IRA) to local government units.

The formula-based revenue sharing led to local governments largely substituting the new revenues from the central government for own-source revenues, especially the local property tax. The situation on the IRA is summarized by a JICA (2008) study. Please see Box 3.

Box 3. The internal revenue allotment vis-à-vis other sources of local income

- For the period 2002-2006, IRA has been the biggest source of revenue of LGUs, contributing, on the average, 63% of the total revenue.
- Locally-sourced revenue consisting of tax and non-tax sources contributed, on the average, 32% of the total revenue. Its share to the total revenue indicated a slightly increasing trend from 31% in 2002, to 33% in 2006.
- Revenues from the real property tax and business tax represent 24% of the total revenue.
- Except for a slight decline from the real property tax in 2004 and from the business tax in 2006, tax collection performed well during the period, recording their highest growths of 23% and 30%, respectively in 2005.

The principal issue is how to make the IRA work better for local government units. Oates (2006) underscores the need for proper design and proper use, which must provide a set of incentives consistent with the objectives of the fiscal transfer and stresses the need for a grant system to be transparent and predictable. According to Oates, there needs to be a well understood set of rules such that the system cannot be "gamed" to one's own advantage (page 27).

Distributable resource pool

Intergovernmental fiscal transfers in the Philippines come in three forms: (1) internal revenue allotment or IRA (formula-based); (2) share in national wealth (origin-based); and (3) *ad hoc* conditional transfers.[44] The

44 The share in national wealth, which is obtained from mining taxes, royalty from mineral reservation, forestry charges, energy resources production and tobacco excise tax, are not conferred to all LGUs. Conditional grants are sourced from the following: (i) lump sum allocations under the central government budget; (ii) allocations from the budgets of central government sector agencies; and (iii) lump sum and/or line item appropriations from discretionary congressional funds (Llanto 2010).

IRA is the major transfer bestowed by the central government to the LGUs as a fixed share (40 percent) of actual internal revenue tax collections of the central government three years prior to the current year. This tax-sharing arrangement[45] adopted in the Philippines has the advantage of guaranteeing LGUs a sure source of revenue, while leaving room for fiscal autonomy[46]. Just as important as increasing the size of the IRA, its predictability helps LGUs program and manage their expenditures effectively.

On the downside, this type of revenue sharing, that is, the IRA creates disincentives to both the central government and the local government. Manasan (1995) finds that the IRA substituted for local tax revenues in each tier of local government in 1992 and 1993, while it had a neutral effect on local revenue performance prior to the Code (1985).

On the part of the central government, the IRA represents a substantial cut from the resources that are finally made available to it after deducting payments for principal and interest charges of various foreign loans. The relatively low tax effort on the part of the central government leaves a relatively thin margin of resources for financing national government development programs and projects.

Therefore, the proposal by the Senate to widen the distributable pool by tapping into all national taxes and not only the internal revenue taxes (Senate Bill 118) should be weighed in the light of its effects on local autonomy and incentives, and also on central government fiscal behavior. The emerging view is that the percentage share will be increased from 40 percent to 50 percent of national internal revenue taxes. One variation of this view is that the incremental 10 percent should be distributed to local governments according to performance. Policy makers have yet to agree on what the performance indicators would look like.

An alternative to tax sharing could be tax base sharing, in which several levels of government share the same tax base. However, tax base sharing can lead to tax disharmony, higher compliance costs, and distortions in fiscal policy progressivity, and if the sharing is not properly designed. Hence, revenue decentralization (through tax base sharing) to enhance accountability comes at the price of efficiency and equity. This alternative needs careful study.

The upshot is that tax harmonization schemes could be instituted without stripping LGUs of the accountability to decide on the amount of own-source revenues to be raised. While such harmonization would not completely eliminate unhealthy tax competition or tax exporting, it would certainly diminish the complexity of the tax system and thwart more detrimental forms of fiscal competition such as sector-specific taxes or subsidies. Canada has been successful in harmonizing its tax system because tax abatement at the central level gave room to sub-national governments to levy supplementary rates on the national tax base.

The choice of the appropriate type of revenue-sharing system has to consider issues of impact on fiscal autonomy, incentives, efficiency, and equity. Under a tax-base sharing system, it is important that the central government regulate intergovernmental competition for the sake of efficiency and equity in resource allocation. Although tax base sharing could only be used for destination-based taxes, it is instrumental in getting to the bottom of both vertical and horizontal fiscal gaps, while allowing LGUs fiscal autonomy. Tax base sharing that incorporates an equalization formula is less targeted than unconditional transfers (from tax sharing).

45 Tax sharing is a type of revenue sharing where the central government collects and shares its revenue (the IRA in the case of the Philippines) with the LGUs. The second type is tax base sharing in which the higher-level government sets the tax base and lower levels either piggyback or charge supplementary rates on higher-level government taxes.

46 Assuming that the local government units will be serious about raising own-source revenues.

Distributive and allocative formula

Two of the most contentious issues in the IRA debate are the proportion of national revenues (the IRA) to be shared by the national government with LGUs, and the formula for the allocation of transfers.

On the first issue, there are proposals to increase the size of the IRA from 40 percent to 50 percent of national internal revenue taxes by the various leagues of government, or to even as high as 60 percent by the Senate (Senate Bill 8). These proposals have to take into account the disincentive effect of simply increasing the size of the IRA transfer from its current level. Simply increasing the size of the IRA will not automatically close the vertical fiscal gap because of the demonstrated incentive of LGUs to substitute it for own-source revenues, which will erode the gains from an increased transfer. A variant of this proposal is to award incremental IRA over and above the current levels conditional to local government performance. A conditional transfer of incremental amounts could be tied to some measure of performance, e.g., demonstrated increase in local own-source revenue effort, better local expenditure management, and others. A matching effort to improve governance, make more efficient procurement, better management of the local environment by the local governments may be used to justify a share in the envisaged incremental IRA.

Currently, the IRA is distributed to LGUs according to this formula: population (50 percent); land area (25 percent); and equal share (25 percent). There are proposals to include additional variables in the formula such as poverty index, municipal waters as part of the LGU "territory", which will be in addition to "land" as an item in the formula, revenue capacity, and fiscal effort. Adding "municipal coastal waters" to the distribution formula is a ploy to increase the size of the LGU territory arising from the combination of the land and municipal coastal waters. The proponents believe that a redefinition of "land" to include coastal waters will lead to an increase in their share of the IRA.

As pointed out by several analysts, the IRA formula lacks an equalizing feature, that is, measures of fiscal capacity and fiscal need. Legislators may have chosen proxy indicators such as population, land area and equal sharing to stand for fiscal need. Size of the population and land area tend to bias the share in the IRA in favor of cities, which as earlier shown, enjoy broader taxing powers and a more revenue buoyant tax base.

A proposed change to the IRA distribution formula is to increase the weight given to equal sharing, which has increased from 10 percent to 25 percent under the 1991 Code. The proposal ignores the heterogeneity of local government units with vast differences in resources available and needs.

At present, the IRA formula does not include fiscal capacity measures either, prompting a proposal to include fiscal effort into the equation. Fiscal effort is hard to measure, and even if it could be calculated in a reliable fashion, incorporating it in the IRA equation would pose some difficulties (See Shah 2007 for a complete treatment). An example would be the incentives it would have on LGUs, especially the poor ones[47], to impose higher taxes so as to profit from larger transfers. The poor LGUs have smaller or weaker tax bases because of weak local economies, and emigration of the local population, mostly the young and educated to the richer (that is, higher income) LGUs and to foreign countries where job opportunities are present. This does not mean that the design of the fiscal transfer should exclude fiscal or tax effort as a determinant. It is certainly useful to consider

47 The 'poor' LGUs are those belonging to the 4th to the 6th income class and are mostly municipalities. The Bureau of Local Government Finance of the Department of Finance has six income classification of local government units.

it but designing a distribution formula that responds to fiscal need especially of the lower income (poor) LGUs and at the same time motivates them to mobilize significant amounts of own-source revenues is a very challenging task.

There is a need for a thorough study of all those proposals to arrive at the most appropriate formula given the country's socio-economic-political context. A haphazard formula without the benefit of an empirical study may do more harm than good compared to the present distribution formula.

CHAPTER 5 **LOCAL GOVERNMENT FINANCING**[48]

The 1991 Code provides substantial borrowing powers to local government units. This is a radical departure from the pre-Code situation where they would need the permission of the Department of Finance to incur borrowings. The liberalization of LGU credit markets has spurred lending by both government and private financial institutions. The 1991 Code has also allowed local government units to float debt instruments such as bonds and a few local government units have actually ventured into tapping the capital markets to finance revenue-generating projects.

However, despite the liberalization of LGU credit markets, policy makers imposed certain limitations to LGU borrowing powers: (a) local government units cannot issue general purpose bonds, (b) debt service should not exceed 20 percent of their regular income, (c) they must budget for due debt service, (d) final clearance on bond flotation must be given by the central bank, which under the New Central Bank Act must render an opinion on the impact of the proposed bond flotation on monetary aggregates, the price level, and the balance of payments, (e) the central government does not provide a sovereign guarantee to LGU borrowings. To borrow from any lending institution, local governments have to get a certification of their borrowing and debt service capacity from the Bureau of Local Government Finance of the Department of Finance.

The principal sources of credit financing are government financial institutions: the Land Bank of the Philippines, (the dominant lending institution), Development Bank of the Philippines and two specialized credit institutions, the Local Water Utilities Administration (LWUA)[49] and the Municipal Development Fund Office (MDFO)[50]. It is noted that these government lending institutions have mostly used loans provided from official development assistance by donor institutions such as the World Bank, Asian Development Bank, and the Japan International Cooperation Agency to finance LGU programs and projects.

The LGU credit markets is dominated by loans from government lending institutions but recently it is reported that a few private commercial banks have started to lend to a select group of local government units, that is those belonging to the first and second income class. Available data from the Bureau of Local Government Finance and government lending institutions indicate total LGU outstanding debts of around Peso 68.02 billion as of September 2010, of which close to 86 percent are from government lending institutions.

There have been a few LGU bonds issued to the public. This mode of financing failed to catch on due primarily to the underdeveloped nature of the Philippine domestic bond market, and also because the government lending institutions, using ODA funds, have managed to provide lower cost credit to local government units. Data from the Local Government Unit Guarantee Corporation (LGUGC), a private corporation that insures bond issuances of local government units,

48 A more detailed discussion is given in Llanto, Gilberto and others (1998). Local Government Units' Access to the Private Capital Markets. Makati City: Philippine Institute for Development Studies.

49 LGUs, which organize water districts, can borrow from LWUA.

50 The MDFO is a unit under the Department of Finance, which is used to channel official development assistance (ODA) to local governments. It caters mostly to the lower-income LGUs.

indicate a total of Pesos 3.25 billion pesos worth of bonds issued by sixteen LGUs from 1999 to 201051.

Overall, local government units have a small appetite for credit financing with the exception of a relatively small number, which have tapped both loans and bonds for financing various local projects. The emerging LGU bond market has been effectively stifled by the availability of cheaper loans provided by government lending institutions. On the other hand, the interest expressed by a few private commercial banks in lending to local governments belonging to the first and second income class is a good signal because competition in credit markets is bound to benefit the local government units in terms of lower cost credit and better service by lenders.

51 The LGUGC was organized by the Development Bank of the Philippines (a government bank) and several private commercial banks in 1997.

The main issue is the reluctance of government banks to move from their monopoly (or more accurately, oligopoly) position in LGU credit markets. They have discovered that LGU lending is very profitable and almost risk-free because of the IRA-intercept wherein LGUs can pledge their IRA as security for a loan. If they default on their loan amortization, the government bank can seize the IRA. This privilege is accorded only to government banks because they are the designated depository banks for local government units. There have been calls to allow private banks to also be designated as depository banks, which will start a financial relationship between them and the local government units. The financial relationship will help deal with the information problem that private banks have with local government units, and thus encourage private bank lending. This is a policy issue that should be addressed by policy makers.

CHAPTER 6 CONCLUSIONS AND RECOMMENDATIONS

In conclusion, decentralization and devolution have ushered a radical approach to steering Philippine development. Decentralization was done both on the political and fiscal fronts. This paper provided an overview of the situation of fiscal decentralization in the Philippines.

Local governments have been given broad taxing, spending and borrowing powers, which they have utilized to discharge the functions and responsibilities that have been devolved to them. Overall, it seems that there have been some improvements in service delivery as indicated by the increase in local spending for various public goods and services. The expenditure assignment seems appropriate although there is a room for reform when it comes to the need for a clearer delineation of public expenditure responsibilities between the central government and local government units, especially in the fields of health, education, environment and natural resource management. There is also a case of more efficient local public expenditure management.

The tax assignment is also in order but the drawback is that the more productive taxes have not been assigned to local government units. The 1991 Code has set certain limits on the taxing powers of local governments and has somewhat diminished the taxing power of provinces in favor of cities. There is a need to review the tax assignment in view of the vertical and horizontal fiscal gaps as shown by the data.

There is also a great need to review the policy and distribution formula for intergovernmental fiscal transfers, basically the internal revenue allotment. It is not an efficient formula in the sense that it fails to address issues of local fiscal capacities and fiscal needs. Performance-based grants seem to open pathways for instilling greater accountability on the part of local government units. At present, the central government and donors are collaborating on the installation and implementation of performance-based grants, which seems to have found resonance among the more progressive local government units.

There is a case for policy reforms in LGU financing and credit markets to make it more competitive. Official development assistance could be used to catalyze greater participation of private commercial banks in the LGU credit markets. Addressing risks and information asymmetry will build confidence in LGU debt instruments.

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This report examines the fiscal decentralisation experience in Philippines. Since 1991, the central government has devolved significant spending, taxing, and borrowing powers to local governments. This paper discusses fiscal decentralization in the Philippines. It reviews the tax regimes in view of the vertical and horizontal fiscal gaps. Local governments receive inter-governmental fiscal transfer or block grants called the 'internal revenue allotment' based on a formula that has population, land size and equal sharing as criteria. In contrast, performance-based grants seem to open pathways for instilling greater accountability on the part of local governments. To make financing more accessible and competitive to local governments, it demonstrates the need to pursue further reforms in credit markets.

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