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The assignment of functions and intergovernmental fiscal relations in the Philippines 20 years after decentralization

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The 1991 Local Government Code devolved substantial spending, taxing, and borrowing powers to local government units (LGUs). Moving governance closer to the people can generate a welfare gain, but local governments must have adequate revenues to finance local development. The paper examines the current status of the tax-expenditure assignment and the intergovernmental fiscal relations, and identifies areas for reform. There is a need for a clearer and more accountable assignment of expenditure by eliminating particular sections of the code, which serve as a route for national government agencies to be engaged in devolved activities, and for politicians to insert funding for pet projects, which distort local decision making and preferences. There is need as well to review the tax assignment to improve local revenue generation. The allocation of intergovernmental fiscal transfers may be improved by introducing matching grants to improve equalization transfers to local governments, and performance-based grants to motivate greater local revenue mobilization. Without a clear funding source, unfunded mandates imposed on local governments defeat the purpose of the policy objectives set in those mandates. Local government alliances and cooperative undertaking may provide public goods with interjurisdictional spillover benefits. Consolidation, better coordination of local government activities, and resource pooling for better local service delivery are pathways indicated by successful experiences of LGU collaboration.

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1. Introduction

Local government units (LGUs) must have adequate revenues to finance their expenditure assignment for fiscal decentralization to achieve its objectives. Moving governance closer to the people, following a well-designed decentralization, which makes local policies and programs reflect local preferences, can generate a welfare gain [Bahl 2008a]. This is the well-known economic efficiency argument for fiscal decentralization as pointed out by Oates [1972] and Tanzi [1995], among others. However, while local governments have the information advantage suitable for discovering and responding to local preferences, not all local governments can turn this "information advantage into an efficiency advantage."[1] Lack of technical and financial capacity to administer the local government, to develop practicable local development plans, and to implement projects may constrain the efficient delivery of services.

There are political reasons as well behind decentralization, which is considered an important element in a strategy of people empowerment [McLure and Martinez-Vasquez 2008]. 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]. 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] because of the opportunity for local people to chart the course of local development. Fiscal decentralization and devolution potentially can make it possible for good economics and good politics to converge, although decentralization is not without its critics (e.g., Prud'homme [1995]).[2]

The 1991 Local Government Code (LGC) has provided local government units with extensive taxing, spending, and borrowing powers and authority. Although the code has weaknesses, which a number of

[1] http://www1.worldbank.org/publicsector/decentralization/what.htm. Accessed 12 February 2012.

[2] I will not discuss the pros and cons of fiscal decentralization. The reader is referred to the vast literature on the subject—for example, Prud'homme [1995] and Tanzi [1995], among others.

proposed legislative bills are attempting to cure, overall it can be lauded for stating in unmistakable terms functional responsibilities for local governments to discharge. With the LGC, the government has conformed to the first fundamental requirement of a well-designed decentralization: a clear assignment of functional responsibilities among different levels of government. McLure and Martinez-Vasquez [2008] argued that a well-defined institutional framework in the assignment of expenditure responsibilities, together with sufficient budgetary autonomy, is required for a stable and meaningful decentralization.

A review of 20 years' experience with decentralization in the country shows mixed results in terms of the achievement of local fiscal autonomy and the efficient delivery of local public goods and services. While there is anecdotal evidence of local development being spurred by decentralization policies,[3] many local government units have failed to improve local service delivery, and this has been chiefly blamed on the insufficiency of local revenues. Own-source local revenues and the intergovernmental fiscal transfers comprising a block unconditional grant called the internal revenue allotment (IRA) and conditional grants are the two principal sources of local revenues. Faced with a growing population, which demand more and better-quality services, LGUs are hard-pressed looking for additional sources of revenues to finance local development expenditures. Policy makers trying to address the mismatch between local expenditure responsibilities and revenue sources have come forward with various proposals to increase local revenues. Those proposals call for an amendment of the 1991 Local Government Code.

The intergovernmental fiscal transfer, which is mainly the IRA, has been the main instrument for addressing the vertical fiscal gap. LGUs, mostly provinces and municipalities, have depended on the IRA for financing local development. Most legislative bills intended to increase local revenues gravitate around proposals to increase the IRA and to change the distribution formula in favor of provinces, municipalities, or barangays. Capuno, Manuel, and Salvador [2002] observed that a common denominator of various proposals to amend the code, including the Consensus Policy Statement on Proposed Amendments to the Local Government Code of 1991 of the three major leagues of local governments in the Philippines,

[3] For example, the awards given to local governments by award-giving bodies, such as Galing Pook Foundation, are often given as proof that decentralization has improved local governance, service delivery, and people's participation in the local polity.

is the augmentation of the local governments' share in the IRA. On the other hand, there are suggestions for greater tax decentralization in order to give LGUs greater fiscal autonomy. Others suggest using performance-based grants to augment local fiscal resources.[4] Another complexity in decentralization and devolution of service delivery is that local governments have different resource bases for funding services. Bird [2008] notes that where interjurisdictional disparities are glaring, more decentralized taxes often require increased balancing transfers to poorer localities. Indeed, improving the efficiency of fiscal decentralization is one of the most significant and pressing issues of public policy in the country today.

In this light, the objectives of this paper are twofold: (a) to examine the current status of the tax-expenditure assignment, intergovernmental fiscal relations, and service delivery; and (b) identify areas for reform. There is a great need for greater efficiency in local public finance and greater accountability on the part of local government units. Local government officials must be held responsible for the quality of public service provided to local citizens.

The paper is organized as follows. After a brief introduction, section 2 discusses the efficiency of tax-expenditure assignment and the role of intergovernmental fiscal transfers. Section 3 examines how well LGUs performed their assigned functions and how the devolved national agencies (Department of Health, Department of Agriculture, etc.) play their post-devolution roles. Section 4 looks at the vexing issue of unfunded mandates and describes attempts of LGUs to deal with interjurisdictional spillovers and economies of scale at the local level. Section 5 provides concluding remarks and some recommendations for future reforms.

2. Efficiency of tax-expenditure assignment and the role of intergovernmental fiscal transfers[5]

2.1. On the expenditure assignment

Decentralization of fiscal activities can improve the allocation of public spending by making it more consistent with local preferences [Tanzi 1995]. By providing a menu of local outputs that reflects the varying wishes and

[4] The Department of the Interior and Local Government (DILG) has successfully convinced the Department of Budget and Management (DBM) to introduce a performance challenge fund for local governments in the budget.

[5] This section draws from Llanto [2011].

conditions in local areas, decentralization can enhance allocative efficiency [Oates 1996]. This is done by assigning the delivery of public goods and services to the lowest tier of government feasible following Oates's decentralization theorem.

The assignment of functions is inefficient if there is ambiguity in the assignment and if vertical and horizontal fiscal gaps appear. The assignment of expenditure responsibilities to local governments when not supported by adequate revenues holds back service delivery to the local populace, and creates social tension in the affected local areas. Bahl is emphatic on the deleterious effect of a vertical imbalance, which can "seriously compromise the intergovernmental fiscal system" [2008b:9]. An "over-assignment" of expenditure responsibilities relative to resources leads to failure to deliver quality service or even nondelivery of services, which both undermine the level of welfare of local citizens.

While there is no single best assignment of expenditure responsibilities [McLure and Martinez-Vasquez 2008], a practical advice in assigning them is to follow the rule of "finance follows function". It is fundamental to have a clear and concrete assignment of functions and responsibilities to local governments and to support these with adequate revenues. Table 1 shows the expenditure assignment under the 1991 Local Government Code.

Local governments have devoted the biggest part of local budgets to general public services, which cover general administration such as executive and legislative services, treasury, assessment, budgeting and auditing services, property and supply administration, and information services. The second biggest portion is expenditure for economic services, which include agricultural, veterinary, and natural resource services; architectural and engineering services; operation of local enterprises such as markets, slaughterhouse, transportation, and waterworks, among others; cooperative programs; livelihood projects and other economic development programs. The rest of the budget is spent on health and nutrition, and population management, with smaller amounts directed to education, housing, social security, and local infrastructure. LGU spending has averaged at only about 3 percent of gross national product (GNP). Table 2 presents a distribution of LGU expenditure.

Table 1. Devolved functions of national government agencies

National government agency	Devolved function
Department of Agrarian Reform (DAR)	Land and home development improvement projects
Department of Agriculture (DA)	Agriculture and fishery extension services; regulation of agricultural and fishery activity; conduct of agricultural and fishery research; procurement and distribution of certified seeds; purchase, expansion, and conservation of breeding stocks; construction, repair, and rehabilitation of water impounding systems; support to fishermen, including purchase of fishing nets and other materials
Department of Budget and Management (DBM)	Local government budget officer services
Department of Environment and Natural Resources (DENR)	Forest management services; mines and geosciences services; environmental management services; reforestation projects; integrated social forestry projects; water rehabilitation projects
Department of Health (DOH)	Extension of medical and health services through provincial health office and district, municipal, and Medicare community hospitals; purchase of drugs and medicines; implementation of primary health care programs; field health services; aid to puericulture; construction, repair, rehabilitation, and renovation of provincial, district, municipal, and Medicare hospitals; provision for the operation of five-bed health infirmaries
Department of Public Works and Highways (DPWH)	Repair and maintenance of infrastructure facilities; water supply projects; communal irrigation projects
Department of Social Welfare and Development (DSWD)	Implementation of community-based programs for rebel-returnees; provision for the operation of a day-care center in every barangay; provision for poverty alleviation in low-income municipalities and depressed urban barangays
Department of Tourism (DOT)	Domestic tourism promotion; tourism standard regulation
Department of Trade and Industry (DTI)	Promotion and development of trade, industry, and related institutional activities
Department of Transportation and Communication (DOTC)	Telecommunication services; transportation franchising and regulatory services
Cooperative Development Authority (CDA)	Promotion, development, and regulation of cooperative functions; cooperatives field operations function
Housing and Land Use Regulatory Board (HLURB)	Regulation of human settlement plans and program functions
Philippine Gamefowl Commission	Regulation and supervision of cockfighting function

Source: Local Government Code of 1991.

Table 2. Distribution of total expenditure, all LGUs, 2001-2009

	2001	2002	2003	2004	2005	2006	2007	2008	2009
EXPENDITURES	100	100	100	100	100	100	100	100	100
General public services	40.51	41.34	40.41	40.02	39.63	40.36	41.74	44.14	53.91
Education, culture & sports / manpower Development	7.09	6.53	6.85	6.61	6.95	6.86	6.53	5.94	6.11
Health, nutrition & population	11.50	11.72	10.85	10.97	10.18	9.8	9.78	9.76	11.35
Labor and employment	0.16	0.15	0.12	0.06	0.07	0.07	0.07	0.06	0.07
Housing and community development	4.38	4.42	2.4	2.05	2.18	2.05	2.01	2.13	3.28
Social security / social services & welfare	3.02	2.83	2.57	2.39	2.39	2.35	2.45	2.41	5.16
Economic services	18.55	16.74	15.76	15.76	15.75	15.04	15.22	15.09	18.55
Debt service	2.41	2.39	2.87	2.73	3.27	3.21	3.23	3.29	1.59
Other purposes	12.37	13.88	18.18	19.42	19.59	20.26	18.97	17.17	0.00

Source: Bureau of Local Government Finance (BLGF).

Ostensibly the expenditure assignment appears to be consistent with the decentralization theorem [Loehr and Manasan 1999]. The code devolved certain activities that may be provided more effectively by local governments, with few activities giving rise to spillover benefits to those outside the political jurisdiction of LGUs (Manasan [2007a]; ADB [2005]). With a few exceptions in the environment and management of natural resources and basic education, it seems that the expenditure assignment in the code conforms to the criterion of a stable and formal assignment of responsibilities to the level of government that is most capable of delivering the service or public good. The code has correctly assigned to LGUs expenditure responsibilities whose benefits are confined within the territorial jurisdiction of local governments. In other countries, the lack of a stable and clear formal assignment has undermined the objectives of decentralization. McLure and Martinez-Vasquez [2008] indicated that the absence of a clear expenditure assignment, which led to weak decentralized systems and fiscally overburdened central governments, was a fundamental mistake of many Latin American countries.

However, various studies have pointed out that Sections 17 (c) and 17 (f) of the LGC, and Executive Order 53 have given national government agencies the excuse to implement devolved public works and infrastructure projects and other facilities, programs, and services provided these are funded under the General Appropriations Act (GAA), other special laws, pertinent executive orders, and those wholly or partially funded from foreign sources.[6] Gonzalez [1996] leveled a withering charge that these provisions and executive order paved the way for a two-track delivery system, where national government agencies implement devolved activities that rightfully fall under LGU domain. The accusation was directed at the agriculture and health departments, which had the most number of personnel and activities devolved to local governments but continue to engage themselves in those activities courtesy of Section 17 (c) and Executive Order 53.[7]

However, the current DOH stance seems far removed from the two-track delivery system noted by Gonzalez. An official of DOH pointed out that "there is no two-track system for health service delivery. As a matter of fact, the DOH has agreements with 77 provinces and ARMM on the specifics of health service delivery, which are renewed annually through Service Level Agreements and five-to-three-year province-wide investment plans for health (PIPHs), which started in 2007 and (in which) all LGUS were participating by 2010".[8] These were the mechanism through which the DOH has extended assistance to local governments in improving health service delivery. According to DOH, it is today more concerned with achieving universal health care and millennium development goals (MDGs) by 2013 and 2015, respectively. Section 33 can also be an opportunity for DOH to leverage resources into cooperative LGUs. In 2012, Php 9 billion out of Php 42 billion in the DOH national budget is allocated for local health services. The increase in the DOH budget since 2004 has gone mostly to LGUs, particularly for infrastructure improvement at the municipal and provincial levels.

One implication of these provisions of the LGC and Executive Order 53 is the enlargement of the budgets of certain devolved agencies—for example,

[6] This will be further discussed in section 3.

[7] The DA transferred to local governments 17,673 personnel (60 percent of total personnel) while DOH transferred 45,896 (61 percent of total personnel) according to the 1993 National Expenditure Program. The devolved agencies suffered budget cuts ranging from 20 percent to as much as 60 percent.

[8] Comments made by Dr. Juan Antonio Perez III (OIC, Director IV, Bureau of Local Health and Development, DOH) during the 1st PIPER Forum on January 16, 2012, at Crowne Plaza Hotel (source: transcription made by the PIPER secretariat).

DA, DOH, and DSWD (Manasan [2007a]; Capuno, Manuel, and Salvador [2002])—in order to carry on with certain devolved activities. Legislators have also used Section 17 (f) as legal basis for inserting a special provision in the GAA to fund their pet local projects. Legislators justify the pork barrel as an instrument to correct the misallocation of resources at the local level or, at the very least, to augment local resources. Critics view it as an instrument of political patronage, which can become an avenue for corruption at the local level.[9] It is noted that a directive in the GAA is to release funds to "projects that are identified by members of Congress". Loehr and Manasan [1999] looked at the insertions made into the General Appropriations Act as a case of coordination failure between Congress and LGU officials, but this has to be qualified because it is seems that members of Congress are in touch with local officials on the proposed insertion and eventual funding of legislators' pet projects. Section 3 below shows data on funding provided through the pork barrel of legislators mostly to municipalities. However, even assuming that coordination exists, the funding of local projects may not necessarily reflect local preferences but the self-promotion of legislators.

What is the verdict on expenditure assignment? It seems consistent with the decentralization theorem but it is inefficient. There appears to be a two-track delivery mechanism for certain devolved services in view of the incursion of some national government agencies into the delivery of devolved services through Section 17 (c) of the LGC and Executive Order 53, and of legislators through Section 17 (f) of the code.

2.2. On the tax assignment

Local government units must have both local fiscal autonomy and accountability to efficiently discharge their assigned functions and responsibilities. Thus, for effective fiscal decentralization local governments acting responsibly should be able to increase or decrease their revenues at the margin by means that make them publicly accountable for their actions Bird [2008]. The code has empowered LGUs 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

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[9] Referring to the serious problem of local funding, Guevara [2007:18] goes as far as saying that "there are other LGUs … whose first impulse is to run to donors and the legislature for countryside development fund (CDF)."The pork barrel was then known as the Congressional Development Fund. Today it is called the Priority Development Assistance—same dog, different collar.

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 levied on the gross receipts of businesses and traders.[10] Table 3 shows the tax assignment for local governments.

Table 3. Tax assignment for 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

Table 4 shows a disaggregation of the local governments' total income according to source. The main sources of local incomes are the IRA, property tax, the business tax, and service and business income from various local economic enterprises.

[10] The first tier of government is the central government, which operates through departments (ministries).The second tier of government is composed of LGUs and one autonomous region, the Autonomous Region in Muslim Mindanao (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—that is, they share the same functions and authorities. Independent cities are divided directly into barangays [Manasan 2005].

Table 4. Distribution of total income, all LGUs, 2001-2009

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Income	100	100	100	100	100	100	100	100	100
Local sources	32.50	31.36	31.56	32.96	34.53	34.33	34.23	33.18	31.96
Tax revenue	24.63	24.33	24.04	24.76	25.74	24.94	24.5	23.28	22.47
Real property tax	12.65	12.34	12.57	12.29	13.2	12.3	11.81	11.04	10.46
Business tax	10.35	10.55	10.1	11.12	11.06	11.19	11.26	10.7	10.75
Other taxes	1.62	1.43	1.37	1.36	1.47	1.45	1.43	1.53	1.26
Nontax revenue	7.88	7.03	7.52	8.19	8.8	9.39	9.73	9.91	9.49
Regulatory fees	2.01	1.83	1.97	1.93	1.94	2.05	2.13	2.01	1.95
Service/user charges	1.15	0.82	0.94	1.09	1.44	1.54	1.49	1.56	1.78
Receipts from economic enterprise	2.62	2.87	3.4	3.6	3.97	3.9	4.31	3.81	4.03
Toll fees	0	0	0	0.04	0.03	0.03	0.03	0.03	0
Other receipts	2.1	1.52	1.22	1.52	1.41	1.88	1.77	2.49	1.73
Shares from national tax	66.31	67.97	66.92	65.74	63.99	64.24	64.74	65.42	64.78
Internal revenue allotment	65.46	67.64	65.46	64.43	62.3	62.61	63.48	63.68	63.8
Other shares	0.86	0.34	1.47	1.31	1.69	1.63	1.27	1.74	0.98
Extraordinary receipts/aids	0.81	0.37	1.03	0.58	0.7	0.8	0.78	0.93	1.28
Interlocal transfers	0.37	0.3	0.48	0.73	0.77	0.63	0.24	0.46	1.98

Source: BLGF.

Locally generated revenues are basically the tax revenues and nontax revenues obtained from regulatory fees, service charge, income from local enterprises, and other receipts. The share of local own-source revenues and nontax revenues to total LGU income was at 62 percent in 1989, decreasing over time.[11] In 2009, it stood at about 32 percent. As IRA's share in the total LGU income increased through the years, tax revenue and nontax revenue shares have decreased. From 38 percent in 1989, tax revenue share dropped to about 25 percent in 2001, and to 22 percent by 2009. As for the nontax revenue, from 24 percent in 1989 it was down to 8 percent in 2001. Nontax revenue was at its lowest at 7 percent in 2002, then slowly picked up and

[11] The 1989 data are not shown in the table but available with the author.

was 9.5 percent by 2009. In general, there is a general downward trend in the contribution of total local tax and nontax revenues to LGU income and an obvious dependency on the IRA.

Tax assignment scores low on the fiscal autonomy criterion because (a) the code fixes the 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; and (d) the code mandates that tax rates can only be adjusted once in five years and by no more than 10 percent (Capuno [2001]; ADB [2005]; Manasan [2005, 2007a]; Uchimura and Suzuki [2009]; Llanto [2011]).[12] A popular view is that an inefficient tax assignment has constrained local government efforts to raise more own-source revenues. The more revenue-productive taxes have been retained by the central government even as the code has constrained the power of LGUs to set local tax rates (Manasan [2005, 2007a]; ADB [2005]). Some local governments have also complained about the seemingly inequitable access to local tax bases wherein one local government has been able to impose revenue-productive local business taxes on a private company while another local government is only able to impose relatively low property taxes on fixed assets of the same private company whose production unit is situated in the territorial jurisdiction of the latter (Box 1). The private company pays local business taxes to the local government where it maintains its head office. This same complaint is echoed in the case of power companies whose generating plants are subjected to real property tax in the province where these are located but whose energy sales or output are reported and taxed in the city where they maintain their headquarters. Local governments hosting the head offices of private companies have the advantage of generating much larger local tax collections because of a more productive tax base—that is, the sales reported by the private companies.

[12] Several legislative bills to improve the fiscal position of LGUs were filed at the 15th Congress over the period July 2010–June 2011—for example, House Bill 149 seeking to increase from the present 40 percent to 60 percent the share of LGUs in national internal revenues.

Box 1. Who gets to enjoy larger tax revenues?

San Miguel Corporation's largest brewery is located in Valenzuela City while the corporation maintains its head office in Pasig City.The only tax revenues that Valenzuela City derives from the corporation are real property taxes imposed on the fixed assets (brewery). Valenzuela does not collect much real property taxes because the brewery is rather old.

The huge sales amounting to billions of pesos of the corporation are reported and are taxed in Pasig City because the corporation is registered in that city. The mayor pointed out that the corporation's employees assigned to the brewery use Valenzuela City roads, use the city health centers, and send their children to the city schools, which are not compensated by the amount of real property taxes paid by the corporation.

Source: Transcript of Mayor Sherwin Gatchalian's comments made during the 1st PIPER Forum held in Crowne Plaza Hotel on January 16, 2012.

The broad taxing powers benefited the cities more than they did provinces and municipalities. The cities have larger tax bases and more buoyant revenue sources and also have 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 convince legislators to pass special laws converting them into cities. Provinces and municipalities have smaller tax bases and cannot raise sufficient own-source revenues except perhaps for municipalities belonging to the first- or second-income class. They have remained principally dependent on fiscal transfers, principally the internal revenue allotment for funding local development activities. 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]. The dependence on IRA results in weak local fiscal autonomy, which creates opportunities for greater control by the central government, contrary to the vision of local governments being able to respond to local needs and to match local outputs with local preferences. Some observers have noted how LGUs substituted the IRA for raising more own-source revenues, which is the more difficult path to follow in raising resources to finance development (Guevara et al. [1994]; Manasan [2005]; Sosmeña [2007]; Llanto [2011]).

The present tax-expenditure assignment has resulted in a significant vertical fiscal imbalance. The gap between total expenditure and total local income has widened 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. Total LGU expenditure is consistently larger than total LGU local own-source revenues and other local incomes. Without substantial intergovernmental fiscal transfers, basically the IRA, local governments would not have been able to finance development expenditures. Figure 1 compares total LGU expenditure, total LGU income without IRA, and total LGU income plus IRA.

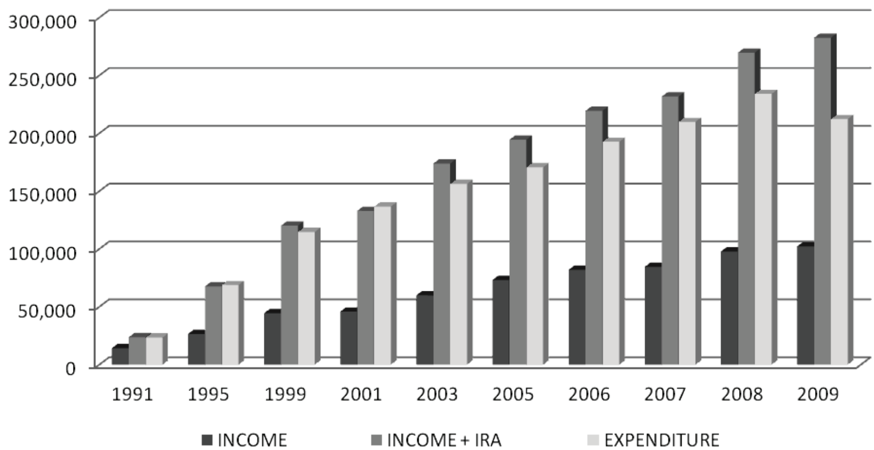

Figure 1. Total income with and without IRA vs. Total Expenditure, ALL LGUs, 1991-2009

To wean themselves away from national government control, LGUs should strive for greater fiscal autonomy by significantly improving own-source revenue collection. Without amending the code, there are many ways to increase own-source revenue collection—namely, (a) simplify the structure of local business tax to make it more convenient for local businesses to pay tax; (b) improve the tax administration by using certified public accountants to improve local tax audit capability; (c) use technology to improve revenue performance; and (d) update the schedule of market values for real property, which have remained untouched for so many years, among others. Local governments could also explore other types of levies such as user charges, betterment levies, and others to improve their fiscal position. This will require an information and education campaign on the user-pay principle among the local population.

It is about time for local governments to amend their respective local tax codes, which carry a wide range of taxes, fees, and charges that can be rationalized. Many of those local impositions are undercollected while some are low yielding, which does not compensate for collection and administrative costs. For example, in one city in the Visayas, there are more than 200 different rates for the mayor's business permit fee depending on the type of establishment. Likewise, local government tax administration should also be improved to increase tax collection. Local government tax administration capacity is constrained due to (a) low professional qualification and training of staff, (b) poor taxpayer registration systems, (c) low-quality record keeping, and (d) inadequate automation of core tasks [Niazi, Llanto, and Fabre 2010]. Thus, it is common to hear of the prevalence of stop filers, nonfilers, and late filers, and infrequent exercise of LGU audit and enforcement authority, which contribute to large tax delinquency and payment arrears, and limited availability of taxpayer services, which result in high taxpayer compliance costs [ADB 2005].

The inability to raise adequate local revenues is at the core of the problem of local government units in failing to efficiently deliver services. While weak local fiscal capacity may be attributable to the low tax effort of local governments, another contributing factor is central government control over major sources of tax revenues. Section 133 of the code provides a detailed list of revenue-productive taxes—such as the individual and corporate income taxes; customs duties; value-added tax; and the excise taxes on alcoholic beverages, tobacco products, and petroleum products—which remain under the control of the central government. Assigning more revenue-productive taxes to increase own-source revenues has been offered as a solution to weak local fiscal capacity. For example, LGUs may be allowed to impose excise taxes or fees on motor vehicle registration and impose piggyback rates on certain taxes [ADB 2005]. The assignment of more revenue-productive taxes to local governments makes sense in view of the requirements of local development.

However, the objectives of macroeconomic stabilization and redistribution of income have to be taken into account in a discussion of vesting local government with those revenue-productive taxes. The stabilization objective requires central control over taxes that may substantially influence central government budget deficits and inflation while the distributive function is an argument for centralized corporate income and wealth taxes [Fjeldstad 2001]. Another point is the fear that giving away taxing powers and excessive share of national revenues will erode the efficacy of fiscal policy as a national instrument [Smoke and Kim 2003]. A reality check is offered by Bird [2008]: the issue is so highly contentious and politicized that in practice the tax assignment is the result of political bargaining and compromise based on the country context. An example of a compromise is to allow LGUs some sort of tax base sharing—for example, a surcharge or supplementary rate on a national tax base—which tries to strike some sort of balance between the macroeconomic goals and the objective of improving local fiscal capacity.

What is the verdict on tax assignment? While the tax assignment is consistent with generally accepted canons of taxation it scores low in fiscal autonomy. The Philippine tax assignment appears to follow the traditional view of tax assignment for local governments but available evidence shows it is inefficient. The immediate effect of an inefficient tax assignment is a huge vertical fiscal imbalance. This leads to the need to have efficient intergovernmental fiscal transfers to address not only vertical but also horizontal fiscal imbalance. How the intergovernmental fiscal transfer mechanism may be improved is discussed in the following section.

2.3. On intergovernmental fiscal transfers

Because certain taxes are more efficiently collected by the national government, there will always be vertical imbalance [Schroeder and Smoke 2003]. Intergovernmental fiscal transfers are used to address a vertical fiscal imbalance arising from an inefficient tax assignment, and to correct a horizontal fiscal imbalance brought about by different fiscal capacities of local governments. The latter is an issue of equity because public policy may warrant that public goods and services should be accessible to all, regardless of the fiscal capacity of a local government, and should be given according to some minimum national standard that is uniformly applied to rich and poor local governments alike.

Intergovernmental fiscal transfers in the Philippines are broadly composed of (a) an unconditional, formula-based block grant called the internal revenue allotment; (b) share in national wealth and certain taxes; and (c) ad hoc conditional grants (Table 5).

Table 5. Fiscal transfers to local government units

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

Source: Llanto [2011].

2.3.1. Internal revenue allotment

Under Section 284 of the LGC, 40 percent of national internal revenues (in the third fiscal year prior to the allocation year) are transferred to local government units.[13] There are two stages for the allocation of the IRA: (a) distribution by levels of local governments (i.e., 23 percent to provinces, 23 percent to cities, 34 percent to municipalities, and 20 percent to barangays) and (b) division of the share of each level of government among individual local government units on the basis of population (50 percent), land area (25 percent), and equal sharing (25 percent). The IRA is the single, biggest source of revenues for the majority of LGUs, an unconditional block grant that allows LGUs full discretion in its utilization. The only restriction is that no less than 20 percent should be set aside and used to fund local development projects. The LGC mandates the automatic release of the IRA without need of any further action directly to the provincial, city, municipal, or barangay treasurer on a quarterly basis and not beyond five days after the end of each quarter. The IRA share of local governments may be adjusted by the president of the Philippines upon recommendation of the secretaries of Finance, Budget and Management, and Interior and Local Government, and in consultation with the House of Representatives, the Senate, and the leagues of local governments in the event that the national government faces an unmanageable public sector deficit.[14]

2.3.2. Share in national wealth and certain taxes

The LGC and other special laws provide local governments with a substantial share in national wealth and certain taxes. In 2012, these will amount to more than Php 16 billion, including prior years' obligations (Table 6). The share comes from revenues collected on the utilization and development of national wealth within the LGU's territorial jurisdiction (e.g., energy resources production, royalties from mineral reserves, and

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[13] The IRA was increased from 20 percent to 40 percent by the 1991 Local Government Code.

[14] Under this provision of the LGC, the central government may declare the existence of severe fiscal stress to justify the reduction in the IRA. Diokno [2003] gave the example of President Ramos's unilateral act through administrative fiat in December 1997 withholding 10 percent of the IRA without going through the process described above. Subsequently, the Supreme Court ruled that the president's unilateral act was "bereft of any legal or constitutional basis".

forestry charges); from other taxes, fees, and charges, including related surcharges, fines, and interests; and from coproduction, joint venture, or production-sharing agreement. Local governments also have a share in (a) value-added tax (VAT) (Republic Act [RA] 7643), (b) gross income taxes paid by all businesses and enterprises within the declared special economic zones (RA 7227 and RA 7916), (c) the franchise tax (RA 7953 and RA 8407), (d) the special privilege tax paid by mini-hydro electric power developers (RA 7156), and (e) the excise tax collection on locally manufactured Virginia-type cigarettes[15] (RA 7171 and RA 8424).

Table 6. Special shares of LGUs in the proceeds of national taxes, CY 2009-2012

Particulars	CY 2009 appropriations	CY 2010 appropriations	CY 2011 appropriations	CY 2012 appropriations
Tobacco excise tax per RA 7171 (Virginia tobacco)	500,000,000	4,085,882,000	3,567,394,000	4,731,464,000
Tobacco excise tax per RA 8240 (Burley and native tobacco)		1,165,434,000	271,914,000	1,117,650,000
Utilization and development of national wealth under RA 7160	607,053,000	1,254,564,000	1,513,655,000	
Utilization and development of national wealth under RA 7160 and RA 9513				2,455,267,000
Gross income taxes paid by all businesses and enterprises within the Ecozones per RA 7227	156,000,000	133,649,000		
Gross income taxes paid by all businesses and enterprises within the Ecozones per RA 7922 and RA 8748			15,736,000	111,055,000
Value added tax per RA 7643	5,433,000,000	1,862,257,000	381,000,000	2,100,000,000
Value added tax in lieu of franchise tax pursuant to RA 7953 and RA 8407	56,514,000	31,214,000	6,945,000	22,577,000
2% special privilege tax (hydroelectric) per RA 7156	12,000,000		9,919,000	37,318,000
Prior years' obligation	4,296,706,000	5,630,463,000	6,104,563,000	6,104,564,000
Total	11,061,273,000	14,163,463,000	11,871,126,000	16,679,895,000

Source: GAA 2009-2012.

[15] Given only to the four Virginia tobacco-producing provinces in Northern Philippines.

2.3.3. Ad hoc conditional grants

Other sources of grants and funding for local projects are (a) the insertions made by members of Congress in the GAA to fund local projects, authorized under Section 17 (f) of the code; (b) funds made available to LGUs or spent for local activities by central government agencies, following Section 17 (c) of the LGC and Executive Order 53; and (c) grants coming from other sources such as donor agencies, made available as technical assistant grants or funding grants for certain donor-driven projects.

The problem with conditional grants is that they are available depending on the fiscal position of the national government and/ or satisfaction or adherence to political objectives of legislators and the central government agencies, which are still engaged in devolved functions. For example, the Local Government Service Equalization Fund (LGSEF) created by Executive Order 48 of 1998 during the Estrada administration was carved out of the IRA, which diminished the block grant to LGUs in that year. The national government later discontinued the LGSEF. Legislators tend to favor local projects that enhance their political stock. Through congressional insertions in the GAA the legislator substitutes his own preferences to those of the local government units. Because of the information advantage, the LGUs have a better idea of what programs, projects, and activities are responsive to local preferences, which potentially will enhance local welfare, but these give way to the politicians' proclivities aided by the power over the purse.

2.3.4. Issues on improving intergovernmental fiscal transfers

At the onset it is essential to recognize the difficulty in designing intergovernmental fiscal transfers in view of different and sometimes conflicting objectives, and in formulating the mechanism or allocation rule to meet those objectives. In the Philippines, the major instrument of fiscal transfers, the IRA, addresses the twin objectives of correcting vertical and horizontal fiscal gaps at the same time. The IRA has been inefficiently used as a single instrument to address two different objectives. The selection of appropriate allocation criteria is a difficult exercise, and measuring them appropriately can be even more problematic [Smoke and Kim 2003]. Each country decides on particular weights to be given those objectives, and the design of the fiscal transfer program and the determination of the allocation rule are ultimately political decisions.

Intergovernmental fiscal transfers in the Philippines have been criticized for (a) the inadequacy of the IRA; (b) failure to equalize fiscal resources among LGUs such that disparities in fiscal capacities are not adequately addressed; (c) disincentive effects on local revenue generation; and (d) poor predictability in the size of the IRA, which undermines the ability of LGUs to effectively plan and manage their expenditures (Manasan [2007b]; Guevara [2007]). In the course of 20 years of decentralization, the IRA has shown itself to be the most critical fiscal instrument at the hands of local governments as shown by their dependency on it. Without substantial IRA transfers, many local governments would have been at a standstill. Thus, several proposals, some of them already in the form of legislative bills, have been submitted seeking to increase the IRA from 40 percent to as much as 60 percent of national internal revenues.

At 18.2 percent of the total expenditure budget of the national government in 2010, the IRA is the next biggest expenditure item after debt service payments. A substantial increase in the IRA share has serious implications on the fiscal position of the central government, on macro stability, and on the financing of the overall national development agenda. In the face of the politically popular proposal for an increase in the IRA share, a sober advice is to strike a balance among the redistributive, stabilization, and efficiency goals in the design of fiscal transfers.[16] Finding a compromise solution to meet conflicting objectives is not an easy exercise but ultimately it is a political decision. Nevertheless, policy makers should be mindful of Smoke and Kim's [2003] admonition to keep the politicization of the process from seriously undermining the fiscal and economic goals of transfers.

In a sober discussion of the issue of intergovernmental fiscal transfer, the total fiscal resource picture of local government, and the need to rationalize the deployment and use of those resources have to be considered. From a total resource picture, local governments are able to cover the vertical fiscal gap brought by an inefficient tax assignment. Table 7 shows the total resource picture for local governments based on available data in 2003.[17]

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[16] Bird and Smart [2002].

[17] The table is from Soriano et al. [2005]. Because of the time it will take to update this table, I decided to use Soriano et al.'s table for illustrative purposes. The data were assembled from various sources over a three-month period in 2005. The table reported 2003 data, signifying the difficulty of getting updated figures in 2005 when Soriano constructed the table.

Table 7. Total resource picture of local governments, 2003

Type of revenue	Size (billion pesos)	Size (million US$)	Share in percentage
I. LGU REVENUES			
1.1. IRA	141	2,601.50	69.2
1.2. LGU shares in other taxes	1.8	33.4	0.9
1.3. LGU tax revenues	42.1	775.9	20.6
1.4. LGU nontax revenues	13.1	241.2	6.4
1.5. Extraordinary receipts	1.8	33.2	0.9
1.6. Interlocal transfers	0.8	15.5	0.4
1.7. Borrowing	3.3	60.2	1.6
Total LGU revenues (1.1-1.7)	203.9	3,761.10	100
II. NON-IRA FUNDING			
2.1. Government-funded programs and projects (GFPP)	4.1	75.7	16.2
2.2. Congressional allocations to devolved functions (CA)	15.6	288.6	61.7
2.3. ODA loans and grant-funded transfers and spending on devolved functions (LGF)	5.4	100	21.3
2.4. Off-budget funding of devolved functions (OBF)	0.2	3.7	0.8
Total non-IRA funding of devolved functions (2.1-2.4)	25.4	468	100%
III. Total funds used on devolved functions (I + II)	229.3	4,229.10	100%
Part 1:Share of LGU revenues of total funds			89%
Part 2: Share of non-IRA funding for devolved functions of total funds			11%

Source of data: Soriano et al. [2005].

LGU financial resources come from different sources, with the IRA at around 89 percent being the biggest component. Local governments have full control of the IRA, which they use for general government administration and various development expenditures. Non-IRA resources, which are substantial in amount, comprise the remaining 11 percent. Non-IRA resources are composed of (a) local own-source revenues, including permits, income from economic enterprises, and other locally sourced incomes; (b) ad hoc categorical and conditional grants; (c) share in national wealth and certain taxes; (d) congressional insertions in the GAA for projects to be implemented at the local level; and (e) funds for devolved projects implemented by national government agencies. In contrast to full control of the IRA,[18] the non-IRA funding composed of congressional insertions, funds for devolved projects implemented by national government agencies, and ad hoc categorical conditional grants are allocated and spent locally through the legislators' intervention and control, through direct spending or transfers to local governments by national government agencies, and through the munificence of bilateral and multilateral donors, respectively. The question is whether it is efficient for certain central government agencies and legislators to continue with what they have been doing under Sections 17 (c) and (f) of the LGC, and Executive Order 53. Local governments should be able to exercise fiscal autonomy and management control over resources so that they may be able to be responsive to local preferences.[19] Given the fiscal implications of increasing the IRA, an expedient solution is to rationalize these non-IRA funds (except official development assistance [ODA] loans and grants, which are subject to specific covenants with bilateral and multilateral donors) to make them subject to local government control.

On the issue of equity of fiscal transfers, it was pointed out that the IRA distribution formula fails to consider the diversity in the needs and resources among LGUs, which is tantamount to distributing resources equally among LGUs, rich or poor alike [Guevara 2007]. It was also noted that the formula has been counter-equalizing with respect to the fiscal capacities of LGUs based on the finding that when all LGUs are aggregated at the provincial level, their combined per capita IRA is found to be positively related to per capita household income in 1995-1999 [Manasan 2007b], and that on a per capita basis, more allotments go to LGUs with higher per capita local revenues and higher per capita assessed value of real properties [Guevara et al. 1994]. There are two issues in the discourse: (a) horizontal inequity, which has resulted in cities enjoying bigger net resource transfers than provinces and cities as indicated in Table 8, and (b) the lack of an equalization feature in the distribution formula to address the vast differences in LGU fiscal capacities. Poorer LGUs—that is, municipalities with very weak fiscal capacities—receive smaller IRA than

[18] Subject only to the provision of the LGC that 20 percent be set aside for development spending.

[19] I return to these points in section 3 where the objectives of local autonomy and the principle of subsidiarity are pointed out as parameters for efficient decentralization.

the rich barangays in Metro Manila cities.[20] The poorest LGUs should have sufficient resources to be able to provide their constituents with a basic package of services that meets some national standard.

Table 8. Comparison between IRA shares and allocation of devolved services

Type of LGU	IRA allocation in percent	Devolved services in percent	
		Pardo's estimate	Manasan's estimate
Province	23	46	37.0
City	23	7	5.7
Municipality	34	47	38.5
Barangay	20	-	18.8

Sources: Pardo [2005]; Manasan [2007b].

It is easy to find fault with the current IRA distribution formula. Changing it will require a thorough design study (technical side) and a widely consulted selling job (political side) to get legislative approval of a new formula. The redesign of the IRA should take into account the following: (a) its disincentive effect on local revenue mobilization, which has led to IRA dependency; (b) an examination of the inefficient tax-expenditure assignment; (c) the IRA-driven incentive to convert municipalities into cities; (d) an examination of the "equal sharing" factor in the distribution formula; (e) the stability and predictability of the IRA; and (f) the political feasibility of a new formula. For lack of space, I provide only brief comments on the technical side of a possible IRA redesign and leave the political feasibility to the competent party, the politicians. A practical suggestion is to use whatever incremental amount is being considered—for example, 10 percent from the current 40 percent IRA share to a proposed 50 percent as a performance-based grant to local governments. This type of grant will be given to local governments conditional on the attainment of certain objectives: for example, substantial increases in own-source revenue collection, sustainable environment protection and management, significant reduction in child mortality rates, and so on. The idea is to recognize and reward local effort. The reexamination of the tax-expenditure assignment has to start with a study of Sections 17(c) and (f), and Executive Order 53. Who should provide what services and impose what taxes and how effectively can they do so? A general principle

[20] Guevara [2007] observed that far from providing more financial resources to LGUs with greater needs and lesser resources, the transfer system does the contrary.

to follow is that local governments need to control their own revenues in order to better implement their expenditure assignment. Any redesign of the IRA should take cognizance that the smaller number of cities has enabled each of them to enjoy a bigger IRA than municipalities, and this has driven municipalities to seek legislation converting themselves into cities. There must be a moratorium on city conversion until policy makers have carefully studied and seriously applied the criteria for conversion. The "equal sharing" factor in the current IRA distribution formula is regressive. There are suggestions to use a poverty index, human development index, or even a "resource indicator" [Guevara 2007] instead of using "equal sharing," which now stands at 25 percent, a substantial increase from 10 percent equal sharing before the code was passed. Under Guevara's proposal a "resource indicator" can direct IRA to LGUs with "limited taxable capacity due to the absence of taxable activities." The stability and predictability of the IRA are also another concern. Guevara [2007] cites as example of the lack of predictability of the IRA some anecdotal evidence of red tape, political partiality in IRA distribution, and control over the release of the IRA by requiring the submission of local Annual Investment Plans. The budget reenactments during the Arroyo administration led to the release of a smaller amount of IRA, while the computation of the IRA based on a three-year lag may likewise result in a smaller fiscal transfer. Guevara [2007] says that LGUs have to wait for three years before enjoying a revenue bonanza coming from a new tax measure—for example, the 2 percentage-point increase in the VAT. Policy makers have to examine an appropriate base for computation of the IRA.

A second-best approach with support from various sectors is to use matching grants that can be used by the poorer LGUs to deliver a basic package of services that meet some minimum standard. There is indeed a need to balance transfers to poorer LGUs. Although there is not one clear formula on how to rectify fiscal and horizontal imbalance, the use of performance-based grants or matching grant programs seem to find traction especially if the political economy setting does not ensure a technically and politically efficient outcomes.

What is the verdict on intergovernmental fiscal transfers? The fiscal transfers, basically the IRA, have performed well in closing the overall vertical fiscal gap. However, the distribution formula is regressive, meaning it favors the more financially capable cities. It has not achieved either its objective to equalize the fiscal capacities of local governments for service delivery. Matching grants could be a good mechanism to equalize fiscal capacities, and as well, performance-based grants could be used as positive incentive to local effort to improve governance, local revenue mobilization, and others. Potential instruments to motivate good behavior on the part of local governments include the following: rewards given to local governments for good performance as indicated in "report cards," matching grants to build more classrooms, and installing LGU score cards similar to "report cards". [21]

3. Post-devolution performance of local governments on service delivery

How well did LGUs perform their assigned functions? In general, because of much bigger resources transferred during the post-LGC period, local government spending has expanded dramatically. From an average of 1.6 percent of GNP in 1985-1991, local government expenditure increased to as much as 3.4 percent of GNP in 1992-2005. The share of local government expenditure in total government expenditure net of debt service rose from an average of 11 percent in the pre-LGC period to as much as 24 percent in the post-LGC period [Niazi, Llanto, and Fabre 2010]. Today local government expenditure stands at almost 2 percent of GNP, and 14.3 percent of total government expenditure. The major items of expense are social services (health and education), general public services, and economic services.

Table 2 shows the distribution of local government expenditure, with general public services comprising the biggest component. In 2009, this item, which may be considered overhead expense, amounted to as much as 54 percent of total local expenditure, leaving only a narrow window for more important expenditure items, such as economic services (19 percent); health, nutrition, and population (11 percent); education (6 percent); and housing and community services (3 percent). Twenty years after decentralization, there is a perception of a growing number of local governments performing well in various areas of service

[21] Professor Roberto de Vera (School of Economics, University of Asia and the Pacific) commented that "stakeholders in decentralization can push for legislation that rewards LGUs that present performance reports every six months which take the form of city report cards". Valenzuela City Mayor Sherwin Gatchalian reported that the Department of Education (DepEd) has a matching grant program wherein a local government can shell out funds matched by DepEd to build more classrooms. Dr. Juan Antonio Perez observed that the LGU scorecard that DOH has introduced would be used by the DOH particularly at the local level to see that the municipalities concerned move forward on health problems (source: Transcription of comments made during the 1st PIPER Forum, "Fiscal Decentralization After 20 Years: What Have We Got to Show? What Have We Learned? Where Do We Go from Here?", Crowne Plaza Hotel, January 16, 2012).

delivery as indicated, for example, by the recognition given to those local governments by award-giving bodies.[22] However, there is a large variation in local government performance in service delivery, with a few local governments distinguishing themselves in resource mobilization, accountable performance, and creditable delivery of public goods and services. Various studies have indicated large areas for improving service delivery, proper delineation of functions between national government and local governments, building capacities, and mobilizing more funds for effective service delivery (Manasan et al. [2010]; Llanto and Quimba [2011]; Capuno, Manuel, and Salvador [2002, 2003]).

The largest item in LGU expenditure is personal services expenditure, which is part of general administrative overhead. Current policy limits personal services expenditure at 45-55 percent of total LGU resources, but in reality this could be much higher due to certain exemptions. The ADB [2005] observed that local governments commonly charge payment of contractual workers to maintenance and other operating expenditures (MOOE) or against development projects; and even for functions and positions whose personal services costs are supposed to be funded entirely from the national budget, LGUs commonly supplement such allocations. The immediate effect is to crowd out spending for social services and capital outlays (e.g., local roads). This implies a need for a local public expenditure review for better allocation of local resources. The increase in spending on health services immediately after devolution was due to the transfer of health personnel to local governments and not necessarily on improved health services.

A related issue is that of unfunded mandates. Through special laws, Congress has assigned certain spending responsibilities to local government units without identifying the source of funds, thus the phenomenon of unfunded mandates has been an annoying phenomenon of Philippine decentralization.[23] The following have been identified as giving rise to unfunded mandates: (a) salary increases under the Salary Standardization Law; (b) additional benefits to health workers under the Magna Carta for Public Health Workers; (c) benefits to social workers; (d) personnel benefits to police, firemen, and employees of local courts, and the maintenance

[22] For example, Galing Pook Award, Konrad Adenauer Medal of Excellencedouthe 1990sof Asia and the Pacific.

[23] The author tried to secure data from DBM on the size of the unfunded mandates but in vain.

expenses of their respective local facilities; and (e) premium subsidy for indigents under the National Health Insurance Program (RA 7875) (local governments cover 50 percent of the premium for each indigent enrolled in the National Health Insurance Program with the national government shouldering the remaining 50 percent). Under the Magna Carta for Public Health Workers (RA 7305), local government employees are granted subsistence allowance, laundry allowance, night-shift differential, hazard pay, and longevity pay. There is also anecdotal evidence that local governments are asked to pay for the travel and other expenses of judges and other national government personnel. Local governments also shoulder the office expenses of personnel of the Department of the Interior and Local Government (DILG), including salaries of temporary employees working in DILG offices [ADB 2005].

Unfunded mandates strain local finances and create distortion in local expenditure programs. Local governments have complained about the great difficulty in complying with those mandates in the absence of an identified stable revenue source for those recurrent expenditures. A recent paper noted that many local governments are not giving all the allowances due public health workers. Less than 50 percent of provinces, cities, and municipalities provide the subsistence and laundry allowances at the prescribed rates under the law. There are also fewer local governments giving the hazard pay at the prescribed rates. The practice described has created conflicts at the local level, which has led even to filing of court cases against local chief executives and local budget officers for non-implementation of the Magna Carta benefits [Castel and Manasan 2010]. The LGC also allows the local governments to grant additional allowance and benefits to judges, prosecutors, public school teachers, police, firemen, officials of the Commission on Elections and the Bureau of Internal Revenue, and other national government officials stationed in various localities. Although not obligatory, such allowances create extreme pressure on local governments to grant them with a corresponding strain on local budgets. The imposition of unfunded mandates should be avoided at all costs because they create undue fiscal pressure on local governments and shortchange expectant beneficiaries when those mandates are not adequately provided.

Local governments have been devoting a large part of their budgets on personal expenditures, and the imposition of unfunded mandates has inflated the wage bill. Unnecessary increases in wage costs impede the ability of local governments to provide better services to the local population. Relative to the mandated compliance with the Salary Standardization Law, local governments should be given the flexibility to set their own compensation and pay policy subject to the constraints in the personal expenditures cap. The pertinent provision of the code allowing the grant of additional allowances and benefits to national government officials should be amended as this puts undue pressure on local governments to provide such allowances at the expense of local service delivery [Niazi, Llanto, and Fabre 2010]. It is necessary for legislators to coordinate with both the national and local governments in ensuring that such legislation, which mandates the provision of certain benefits to government workers, identifies the source of funding.

Several studies looking at service delivery yielded mixed findings on local performance. Diokno [2003] noted the difficulty of making a definitive assessment of local service delivery without a systematic performance monitoring system, and one may add hard data. His general conclusion was that while there has been no significant body of evidence showing efficiency gains from decentralization, there might have been no deterioration of public services after decentralization either. This was based on his observation that after decentralization the Human Development Indicators by province did not show a deterioration of social services. Local government social services expenditures, which grew at an annual average rate of 41 percent between 1991 and 1996, managed to increase by 12.5 percent compared to an increase of only 7.9 percent for total local government spending after the Asian financial crisis.

More recent data, however, seem to indicate that the increase in local expenditures has not been accompanied by an improvement in the quality of services. Citing a 2001 World Bank survey, Capuno [2007] revealed that 74 percent of people bypassed rural health units and 68 percent bypassed barangay health stations in favor of higher level but more distant government and private hospitals because of the low quality of primary health care services at the local level.[24] In terms of share of GDP, local expenditures on social services rose from 0.2 percent in 1991 to only 0.8

[24] The low quality of health care at the local level may be due to low (unrealistic) or minimal health budgets in many LGUs. Dr. Juan Antonio Perez III (OIC, Director IV, Bureau of Local Health and Development, DOH) pointed out during the 1st PIPER Forum on January 16, 2012, that when health services were devolved, "costs are fixed to the 1992 level, without linking this to increasing populations, new and unfunded mandates, new health initiatives and local concerns to upgrade existing health infrastructure".

percent in 2003. There was an upward trend in LGU spending on social services in the 1990s, especially with respect to health and education, but it stagnated in 1998-2003, which was blamed on the delay in the release of the IRA in the 1990s and the decline in own-source revenues due to the Asian financial crisis [Manasan 2007a]. These findings are corroborated by recent findings of Llanto and Quimba [2011] that local governments have underspent for health and education, and have devoted a huge part of local budgets to the payment of personnel and other overhead expenses. There has been an increase in the number of barangay health stations (BHS), which now stand at about 17,000 units in contrast to 2,300 rural health units (RHU). The BHSs are manned usually by midwives or paramedical personnel while RHUs are run by doctors and nurses. A decomposition of the increase in local health spending shows a marked decline in the number of government health workers (doctors and nurses) and a stagnation in the number of rural health units. This is somewhat offset by the increase in the number of barangay health stations and an increase in the number of midwives. This does not augur well for the objective of providing better local health care services. The PIDS [2009] study of local service delivery for health, education, and water found overlaps between LGUs and the national government in the provision of health services. The study also pointed out the need to build LGU capacity in providing better health care services and to firmly delineate functions between local and central government. In the education sector, 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.

It is noted that the effectiveness of service delivery by local governments may have been deterred by their lack of control over substantial amounts of resources, which ironically are intended for local projects. As stated earlier, national government agencies and legislators had effective control over the deployment and use of about Php 25 billion in 2003 alone. Table 9 provides a detailed breakdown of sources of the non-IRA funds reported in Table 7.

Table 9. Funding of local projects by devolved agencies, legislators, and donors, 2003 (in thousand pesos)

Department/ corporation	Government- funded programs/ projects (nondonor support)	Congressional allocations	Loans and grants funded (the transfer component)	Off-budget funding	Grand total	Percent of grand total
NGAs						
Department of Agriculture	847,224	211,484	484,616		1,543,324	6.08%
Department of Education	1,710,433		1,415,497		3,125,930	12.32%
Department of Environment and Natural Resources	8,415		644,063		652,478	2.57%
Department of Health	94,669				94,669	0.37%
Department of the Interior and Local Government	500	685,602	136,396		822,498	3.24%
Department of Land Reform (formerly Department of Agrarian Reform)		149,000	654,551		803,551	3.17%
Department of Public Works and Highways	836,637	14,458,011	1,329,860		16,624,508	65.54%
Department of Social Welfare and Development			218,887		218,887	0.86%
Department of Tourism	6,915				6,915	0.03%
Department of Transportation and Communication	27,961				27,961	0.11%
Municipal Development Fund Office			460,049		460,049	1.81%
Pasig River Rehabilitation Commission			76,675		76,675	0.30%
Subtotal, NGAs	3,532,754	15,504,097	5,420,594	0	24,457,446	96.42%

Table 9. (continued) Funding of local projects by devolved agencies, legislators, and donors, 2003 (in thousand pesos)

Department/ corporation	Government- funded programs/ projects (nondonor support)	Congressional allocations	Loans and grants funded (the transfer component)	Off-budget funding	Grand total	Percent of grand total
GOCCs						
Philippine Charity and Sweepstakes Office	114,313	139,942			254,254	1.00%
Philippine Amusement and Gaming Corporation	433,200				433,200	1.71%
Philippine Tourism Authority	20,378				20,378	0.08%
Subtotal, GOCCs	567,891	139,942	0	0	707,832	2.79%
Off-budget funding (OBF)				200,000	200,000	0.79%
Subtotal, OBF	0	0	0	200,000	200,000	0.79%
Grand total	4,100,645	15,644,039	5,420,594	200,000	25,365,278	100.00%
Percent of total	16.17%	61.68%	21.37%	0.79%	100.00%	

Source of data: Soriano et al. [2005].

The bulk of non-IRA funding comes from congressional insertions in the DPWH, mostly for the construction of farm-to-market roads. Likewise, the funds controlled by the DA, DPWH, and DepEd indicate the extent of their involvement in devolved projects. the DOH is also engaged in devolved activities but to a lesser extent than these departments. Table 10 gives a finer breakdown of the funds controlled by devolved agencies into those that they directly spend and those that they transfer to local governments. The Departments of Agriculture, Education, and Public Works and Highways directly spend the bulk of non-IRA funds under their control.

Table 10. Funding of local projects by devolved agencies, legislators, and donors, by department, 2003 (thousand pesos)

Particulars	Direct spending	Transfers to LGUs	Total	Percent
Department of Agriculture	1,078,966	464,358	1,543,324	6.08%
Department of Education	2,692,396	433,534	3,125,930	12.32%
Department of Environment and Natural Resources	633,390	19,089	652,478	2.57%
Department of Health	94,669	0	94,669	0.37%
Department of the Interior and Local Government	593,073	229,425	822,498	3.24%
Department of Land Reform	149,000	654,551	803,551	3.17%
Department of Public Works and Highways	16,403,738	220,770	16,624,508	65.54%
Department of Social Welfare and Development	0	218,887	218,887	0.86%
Department of Tourism	0	6,915	6,915	0.03%
Department of Transportation and Communications	0	27,961	27,961	0.11%
Municipal Development Fund Office	112,521	347,528	460,049	1.81%
Pasig River Rehabilitation Commission	76,675	0	76,675	0.30%
Philippine Charity Sweepstakes Office	0	254,254	254,254	1.00%
Philippine Amusement and Gaming Corporation	0	433,200	433,200	1.71%
Philippine Tourism Authority	9,695	10,683	20,378	0.08%
Off-budget funding	133,000	67,000	200,000	0.79%
Grand total	21,977,123	3,388,155	25,365,278	100.00%

Source of data: Soriano et al. [2005].

In this respect, it will be instructive to examine how the budgets of devolved agencies currently look. Have the budgets of the devolved agencies as a proportion of total government budget substantially increased during the post devolution period? Table 11 provides a snapshot of the budgets of devolved agencies.

Table 11. Budget share of devolved departments before and after devolution

Department	1987	1991	1999	2000	2005	2010
Agriculture	2	2.44	3.43	0.62	0.48	2.95
Budget and Management	0.15	0.19	0.1	0.08	0.15	0.14
Environment and Natural Resources	1.23	1.89	1.27	1.14	0.96	0.99
Health	3.23	3.9	2.64	2.06	1.61	2.14
Social Welfare and Development	0.46	0.62	0.41	0.41	0.53	1.36

Source: BESF.

Devolution transferred a large number of personnel mainly from the DA and the DOH, and to a lesser extent, the DSWD and the DENR.[25] However, these departments have continued to perform devolved activities as noted in the discussion of expenditure assignment, but with the exception of the DSWD, which pursued a smooth transfer of both personnel and funding to local governments. The problematic department seems to be the DENR, which has clung to activities that should have been devolved a long time ago.

There seems to be a relatively slight increase in the budget of the Department of Agriculture as a share of total government budget from 2.44 percent in 1991 to 2.95 percent in 2010. For the DOH, it has been a decline from 3.9 percent in 1991 to 2.14 percent in 2010. However, the significant increase in the budget share of the DSWD is noticeable in view of a shift in poverty alleviation projects to community-driven delivery of services and conditional cash transfers (CCT), which bypass the local governmental structure by directly delivering funds and/or services to households. Overall, while the budgets of devolved agencies may not have significantly increased except for one or two agencies, still those agencies

[25] The DOH transferred to LGUs more than 60 percent of personnel and about 40 percent of its budget. The LGUs also absorbed 595 hospitals and around 12,560 health facilities composed of rural health units, municipal health centers, and barangay health stations.

continue to implement devolved projects. It is noted that the DOH has been proactive in giving greater leeway to local government implementation of health services funded by that department. Please see Box 2.

Box 2. Collaboration between DOH and LGUs in health service delivery

Over the last 20 years, the DOH has had two phases in its devolution policy. The first phase was in the Ramos-Estrada administrations when the initial policies of facilitated assistance to LGUs (Comprehensive Health Care Agreements or CHCAs) and the crafting of health districts were advocated. The post-Estrada administration saw the decline of this policy. After the 2004 elections, there was an increase in the DOH budgets in response to criticisms about the state of health in the country.

The DOH reexamined its post-devolution policies and came up with Province-wide Investment Plans for Health (PIPH) and interlocal health zones (ILHZs). This is how the DOH has defined in concrete its collaboration with local governments. Today, the department is more concerned with achieving universal health care and MDG goals by 2013 and 2015, respectively. The LGU scorecard that the DOH has introduced will be used to see whether the municipalities concerned have moved forward in addressing local health problems.

Decentralization has allowed the DOH to focus on specific municipalities and even barangays in urban areas. PIPH and ILHZ agreements may be increasingly used by LGUs and the DOH to limit any spillover effects in health. It is more likely that spillover concerns will be eliminated through universal health care coverage. In 2012, Php 9 billion out of Php 42 billion in the DOH national budget is allocated for local health services. The increase in the DOH budget since 2004 has gone mostly to LGUs, particularly for infrastructure improvement at the municipal and provincial levels.

Source: Dr. Juan Antonio Perez, DOH.

What is the verdict on local government performance on service delivery? Except for some local governments, which have shown improvement in service delivery, the overall conclusion is that there is a large room for improving service delivery across local government units. There is also a need to monitor local government performance through an objectively verifiable performance monitoring system based on actual data of service delivery. It will also be to the advantage of the public and local governments to conduct a regular local public expenditure review in order to help local governments improve service delivery. There is also a need to review the practice of congressional insertions and the involvement of national government agencies in devolved activities. For finance to follow function at the local level, it is crucial to provide local governments with control over resources that they can use for effective service delivery.

For decentralization to work, local governments must be held accountable, and this will be attained through a firm and clear delineation of functions and responsibilities between the national government and local governments and better local fiscal autonomy.The matter of the pork barrel is surely a lightning rod of brickbats from legislators who believe that the best way to serve their constituents[26] is through the implementation of their pet projects. But precisely, devolution is intended and designed to bring to fruition local preferences through the accountable local officials' exercise of their functions and responsibilities, which may be undermined by an inefficient system of substituting congressional fiat for local autonomy and subsidiarity.

4. Treatment of interjurisdictional spillovers and exploiting economies of scale

Commenting on the expenditure assignment, Loehr and Manasan [1999] noted that the activities that have been devolved are those that can be provided by lower levels of government, consistent with the decentralization theorem. They added that few activities have benefits that would spill over outside the territorial jurisdictions of local governments, with the exception of those related to environmental management. This is an encouraging statement because theoretical literature argues that decentralization performs poorly when there are significant interjurisdictional spillovers or externalities, while an empirical study of decentralization and public service delivery in Uganda and the Philippines found that public goods with interjurisdictional externalities are particularly vulnerable to deterioration in decentralized settings [Khaleghian 2003].[27] The implication is that such local public goods may be underprovided because there is the chance that some local governments may free ride and avoid the cost of provision of such public good.

It is noted that there are public services—such as health services, environmental protection, etc.—whose benefits are not confined to the territorial jurisdiction of local governments that have spent for them. There are also economies of scale in providing certain services—such as supply of potable water and collection, transport, and treatment of municipal

[26] And to be reelected.

[27] Referring to Besley and Coate[1999] and Bardhan and Mookherjee [1998] on the theoretical literature; and Azfar, Kähkönen, and Meagher [2000] on their findings from a study of decentralization and service delivery in Uganda and the Philippines.

waste—which have to be provided to a large enough population, distributed over several territorial jurisdictions, to bring down local service costs and make service delivery sustainable. Is there scope for Philippine local governments to take advantage of joint or collective action in the delivery of such public goods and services with spillover benefits?

Section 33 of the code allows local governments to coordinate their efforts, services, and resources for purposes that are commonly beneficial to them. Through appropriate ordinances, local governments may group themselves, consolidate, or enter into joint ventures to deliver certain local public goods. There are a few cases where local governments have banded together to address a common problem (e.g., coastal resource management) or to carry out specific responsibilities (e.g., solid waste management and water supply development and distribution) because they realized that economies of scale and/or externalities make such cooperative undertakings appropriate [Mercado and Manasan 1999]. A good example of cooperation in investment planning and project implementation among local governments is the construction of a circumferential road across Cabanatuan City and adjacent municipalities. Construction of this toll road is financed by contributions from adjacent local governments [ADB 2005]. In the area of coastal resource management, the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) [2008] reported that the establishment of Banate Bay Resource Management Council by adjacent towns sharing in the fishing grounds of Banate Bay in southeast Iloilo was a response to threats to their common resource base posed by rapid population growth in the coastal barangays, river siltation due to upland denudation, mangrove destruction, and destructive fishing methods. The Banate Bay alliance served as model for other coastal resource management councils like LIPASECU (Libertad, Pandan, Sebaste, and Culasi) in Antique, formed in 1997, and NNARMAC (Northern Negros Aquatic Resources Management Council), formed in 2000 [GTZ 2008].

Local collaboration may also be fostered through donor assistance. Two examples given by Brillantes [2007] are the creation of an alliance among the following local governments: Marihatag, Cagwait, San Agustin, Lianga, Tago, Bayabas, and San Miguel (MACASALTABAYAMI) Alliance under the auspices of the Canadian International Development Agency, and the organization of the Metro Iloilo Development Council with the assistance of the Canadian Urban Institute.

The common policy instrument to forge an alliance or collaborative effort is a memorandum of agreement, which spells out the responsibilities, functions, and specific roles of the participating local government. The Central Panay Economic Union (CPEU), composed of five upland municipalities in Capiz and Aklan, was organized under a memorandum of agreement. The other policy instruments are (a) resolution by the Regional Development Council, (b) a presidential executive order, and (c) an act of Congress.[28] The Metro Cebu Development Council was created in 1997 through a resolution of the Regional Development Council while the Metro Naga Development Council was established in 1993 by virtue of an executive order. Two examples of an act of Congress are the creation of Sorsogon City through the merger of the municipalities of Sorsogon and Bacon (through RA 8806) to stimulate the local economy, and the merger of the municipalities of Babak, Samal, and Kaputian into the Island Garden City of Samal through RA 8471 to preserve the marine environment [Brillantes 2007].

Interlocal cooperation through such mechanisms as alliances, councils, and integrated projects to be implemented by participating local governments, has not yet taken deep roots. There are recent experiences of collapse of interlocal collaborations or cooperative undertakings, which have lost the support of an incoming local chief executive, or have become victim to the shifting sands of political alliances, or have foundered due to a lack of sustainable funding after donor money has run out. The interlocal cooperative activities that collapsed were established through memorandums of agreement signed by participating local governments. Brillantes [2007] wryly observed that the collapse of Batan Bay Integrated Municipal Council and CPEU was due to lack of financial resources. Differing political interests and priorities and the change in leadership doomed the MACASALTABAYAMI Alliance. Dysfunctional organization and management led to the demise of Metro BLIST (Baguio City–La Trinidad–Itogon–Sablan–Tuba) alliance.

Successful cases of local government alliances documented by GTZ [2008] indicate the importance of binding and unbinding factors in understanding the sustainability of local alliances. Based on the experiences of LGU alliances, the following binding factors are indicated: unity of purpose, clear legal basis for forming the alliance, alliance champions, clear organizational structure and systems and procedures, commitment of

[28] Enumerated by Brillantes [2007].

resources by member-LGUs, joint activities, and a sense of accomplishment. The major unbinding factors identified are presence of vested interests; lack of political maturity and political will; changes in political leadership, new political alignments, changes in personnel deployment, or refusal to honor commitments; lack of transparency in financial transactions; credit grabbing in case of success and finger-pointing in case of failure; and loss of interest in the alliance due to the lack of visible immediate results.

While interlocal cooperation or collaboration is feasible, there is no guarantee it will endure without committed political leadership inspired by a common vision and a robust political framework that is stronger than a mere memorandum of agreement. Merger and consolidation of small local government units by an act of Congress offers the most robust political framework for such alliances to endure. Pressure from and support by local citizens to continue with an activity or project with spillover benefits is an important driver of interlocal cooperation. Sustainable financial resources and a working operational system that deliver expected results (e.g., higher fish catch due to protection of a common fishing ground) are also key elements of successful interlocal cooperative or collaborative undertakings.

The Philippines does not lack examples of successful interlocal collaboration.The challenge ahead is how to motivate large-scale adoption of the few examples of successful cooperative or joint endeavors among local governments—for example, coastal resource management and environmental management. In addition to having the success or binding factors mentioned by the GTZ, there will be a need to review and assign the expenditure responsibility to the most appropriate level. In the provision of local public goods and services with spillover benefits, which will require interjurisdictional cooperation and support to avoid underprovision or underinvestment by free-riding local governments, policy makers have to think of mergers and consolidation sanctioned by an act of Congress as a more feasible solution. As shown by the long experience of GTZ and the United States Agency for International Development (USAID) in implementing successful coastal resource management projects in the country, LGU alliances can bring economies of scale while enhancing the individual LGUs' capacity in managing their resources. LGU alliances can and do work.The challenge is how to make them permanent bodies to address interjurisdictional externalities.

5. Concluding remarks and implications for future reforms

Twenty years after fiscal decentralization, local government units are saddled with an inefficient assignment of expenditure and tax functions and responsibilities. The immediate result is the rather uneven performance of local government units. The lack of good governance also has a lot to do with bad performance, but improving local government performance is anchored on giving them sufficient local fiscal autonomy.

The expenditure assignment seems consistent with the decentralization theorem, but it is inefficient. A seemingly two-track delivery mechanism for certain devolved services seems to be behind suboptimal service delivery when local governments fail to produce public goods and services that are responsive to local preferences. Except for some local governments, which have shown improvement in service delivery, the overall conclusion is that there is a large room for improving service delivery across local government units. The following are recommended:

- Review the expenditure assignment to designate expenditure responsibilities to the most appropriate level of government.
- Conduct regular local public expenditure review in order to help local governments improve service delivery.
- Monitor local government performance through an objectively verifiable performance monitoring system based on actual data of service delivery.
- Match local spending proposals with an identified revenue source.

The Philippine tax assignment appears to follow the traditional view of tax assignment for local governments, but available evidence shows it is inefficient. The following are recommended:

- Improve local tax administration in order to increase own-source revenues—for example, use IT to improve revenue performance, update and secure land records, and conduct regular tax audits, etc.
- Provide greater flexibility to local governments in determining and adjusting tax rates.
- Review and assign taxes to the most appropriate level of government.
- Review and update local tax codes, including the schedule of market values for purposes of real property taxation.

The fiscal transfers, basically the IRA, have performed well in closing the overall vertical fiscal gap. However, the IRA distribution formula is regressive and has not achieved its objective to equalize the fiscal capacities of local governments. The following are recommended:

- Use performance-based grants as positive incentive to local effort to improve governance, local revenue mobilization, and others.
- Use matching grants to equalize fiscal capacities of local governments.

Finally, the underprovision or underinvestment in local public goods and services with spillover benefits can be avoided through interlocal cooperation. LGU alliances can bring economies of scale while enhancing the individual LGUs' capacity in managing their resources. The following are recommended:

- Foster LGU alliances and similar type of cooperative behavior by disseminating information on the benefits of interlocal collaboration/ cooperation, factors behind successful cases, and factors that hinder cooperative behavior, etc.
- Work with various stakeholders, the national government, and donors to replicate in a larger scale such cooperative endeavors.
- Advocate for merger and consolidation of small and weak municipalities and cities to create economies of scale for better service delivery.

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