THE PHILIPPINE REVIEW OF ECONOMICS
Vol. XLIX No. 1, June 2012 pp. 9-26

# Fiscal decentralization after 20 years: What have we learned? Where do we go from here?

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Local government units (LGUs) in the Philippines have been given significant resources through grants (called internal revenue allotment or IRA) and taxing powers. But after 20 years, LGUs have become even more dependent on the IRA. A body of evidence suggests no sharp improvement in local public service delivery. The share of local budgets devoted to devolved functions has declined, due to creeping re-centralization of health and social welfare functions, increasing substitution of centrally controlled funds for local funds, and misplaced priorities on the part of local authorities.

The missing link in ensuring better delivery of devolved services is the weak process of accountability. The electoral process failed to hold local authorities accountable for their fiscal behavior. The generation of timely, relevant, and consistent information and indices of performance is the next challenge for better local public service delivery. Such information may be used by voters in holding local authorities accountable.

With the threat of a fiscal crisis due to the global slowdown, and with poverty rising, the march toward fiscal decentralization might be constrained. Between reducing poverty or deepening fiscal decentralization, policy makers are likely to choose the former.

***JEL classification***: H71, H72, H77
***Keywords***: local government units, decentralization, public service, intergovernmental grant

## 1. Introduction

For decades, decentralization has been on the policy agenda of many governments. The Philippines embarked on its own decentralization journey in 1991. With the enactment of the Local Government Code of 1991 (LGC 1991), then-president Corazon Aquino fulfilled her promise to give local governments[1] greater autonomy, a clear break from the centralized setup during the martial law regime.

The legal basis for the local autonomy of local governments in the Philippines is the 1987 Constitution. Article 2, Section 25, provides that the "state shall ensure the autonomy of local governments" while Article 10, Section 6, provides that "local government units shall have a just share, as determined by law, in the national taxes which shall be automatically released to them". This provision provided a solid basis for revenue sharing. The law referred to in the constitution, called the Local Government Code of 1991, became the basis for the most sweeping reform in fiscal decentralization in the Philippines. The LGC 1991 significantly changed intergovernmental structure and fiscal rules in the Philippines. It broadened the assigned responsibilities and taxing powers of local governments. The Local Government Code drastically changed the grant system by (a) raising sharply the transfers to local government units (LGUs), (b) making the system rules-based, and (c) mandating as automatic its fund release.

Significant expenditure responsibilities were devolved to provinces, cities, and municipalities. These include basic health care, social welfare programs, agricultural extension work, local environmental concerns, and local public works. The responsibility of LGUs in education is limited to activities done by the Local School Board, which manages part of the real property tax collection, a local tax, for augmentation of central government expenditures on education.

Health care is a shared responsibility, with local authorities providing for basic health care, and central authorities responsible for health policy and funding of major health programs. Social welfare provision is a shared responsibility, with direct welfare benefits provided by subnational governments while the central government is responsible for overall welfare policy and major programs, including the conditional cash transfer (CCT) program.

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[1] The Philippines is a dispersed archipelago composed of 7,107 islands. It is divided into three major island groups: Luzon, the Visayas, and Mindanao. Administratively, the country is divided into 17 regions.

Elementary, secondary, and tertiary education is the responsibility of the central government, although rich LGUs may put up their own schools and universities, which are subject to the overall supervision of central government agencies—namely, the Department of Education (DepEd) for primary and secondary schools, and the Commission on Higher Education (CHED) for colleges and universities.

After 20 years, it makes sense to evaluate how fiscal decentralization has changed the way public services have been delivered. What is the promise and the reality of decentralization in social service delivery? Has governance become more cost-effective? Have local authorities become more responsible, transparent, and fiscally accountable as a result of decentralization? In general, what lessons have we learned after 20 years?

Recent challenges—the Great Recession, increasing disparities between provinces and population subgroups, rapid urbanization, rapidly growing population, environmental degradation, and climate change—might make the process of pushing decentralization forward more difficult. In the face of mounting challenges, and what history has revealed thus far, where do we go from here?

### *1.1. What motivates decentralization?*

The motivation for decentralization is varied. Decentralization could be motivated by the desire to provide public services more efficiently and effectively, hasten the development of backward regions, have a clear break from previous political regimes and overly centralized planning, empower local authorities, and for other political purposes.

Decentralization does not happen overnight. It is usually preceded by long-run structural transformation. Continuous periods of economic growth, rising population, and rapid urbanization put pressure on central governments to decentralize to make the delivery of public services more efficient and effective. This pressure to provide for the rising demand for public services and increased local government administrative capacities (especially computerization of transactions and improved telecommunications) has created an environment conducive to decentralization.

In the case of the Philippines, with growing population, rapid urbanization, a diverse and dispersed geographical setup, and increasing pressures for better delivery of public services, the move toward greater local autonomy appears logical.

### *1.2. Benefits and costs of decentralization*

The first benefit of decentralization is the social welfare gain that comes from moving governance closer to the people. This is the economic efficiency argument that drives the thinking of most economists working on the subject.[2] Whether or not fiscal decentralization actually leads to accountability at the local levels depends on many things. For one, there must be credible and periodic elections. Local chief executives must have the power to control their employees, and there must be enough accurate information so that voters can evaluate the decisions of their local officials.

The second benefit of decentralization is the promise of better resource mobilization. This happens because decentralization can broaden the overall tax base—that is, when subnational governments are more directly involved in collecting taxes, a greater share of the overall economic activity might be reached by the tax system.

The first cost of fiscal decentralization is the loss of macroeconomic control. Central government authorities would argue that they should have the flexibility to respond quickly to changes in economic conditions. For example, the central authorities should be able to raise taxes, cut spending, or limit credit in the event of a ballooning budget deficit.

The second cost of decentralization is the possible loss of control over infrastructure development in cases where the subnational governments have discretionary spending power. The spending preference of the central government differs from that of most local governments. For example, if the central government favored infrastructure spending while subnational governments preferred consumption of goods and services, then the net effect of fiscal decentralization might be lower public investment. A lower rate of public investment, other things being equal, would lead to slower overall long-run growth.

Third, decentralization is not an inherently equalizing development policy. Depending on how the system is designed, there may be little in it for poorer and rural-based local governments.

Finally, decentralization may be costly relative to the benefits gained. Subnational governments may not have the administrative skills to deliver centralized services or collect taxes efficiently.

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[2] See, for example, Oates [1999].

## 2. Intergovernmental transfer system: before and after the reform

The grant system after the reform was significantly higher, totally predictable, and automatically appropriated. Before the passage of the Local Government Code of 1991, the internal revenue allotment (IRA) was equivalent to 20 percent of all internal taxes, based on the second year prior to the grant. This was increased to 40 percent of all internal taxes, based on the third year prior to the grant.

The old and the new systems are both formula-based. But the new allocation is mandatory and automatically released, while the old one was discretionary and thus subject to political bargaining. The old system had made budget planning more difficult since the actual IRA releases were not known in advance.

**Table 1. IRA criteria: before and after LGC 1991**

| Criteria | Before 1991 | After 1991 |
|---|---|---|
| 1. Size | 20% of all internal taxes, two years removed | 40% of all internal taxes, three years removed |
| 2. Predictability | Formula-based, discretionary | Formula-based, mandatory |
| 3. Determinants | Population, land area, equal sharing | Population, land area, equal sharing |

The determinants of the allocation were the same—population, land area, and equal sharing—although under the new system, the weight given to population was reduced (from 70 percent to 50 percent) while the weights assigned to land area and equal sharing were increased. For land area, the weight was increased from 20 percent to 25 percent, and from 10 percent to 25 percent for equal sharing. The latter has the effect of favoring smaller (generally poorer) LGUs, making the new IRA system mildly equalizing.

**Table 2. IRA allocation by LGU: before and after LGC 1991**

| | 1. By type of LGU | | 2. By economic attributes | |
|---|---|---|---|---|
| Before LGC 1991 | Provinces | 27% | Population | 70% |
| | Cities | 22% | Land area | 20% |
| | Municipalities | 41% | Equal sharing | 10% |
| | Barangays | 10% | | |
| After LGC 1991 | Provinces | 23% | Population | 50% |
| | Cities | 23% | Land area | 25% |
| | Municipalities | 34% | Equal sharing | 25% |
| | Barangays | 20% | | |

While all local government units benefited from the higher grant resulting from the doubling of the IRA share on an expanding internal tax base, cities and barangays were generally favored in relative terms. Legislators and governors are natural political adversaries, except in some dynastic cases (husband and wife, or father and son/daughter teams), hence legislators consciously provided less resources to provinces than what they deserved. One can argue that from a purely economies-of- scale argument, a province or a municipality should get a bigger allocation of resources than a city and a barangay. A city has a more developed tax base and is more economically developed, and hence deserves less grants from the central government. The barangay, the smallest unit of government, do not have the administrative machinery to deliver government services efficiently.

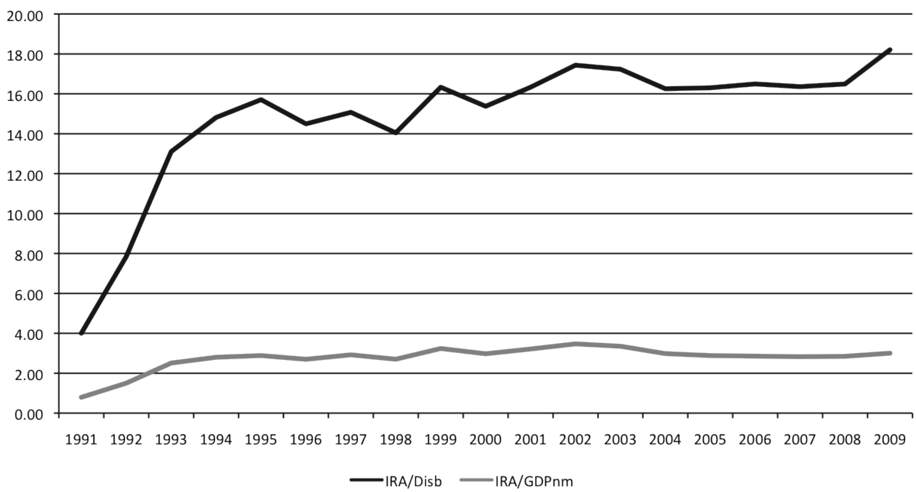


**Figure 1. Rapid rise in internal revenue allotment (In percent of total disbursement and GDP [nominal])**

The IRA has increased exponentially in the first few years of decentralization and has remained to be a significant portion (slightly less than 18 percent of total disbursements), and about 3 percent of nominal gross domestic product (GDP).

In 2012, the IRA will decline by Php 13.6 billion, from Php 286.9 billion in 2011 to Php 273.3 billion this year. This is because internal taxes declined in 2009.

## 3. What have we learned?

### *3.1. Rapid conversions of municipalities to cities*

During the last 20 years, there has been a rapid conversion of municipalities into cities. This is a logical response to the IRA formula. Seventy-two municipalities were converted to cities. This phenomenon imposes no additional financial burden on the national government.

But there are "losers" and "winners" as a result of the rapid conversion of towns to cities. The big winners are the newly converted cities; the big losers are the "old" cities that have to settle for a lower grant allocation. Specifically, a municipality that has become a city would have a bigger IRA share—from 1/1496 x 0.34 x total IRA to 1/138 x 0.23 x total IRA. An old city, say, one of the original 66 cities, would have a lower IRA—from 1/66 x 0.23 x total IRA to 1/138 x 0.23 x total IRA. There are no additional costs to the central government since the formula is a zero-sum game.

### *3.2. "Creeping" reverse decentralization*

Reverse decentralization can be observed in two of the three major departments that were devolved in 1999: the Department of Health (DOH) and the Department of Social Welfare and Development (DSWD). Hospitals that were originally devolved to local governments have been renationalized. A new and enormously large program—the conditional cash transfer (CCT), about Php 39 billion in 2012—is now being administered by the DSWD. This is a major departure from previously existing policy recognizing social welfare as a devolved responsibility.

*DOH.* There has been increasing recentralization of devolved hospitals. This imposes potentially large additional costs on the near- and long-term finances of the national government.

The big "winners" are local governments whose constituents would enjoy hospital services without appropriating local resources for the purpose. For example, the budget of a devolved hospital, which used to be funded by a provincial or city government, will, through the process of recentralization, be funded by the central government.

The budget of the DOH has grown considerably in recent years to finance health insurance.

*DSWD.* Social welfare is one of the three major expenditure responsibilities devolved to local governments in 1991. The transfer of social welfare responsibilities has been the least disruptive of all devolved functions. In recent years, there has been a creeping recentralization of social welfare services with the increased allocation for the CCT program.

### *3.3. Public spending at central level has more than recovered for two of five devolved agencies: Department of Agriculture (DA) and DSWD*

In terms of budget shares, the clear outlier is the DSWD, whose budgetary allocation has grown exponentially in recent years—but especially so in 2010 and 2011, and likely in the foreseeable future.

**Table 3. Budget shares of devolved agencies before and after decentralization (In percent of total expenditures net of debt service)**

| Offices | 87- 91 | 1999 | 2000 | 2001 | 2003 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|
| DA | 2.80 | 3.37 | 0.67 | 0.71 | 0.60 | 3.57 | 2.80 | 2.53 |
| DBM | 0.30 | 0.10 | 0.09 | 0.12 | 0.08 | 0.08 | 0.14 | 0.06 |
| DENR | 2.30 | 1.24 | 1.22 | 1.31 | 1.12 | 1.12 | 0.95 | 0.83 |
| DOH | 5.10 | 2.58 | 2.20 | 2.01 | 1.87 | 2.50 | 2.05 | 2.38 |
| DSWD | 0.58 | 0.40 | 0.43 | 0.34 | 0.40 | 0.94 | 1.29 | 2.46 |

Source: Department of Budget and Management, Budget of Expenditures and Sources of Financing, various issues.

The budget shares of the Department of Budget and Management (DBM) and the Department of Environment and Natural Resources (DENR) have contracted significantly and have remained low, compared to their levels before the LGC of 1991 was passed. The creeping recentralization of the DOH and the DSWD is reflected in the sharp rise in their respective budget shares. In the case of the DOH, the rise is driven by higher spending for health insurance.

The increased budget share of the Department of Agriculture was in response to the series of natural calamities in recent years, which needed massive reconstruction of damaged farms and irrigation facilities, and the need to address the food crisis, including the importation of rice.

### *3.4. Decentralization has resulted in a leaner bureaucracy, except for DENR and DA*

Has there been a downsizing of the size of central government agencies whose responsibilities were devolved to local governments?

Column 1 of Table 4 shows the permanent positions before the Local Government Code of 1991 was passed. Column 2 shows the number of devolved personnel. As the numbers suggest, the devolution of functions was serious, with the DOH having the highest number of personnel devolved to LGUs, followed by the DA, and then by the DSWD. Column 3 shows the number of permanent positions after the devolution, while column 4 shows the permanent positions as of 2011. A comparison between column 3 and column 4 suggests the extent of downsizing.

In the case of the DBM, the size of its permanent staff was cut by more than half (51.3 percent). Local budget officers were returned to their respective local units (provinces, cities, and municipalities). In 1987, in an apparent political move, and through an executive order that had the effect of a law, local budget officers were reassigned and were placed under the direct supervision of the Budget and Management secretary. In the spirit of local autonomy, the local budget-officer positions were returned to local chief executives who now exercise the power to hire and fire local budget officers.

The DENR is a major outlier—expanding rather than contracting its personnel. This may be explained by the expansion of responsibilities assigned to the central government—for example, the Clean Air Act. Still, one may argue that the DENR may be overstaffed.

**Table 4. Downsizing of some central government agencies**

| | Personnel before the LGC 1991 (1) | Devolved personnel (2) | Net of devolved personnel (3) | Permanent positions 2011 (4) | Percent change (5) |
|---|---|---|---|---|---|
| DA | 29,638 | 17,673 | 11,965 | 12,614 | 5.4 |
| DBM | 3,532 | 1,650 | 1,882 | 916 | -51.3 |
| DENR | 21,320 | 895 | 20,425 | 21,960 | 7.5 |
| DOH | 74,896 | 45,896 | 29,000 | 29,106 | 0.4 |
| DSWD | 6,932 | 4,144 | 2,788 | 2,758 | -1.1 |

Source: Department of Budget and Management, Staffing Summary, various issues.

How can the DSWD manage to keep its permanent staff in the face of expanding responsibilities such as the CCT program? Apparently, the implementation of the CCT program has been done through nonpermanent staff and through the use of private contractual services.

Overall, the process of devolution has resulted in a leaner bureaucracy, with the exception of the DENR and the DA.

### *3.5. LGUs' dependence on IRA has increased*

The higher, predictable, formula-based, and mandatory grant system has resulted in heavier dependence of LGUs on the IRA. LGUs have never had it so good. Instead of being "stimulative"—that is, motivating local authorities to raise more local resources to complete central government grants—the IRA, for most local governments, has become a substitute for raising their own taxes. What has emerged is a pattern of total dependency. For many provinces and municipalities, the IRA has accounted for more than 90 percent of their financial resources.

In 2008, IRA accounted for 78.5 percent of total revenues for municipalities, 43.3 percent for cities, and 73.6 percent for provinces. In 2010, the percentage shares are 78.6 percent, 49.6 percent, and 74.5 percent, respectively. For all LGUs, the dependence has deepened, with cities showing the most severe deterioration.

**Table 5. Sources of LGU funds (In percent of total revenues)**

| | 2008 | | | 2009 | | | 2010 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Mun | Cities | Provs | Mun | Cities | Provs | Mun | Cities | Provs |
| Local sources | 16.9 | 50.1 | 11.1 | 15.7 | 47.0 | 11.1 | 17.0 | 46.0 | 10.5 |
| RPT | 2.7 | 12.0 | 3.0 | 2.6 | 12.7 | 3.5 | 2.9 | 12.3 | 5.6 |
| Business | 4.4 | 8.6 | 3.1 | 4.1 | 8.5 | 3.7 | 4.4 | 8.3 | 3.5 |
| External sources | 80.6 | 44.9 | 86.7 | 82.2 | 48.2 | 86.7 | 81.1 | 50.9 | 88.6 |
| IRA | 76.5 | 43.3 | 73.6 | 78.7 | 46.2 | 79.7 | 78.6 | 49.6 | 74.5 |

Source: Bureau of Local Government Finance, Department of Finance.

### *3.6. LGUs' spending for social services declined, even as spending for general public services rose*

A review of the pattern of local government expenditure from 2001 to 2008 suggests misplaced priorities. General public services rose, while the allocation for social services and economic services declined. A catchall expenditure category, Other Purposes, was also on the rise, suggesting an increasing opaqueness of the local budget process.

**Table 6. Uses of funds: misplaced priorities**

| Budget shares | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| General public services | 40.5 | 41.3 | 40.4 | 40.0 | 39.6 | 40.4 | 41.7 | 44.1 |
| Social services | 26.2 | 25.6 | 22.8 | 22.1 | 21.8 | 21.1 | 20.8 | 20.3 |
| *Education* | 7.1 | 6.5 | 6.8 | 6.6 | 7.0 | 6.9 | 6.5 | 5.9 |
| *Health, nutrition & pop.* | 11.5 | 11.7 | 10.9 | 11.0 | 10.2 | 9.8 | 9.8 | 9.8 |
| *Labor & employment* | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| *Housing & com dev't.* | 4.4 | 4.4 | 2.4 | 2.1 | 2.2 | 2.0 | 2.0 | 2.1 |
| *Social services, welfare* | 3.0 | 2.8 | 2.8 | 2.4 | 2.4 | 2.4 | 2.4 | 2.4 |
| Economic services | 18.6 | 16.7 | 15.8 | 15.8 | 15.8 | 15.0 | 15.2 | 15.1 |
| Debt servicing | 2.4 | 2.4 | 2.9 | 2.7 | 3.3 | 3.2 | 3.2 | 3.3 |
| Other purposes | 12.4 | 13.9 | 18.1 | 19.4 | 19.6 | 20.3 | 19.0 | 17.2 |

Source: Bureau of Local Government Finance, Department of Finance.

The budget share of general public services rose from 40.5 percent in 2001 to 44.1 percent in 2008, suggesting that an increasing part of the local budget is being used for general administration. The rise in the budget share of the category Other Purposes, from 12.4 percent in 2001 to 17.2 percent in 2008, may be interpreted as increase in administrative overhead, and certainly not for social and economic services.

The budget share of social services contracted from 26.2 percent in 2001 to 20.3 percent in 2008. The budget shares for specific activities like education, health, nutrition and population, labor and employment, housing and community development, and social welfare services all declined: education from 7.1 percent to 5.9 percent; health, nutrition and population from 11.5 percent to 9.8 percent; and social welfare services from 3.0 percent to 2.4 percent. These three expenditure categories are expected to grow with population growth. The fact that their budget shares fell in the face of rising population suggests deterioration in the provision of social services at the local levels.

### *3.7. Fragmentary evidence suggests an overall deterioration in the delivery of essential public services*

A recent World Bank Public Expenditure Review (WB-PER) finds that "decentralization in the Philippines has not played an important role in reducing geographic disparities and instead may be exacerbating them" [World Bank 2011:82].[3] This, despite the fact that the internal revenue allotment system is mildly equalizing. To be fair, the development of backward regions is not an expressed intention of the 1991 Decentralization Act.

On health performance, a devolved function, the WB-PER finds the following:

- Health indicators that can be directly attributed to the role of the health sector, such as immunization rates, have not been converging.
- The most impressive case of convergence can be seen in infant and child mortality rates. Between 1990 and 2006, infant mortality rates for the Philippines as a whole fell from 57 (per 1,000 live births) to 23. These improvements were widespread but the fall has been more rapid for regions with low initial conditions.
- Access to safe water supply and sanitary toilets across regions seemed to converge until 2003-2004 and has diverged since then. This suggests policy neglect after 2004. The conclusion is that there is no convergence (except in infant and child mortality rates), and where there was convergence, such was not sustained.
- "Two decades into decentralization, regional inequality remains stark in the Philippines" [World Bank 2011:88]. To be fair to local authorities, poverty reduction is not one of the expressed reasons for decentralization in the Philippines. Theory and practice support the view that poverty reduction or equitable distribution of income is best done at the national level.
- "Local roads, an LGU responsibility, are also highly unequally distributed across regions and inversely correlated with the poverty rate" [World Bank 2011:89]. This may be because congressional "pork" and Department of Public Works and Highways (DPWH) allocations gravitate

[3] The convergence analysis uses the region as the main level of analysis since provincial-level data are not available. It is argued, however, that differences across provinces are even higher as regions moderate inequality across provinces.

to regions with higher per capita incomes or to regions with greater concentration of voters.

- "Devolution has not improved service delivery." There are some examples of well-managed local governments. But they are more an exception rather than the rule. A World Bank study on decentralization presents a simple Human Development Index (HDI) transition matrix, which indicates whether provinces grouped by their HDI scores in 1990 progressed, regressed, or stagnated over the following ten years. Of the 74 provinces analyzed only 8 managed to improve their scores enough to move up to the next higher cohort, while 3 provinces actually registered lower HDI scores.

Another study found that growth in provincial income after decentralization has had a weak impact on poverty reduction, suggesting that LGUs have been unable to translate growth at the provincial level into poverty reduction through more effective service delivery [Balisacan, Hill, and Piza 2008].

Decentralization has not conclusively improved governance. Theory argues the gains in governance from decentralization. A study of the Philippines and Indonesia finds that "not surprisingly, in neither country has decentralization fulfilled the governance goal predicted by the most optimistic theories" [Campos and Hellman 2005]. In the Philippines, which has a longer record of decentralization, the picture is more mixed. Overall, perceptions of corruption have declined, and service delivery standards have improved somewhat. However, the link between these outcomes and improvements in the accountability of local politicians is weak.

## 4. Where do we go from here?

### *4.1. Fiscal decentralization challenges in an uncertain world*

The decision to decentralize or not has to be consistent with the societal goals of any government. Decentralization is a journey of a thousand miles. Embarking on such a journey should be carefully planned if such policy would detract from other policy objectives. Should decentralized governance take precedence over more effective and more equitable delivery of social services? How about meeting the Millennium Development Goals? Should decentralization take precedence over fiscal sustainability and social progress?

The Great Recession[4] has negatively affected the fiscal health of many countries. The "before-and-after" comparison of fiscal balance of East Asia and Pacific suggests the extent of fiscal deterioration. And the global crisis is not over yet. The fiscal deterioration has been quite severe for Cambodia, Fiji, Laos, Malaysia, Mongolia, Papua New Guinea, Philippines, Thailand, and Vietnam.

The ongoing major global recession may have changed the speed of decentralization in many parts of the world. The push for fiscal decentralization may have to take a backseat as the government addresses the problem of fiscal sustainability and poverty reduction. The argument here is that many countries, the Philippines included, may face fiscal problems moving forward, and that income redistribution is best addressed under a centralized, rather than a decentralized, regime.

The impact of global crisis and its subsequent effect on the fiscal health of many governments are twofold. First, it will result in lower spending for practically all sectors. Second, the depreciated level of public resources will result in lower grants, in any form, to local governments. A combination of both would seriously reduce spending for all countries, some more acutely than others, depending on the country's demographic characteristics. Countries with a young population like the Philippines, Vietnam, and Cambodia will suffer, as will countries with an aging population such as China, Japan, and European countries. On the tax side, the need to repair the run-down fiscal house may require higher taxes and social security contributions, hence effectively reducing the disposable income of households.

As a result of the ongoing global crisis, pushing decentralization policies forward has become more challenging. Some governments should choose between fixing their long-term fiscal problems or pushing forward decentralization reforms. For some, the focus should be first on fiscal sustainability and better delivery of public services before fiscal decentralization.

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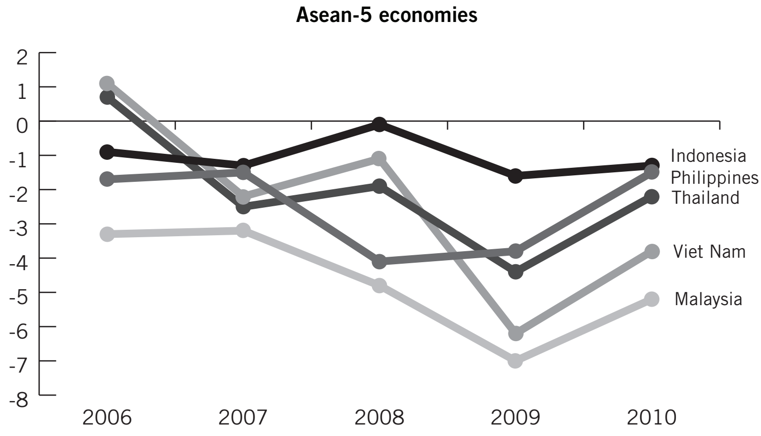
[4] The global economic crisis, the second worst since the Great Depression of the 1930s, started as a housing and financial crisis in the United States in 2008. The crisis has engulfed the whole world. There was a relatively quick recovery after coordinated and synchronized efforts by major industrial countries and large developing economies. But the recovery appears to be short-lived, as another round of economic slowdown, potentially a recession, has emerged. Many major European countries face serious debt and deficit problems.



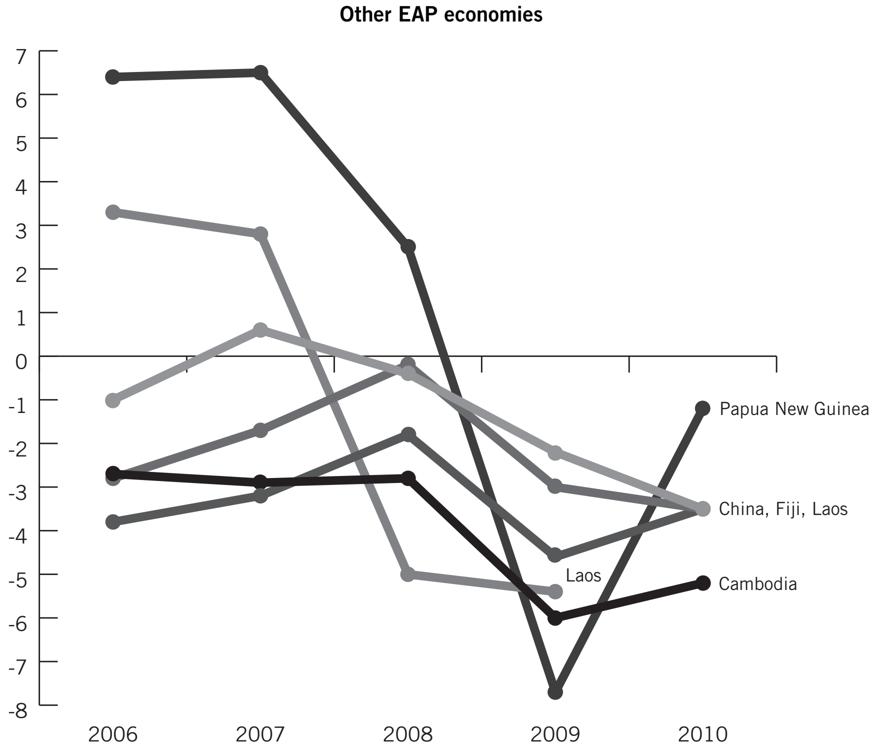




**Figure 2. Fiscal balance: selected East Asia and Pacific (EAP) economies (In percent of GDP)**

While the current formulation of the IRA is mildly equalizing, it needs further enhancement. But any attempt to change the present IRA formula is unlikely to succeed. Any equalization grant, which should be in the form of a specific grant with matching component, may be incorporated in the annual budget. This appears to be the best solution.

Mechanisms for holding elected local authorities accountable for performance, currently virtually nonexistent, should be strengthened. This requires better—meaningful, synchronized, consistent, and timely—information to be gathered systematically by designated government agencies. Local chief executives should be required to submit a report on the key outputs and outcomes in the core areas of devolved services.

In the spirit of transparency and fiscal accountability, annual and quarterly fiscal data should be disaggregated by region, province, city, sector, and expense class (economic classification). The new data system should have the following characteristics:

- All national and local data should be consistent with the International Monetary Fund–Government Finance Statistics (IMF-GFS) (1986/UN's Classification of Functions of Government [COFOG]) categories.
- National government expenditures should be disaggregated by region, province, and city.
- The expenditure reports prepared by the Commission on Audit (COA), the DBM, and the Bureau of Local Government Finance (BLGF) should be made consistent. COA reports expenditures by economic class (wages, capital spending, etc.) whereas the BLGF reports expenditures by functional categories (general public services, health, education, etc.).

An officially designated academic institution or government think tank should prepare annual indices of performances, similar to the World Bank's Governance Index, for each province, city, and first-class municipality based on the revised national and local fiscal statistics. The report will be published online. It is hoped that citizens would use the report to hold their chief executives accountable for their performance and in deciding whether to move from or stay in their present local communities. In addition, the National Statistics Coordination Board, working closely with the BLGF and the COA, should publish an annual Local Fiscal Statistics series as part of its regular statistics gathering and compilation responsibilities.

## 5. Final words

The Local Government Code of 1991 has provided local governments significant resources through the IRA and through delegated taxing powers to carry out limited expenditure responsibilities. But an unwanted consequence of the IRA is the rising dependence on it by local governments, especially provinces and municipalities.

Some anecdotal evidence supports the view that there have been improvements in public services in some local communities. The overall consensus, however, is that there has been no improvement, or even serious deterioration, in the delivery of local public services and in governance.

The falling shares of local expenditures devoted to devolved activities may be attributed to the creeping recentralization of devolved agencies (DSWD and DOH), the rising substitution of centrally controlled funds (for example, congressional "pork") for local funds, and misplaced priorities on the part of local authorities.

The missing link in the higher and better delivery of devolved activities is the process of accountability for the performance of local authorities. The electoral process has failed to hold local authorities accountable for their fiscal behavior.

The next challenge for fiscal decentralization is how to generate timely, relevant, and consistent information and indices of performance to be put together by an unbiased institution but funded by the government. The performance rating shall be used by voters in evaluating the performance of their local officials.

The current economic crisis and the threat of a fiscal crisis down the road, and rising poverty may limit moves to increase the level of intergovernmental grants to local governments. What should be the government's priority: fiscal sustainability or higher IRA? In the face of rising or, at best, stagnating poverty, what should be the government's priority: reducing poverty or deeper fiscal decentralization?

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