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Fiscal Tranfers, Centrally-Provided Local Public Services and Fiscal Balance: Exploring Alternative Transfer Formulas

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Abstract

A conceptual framework is developed and used to estimate the Internal Revenue Allotment (IRA), other central fiscal transfers and the funds for local public services directly provided by national government agencies in the Philippines. The estimates show that the total central resource transfers to local governments or their constituencies have been increasing during the period 1995-99. The bulk of these transfers was the centrally-provided local public services, whose allocation however may have aggravated the fiscal imbalances across local government units. However, improvements in the fiscal imbalances achieved solely through an adjustment in the current IRA formula would be minimal or very costly to either some local government units or to the national government. The results therefore suggest a more consistent allocation of the IRA and other fiscal transfers and, possibly, the further devolution of the centrally-provided local public services.

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* This is largely based on the paper which the authors presented during the 3rd IRSA International Conference held in Jakarta, Indonesia on March 20-21, 2001 and also during the National Orientation Forum on Central Transfers to LGUs held in Angeles City, Pampanga, Philippines on December 5, 2000.

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I. Introduction

How much resources from the central government actually go to the provision of local public services? What implications do these transfers have on fiscal balance (or imbalances)? What can be done to improve the equity of these transfers?

These are the main research questions this paper attempts to answer in the Philippine context. Answers to these questions are crucial to the ongoing assessment of the fiscal decentralization program adopted in the Philippines since 1991, which has led to fundamental changes in intergovernmental relations in the country. The answers, however, are not quite obvious, due both for conceptual and methodological reasons.

At the conceptual level, it is important to distinguish between two types of central government resources that are used to provide local public services in such areas as basic personal health, education, housing and infrastructure. The more widely known type is the central fiscal transfers, consisting of revenue shares and categorical grants, which are used to augment local finances or to influence certain local expenditure priorities. In the Philippines, various studies have already bee made that trace the evolution of these transfers [Manasan 1992a] and their impact on LGU fiscal capacity [Cuaresma 1992, Manasan 1992b, 1995].

In contrast, scant attention has been given to the funds for local public services administered by the national government. Earlier studies have focused more on the regional allocations of the budget of national government agencies [Lamberte et al. 1993; Mercado 1999]. The spatial impact of central government expenditures however has been gaining recognition; suggestions have been made to rationalize these resources to account for possible spillovers or externalities across jurisdictions [Alonzo 1999], a problem peculiar to a decentralized system.

A narrower and greater focus on centrally-provided local public goods and services is important for at least two reasons. First, since their benefits are “localized”, their magnitudes and distribution therefore determine the overall fiscal balance or the availability of public services across areas. Second, they indicate the extent to which the fiscal decentralization program can be pushed. However, the distinction between fiscal transfers and centrally-provided local public goods is not clearly made in most public finance textbooks, glossing over the fact that national governments in many countries, like in the Philippines, continuously administer such public services through the regional budgets of their line agencies for historical or institutional reasons.

Measuring the amount and allocations of centrally-provided local public services in the Philippines is also fraught with difficulties. The main difficulty arises from the inadequacies in government accounting convention which provides more details about the recipients of fiscal transfers (especially of cash) and less information about the local government-recipient of centrally-provided local public services (which are always in kind).

The conceptual and methodological issues are addressed in this paper, which was primarily undertaken to provide inputs to the debate concerning adjustments in the principal revenue-sharing scheme between the national government and local governments in the Philippines. In particular, the paper has three main objectives, namely: (1) to develop a conceptual framework for estimating the total resource transfers; (2) to provide estimates of these resources; and (3) to simulate the effects of alternative transfer formulas for these resources. The policy implications of the results of the estimation and simulation exercises will also be identified. In this paper, local public services and local public goods are used interchangeably.

Briefly, the results show that the total central resource transfers to local governments and their constituencies have been increasing during the period 1995-99. The biggest proportion of these resource transfers is composed of centrally-provided local public services, followed by the shares of the local governments in the internal revenues of the national government. These two major types of central resource transfers may have aggravated the existing vertical fiscal imbalances among the provinces, cities and municipalities; although they appear to be progressively allocated across income classes within each LGU level. The simulation exercises underscore the politically-difficult trade-off involved in improving overall fiscal balance and ensuring wide social support for an alternative transfer formula. These two policy goals may be achieved, however, if the adjustments in the formula were to be applied only to an incremental fund, such as the annual increase in the internal revenue allotments of local government units. Alternatively or in combination with a revised transfer formula, the national government may opt to reduce its revenue shares or to devolve further some of its administered local public services.

The rest of the paper is divided as follows: Section II provides an overview of the current fiscal decentralization program in the Philippines. The conceptual framework is presented in Section III. Section IV discusses the major methodological issues encountered in the estimation. The estimates of the total resource transfers are presented and analyzed in Section V. These estimates are then used to simulate the effects of alternative distribution formulas to achieve certain policy goals in Section VI. Finally, conclusions and some policy recommendations are presented in the last section.

II. An Overview of the Fiscal Decentralization Program

A. Implications of the Local Government Code of 1991

A watershed in the country’s history, the Local Government Code (LGC) was enacted in 1991 as part of the country’s fiscal and political reforms. The LGC contains the blueprint of the current fiscal decentralization program, which is best characterized as devolution in that primary responsibility over a range of public services has been transferred from national government agencies (NGAs) to local government units (LGUs). In the Philippines, the four major types of LGUs are provinces, cities, municipalities and barangays (villages). All barangays are directly under the administrative control of cities and municipalities; while most cities and municipalities are directly under the administrative controls of provinces. Exceptions are the independent cities and municipalities found in Metro Manila and other highly urbanized areas. These cities and municipalities, like the provinces, are directly under the administrative control of the national government. In the Autonomous Region of Muslim Mindanao, however, the regional government is an added layer between the provinces in the region and the national government.

Among the many provisions of the LGC, two have major implications on the fiscal performance of LGUs. First, the LGC mandated the devolution of several expenditure functions including the provision of agricultural extension services, field health and hospital services, public works and infrastructure projects funded out of local funds, school building program, social welfare and housing services, and tourism promotion (Table 1).

The budgetary requirement for the devolved functions is estimated at 7.23 billion pesos, based on the budget appropriations in 1992 of the concerned national government agencies for the devolved functions, services, personnel, facilities and supplies (Table 2). Of the total budget requirement (also known as the Cost of Devolved Functions or CODEF), about 53 percent (3.9 billion pesos) constitutes the budget for the devolved health functions. Also, close to 46,000 health personnel have been assigned to LGUs under the fiscal decentralization program, i.e. two out of every three devolved personnel.

Second, the LGC also mandated the increase in the LGUs share in total public revenues following the formulas enunciated in the Code. The most significant increase is in the share of the local governments in the internal revenues of the national government.[1] This share is known as the Internal Revenue Allotment (IRA), which continues to be the single most important form of fiscal transfer in the Philippines since 1991.[2] Under the Code, the IRA should be automatically released to local governments, without lien from the national government, and may be used by them in any way they see fit, subject only to the requirement that 20 percent of the IRA should be earmarked for local development projects.

While local governments were already receiving IRA even prior to the LGC of 1991, they received under the new codal IRA formula about 18.1 billion pesos in 1992, up from an estimated 10 billion pesos in 1991[3]. By 1993, the IRA has risen further to 36.7 billion pesos [Capuno 2001]. The rising trend continued thereafter, a phenomenon also partly due to the normal annual growth in the internal revenue collections of the national government.

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[1] The second major revenue share is in the proceeds from the development and utilization of the national wealth (i.e., natural resources within the areas of LGUs but are under the control of the national government).

[2] This can be seen in terms of proportion to either the total central fiscal transfers or the total local government revenues [Capuno 2001].

[3] The total for 1991 includes other revenue shares (Specific Tax Allotment and Local Revenue Stabilization Fund) of local governments.

The assignment of additional expenditure functions and the increased share in internal revenues together have significantly enlarged the fiscal role of local governments and reduced that of the national government in the Philippines. From 92.9 percent, the share of the national government in the total public revenues (i.e., combined national and local government) dropped to 85.9 percent in 1993, and to 83.2 percent by 1999. Consequently, the share of the national government in the total public expenditures (again, combined national and local governments) also declined from 88.6 percent in 1991 to 84.8 percent in 1993. By 1999, the national government share had shrunk further to 80.6 percent. [Capuno 2001]

Table 1. Devolved Functions of National Government Agencies*

National Government Agency	Devolved Functions
Department of Agrarian Reform	- Land and home development improvement projects
Department of Agriculture	- Agriculture and fishery extension services; regulation of agricultural and fishery activity; conduct of agricultural and fishery research activity; 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	- Local government budget officer services
Department of Environment and Natural Resources	- Forest management services; mine and geo-sciences services; environmental management services; reforestation projects; integrated social forestry projects; watershed rehabilitation projects
Department of Health	- Extension of medical and health services through provincial health office, 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 5-bed health infirmaries
Department of Public Works and Highways	- Repair and maintenance of infrastructure facilities; water supply projects; communal irrigation projects
Department of Social Welfare and Development	- 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	- Domestic tourism promotion; tourism standard regulation
Department of Trade and Industry	- Promotion and development of trade, industry and related institutional activities
Department of Transportation and Communication	- Telecommunication services; transportation franchising and regulatory services
Cooperatives Development Authority	- Promotion, development and regulation of cooperatives functions; cooperatives field operation function
Housing and Land Use Regulatory Board	- Regulation of human settlement plans and programs functions
Philippine Gamefowl Commission	- Regulation and supervision of cockfighting function

*In addition, functions and locally-funded projects of the Commission on Population, Fiber Industry Development Authority, National Agricultural Fishery Council, Livestock Development Council and National Meat Inspection Commission are also devolved. Table adapted from Manasan [1997].

Table 2. Devolved Functions: Costs and Personnel
(Estimates as of March 1993)

National Government Agencies	Estimated Devolved Budget* (in million pesos)	1992 Agency Budget (in million pesos)	Share of the Devolved Budget in the total 1992 Agency Budget (%)	Number of Devolved Personnel	Number of Personnel Before Devolu-tion**	Share of the devolved personnel in total number of personnel before devolu-tion** (%)
Dept of Agrarian Reform	9.4	1842.4	0.51	-		
Dept. of Agriculture	1055.6	5210	20.26	17673	29638	59.63
Dept. of Budget and Management	172.8	465.4	37.13	1650	3532	46.72
Dept of Environment and Natural Resources	167.7	1941.8	8.64	895	21320	4.20
Dept. of Health	3851.1	9991.4	38.54	45896	74896	61.28
Dept. of Public Works and Highways	1096.3	27109.3	4.04	-		
Dept. Social Welfare and Development	866.4	1320.7	65.60	4144	6932	59.78
Dept. of Tourism	2.8	207.7	1.35	-		
Dept. of Transportation and Communication	0.1	7563.9	0.00	-		
Philippine Gamefowl Commission	8.7	15.3	56.86	25	191	13.09
Total	7230.9	55667.9	12.99	70283	136509	51.49

*Based on 1992 agency budget for the full year impact of the functions/projects/activities devolved.
**Only for agencies with devolved personnel. Table adapted from World Bank [1994].

The Codal IRA Formula

Under the LGC, the annual IRA of each LGU is determined following a three-step formula. The first step (also known as the base formula) involves the determination of the total IRA, or collective share of the LGUs in the gross internal revenues of the national government. Since 1994, the sharing scheme has been 60-40, in favor of the national government, and is applied on the gross internal revenues collected in the third fiscal year preceding the fiscal year when the allocation is made.

The last two steps together constitute the distribution formula, which essentially specifies how the 40-percent share of the LGUs is to be divided individually. The second step first apportions the IRA among LGU levels using the following rule: 23 percent to provinces, 23 percent to cities, 34 percent to municipalities, and 20 percent to barangays (villages). Once determined, each level share is then distributed among the LGUs (belonging to that level) using weight factors: 50 percent to population, 25 percent to land area, and 25 percent as the equal sharing part. Also, a barangay with a population of at least 80,000 inhabitants should receive an IRA not less than 80,000 pesos per annum.

B. Emergent intergovernmental fiscal issues

Apparently, therefore, the fiscal decentralization program is based on the basic tenet that “finance follows function”. In fact, however, the program has some design and implementation flaws, giving rise to a number of intergovernmental fiscal issues. The emergent issues may be classified as follows:

1. *Deficiencies in the assignment of expenditure functions*. A number of devolved provincial hospitals are located in cities, providing a source of interjurisdictional spillovers and tension between cities and provinces. Further, the national government has not fully devolved some of the functions mandated in the LGC and, more critically, appears to be arbitrary in assuming back the responsibility over some of the devolved functions (like hospital services).
2. *Inequities and delays in the distribution of finances*. - While based on a formula, the current computation of the IRA is legally contestable. In particular, local governments contend that the IRA should be based on the gross internal revenues of the national government, i.e. without the deductions imposed by the Bureau of Internal Revenues and the Department of Budget and Management on the gross internal revenues for the supposedly special laws [Bito-on 1999]. While the LGC also mandates the automatic release of the IRA to LGUs, only 90 percent of the IRA was transferred in 1997 - a permissible although unilateral cash management decision of the national government following the Asian financial crisis. However, following a 2000 Supreme Court ruling on the issue, the withheld portion of the IRA has now been granted back to LGUs, although in tranches (and without interest). Another source of inequity is the perennial adjustments in the land areas of LGUs owing to the inconsistencies in the national government land surveys and the creation of new LGUs.
3. *Mismatch in the finances and functions*. A number of local government units are found to have negative resource transfers, i.e. their IRAs are less than their shares in the CODEF [World Bank 1994, Capuno 2001]. The primary reason for this is the inconsistency in the formulas used for the IRA and the CODEF. The financing problem may have been aggravated further by the additional expenditure functions assigned to LGUs by the national government or by Congress without the requisite funding. Among these so-called “unfunded mandates” are the Magna Carta of Public Health Workers (RA 7305), Barangay Health Workers’ Benefits and Incentives Act of 1995 (RA 7883) and the Technical Education and Skills Development Authority (RA 7796) [Balgos 2001]. According to Manasan [1999b], however, the annual increase in the IRA has been large enough by 1999 to enable the local governments to shoulder the “unfunded mandates” out of their IRA shares, even after adjusting for inflation and population growth.

C. Efforts to deepen local autonomy

To address the emergent fiscal issues and thereby deepen local autonomy, there have been several executive and legislative initiatives undertaken. Principal among the legislative initiatives and espoused by local government officials, civil society organizations and members of Congress is the amendment of the key provisions of the LGC. In the *Consensus Policy Statement on Proposed Amendments to the Local Government Code of 1991*, for example, the three major leagues of local governments in the Philippines advocate changes in the relations between the national government and local governments and among local governments, the regulatory powers and franchising authority of local governments, the provisions concerning local development corporations and enterprises, and popular participation. While there are other proposed amendments, the common thread that weaves through these proposals is the augmentation of the LGUs' share in the IRA and other financial resources.

The national government has also adopted certain corrective measures to address the intergovernmental fiscal problems under the devolution. Starting in 1999, it promulgated the Local Government Service Equalization Fund (LGSEF) in response to persistent clamor to address the funding shortfalls in the delivery of basic services at the local levels. Touted to be an "augmentation fund," the LGSEF has an annual appropriation of five billion pesos. The LGSEF, however, is taken out of the annual total IRA before the codal IRA formula is applied on the residual.

Further, the Oversight Committee on Devolution has issued Resolution No. 99-001 "adopting the policy for determining the 25 percent, on the basis of LGUs land areas, in the distribution formula for the computation of the annual IRA of LGUs." This policy specifies that land areas would be based on the certified master list of land areas submitted by the Land Management Bureau, which has been directed to submit such list not later than 15 December of every third year after 2001.

Operationally, the IRA computation made by the Department of Budget and Management (DBM) has been perennial target of criticisms because of (a) "unauthorized" deductions of certain incomes as a result of special laws or special accounts from the total internal revenues, thus effectively reducing the mandated 40 percent IRA share of LGUs (Lopez, 1999), and (b) perennial adjustments in the land areas of certain LGUs which have lowered their IRA and thus resulted in problems particularly related to the implementation of local development plans, delivery of social services, and in certain cases, even personal services.

The 1999-2004 *Medium Term Philippine Development Plan* (MTPDP) best expresses the national government's commitment to deepen local autonomy. While the national government maintains the present 60-40 sharing scheme, it plans to improve the allocation and utilization of budgetary transfers to LGUs by reformulating the IRA allocation to encourage better revenue mobilization by LGUs, favor poorer areas and *those deprived of national government-supported social services*. Further, it supports the strengthening and monitoring of the utilization of LGU funds and encouraging cost-sharing schemes and capacity-building programs for devolved activities and implementing a time-bound removal of the NG funding for these activities. Finally, the national government also encourages the co-financing, based on ability to pay by LGUs, of projects which shall be awarded on a competitive basis and the *rationalization of the grant system for LGUs to improve its transparency and effectiveness*.

III. Conceptual Framework

The conceptual framework underlying the measurement of the total resources used in the provision of local public services is depicted in Figure I. The total central resource transfers (CRT) consists of the central fiscal transfers (CFT) and centrally-provided local public services (CPLPS). Following standard definition, central fiscal transfers refer to the national government transfers to LGUs. In the Philippine context, these transfers may be broadly classified into revenue shares (RS), which are always in cash, and categorical grants (CG), which may be in cash or in kind. Revenue shares are intended to augment the own-income of local governments or their purchasing powers. The two principal types of revenue shares in the Philippines are the IRA and the local government shares in the proceeds from the exploitation of natural resources in their localities (i.e. shares in national wealth).

In contrast, categorical grants are designed to influence the expenditure priorities of local governments towards certain goals or objectives set by the national government. Central fiscal transfers are directed to local government units (as political units), which then make adjustments in its revenue or expenditure decisions. Hence, central fiscal transfers are used to help LGUs finance their provision of local public services.

In contrast, the funds for the centrally-provided local public services are used by the national government to finance its direct provision of local public services. The beneficiaries of the centrally-provided local public services are the constituencies of the LGUs. These services are differentiated from the other forms of services provided by the national government such as monetary policy and national defense in that the benefits derived from the former are "localized, i.e. naturally limited to a smaller area. This is not to say, however, that the effective benefit area of these local public services follows the political subdivisions of local government units. The effective benefit area may be smaller or bigger than the political jurisdiction of one LGU, but small enough to be contained within the combined political jurisdictions of adjacent LGUs.

Despite their "localized" benefits, these local public services are continuously financed and provided by the national government for historical or institutional reasons. In countries where the national government preceded the system of local governments, the provision of local public services may have originally been the responsibility of the national government. But even if he hierarchical structure of government has thus developed, the central government may refuse to cede control over these local public services to local governments for political control.

In the Philippines, for example, the provision of health, education and infrastructure services has been primarily a national government responsibility. While most health services – including hospital and primary care services – have been devolved to local governments since 1992, public works (e.g., provincial roads and bridges) and tertiary education (e.g., state universities and colleges) are still provided by the national government. Unlike other types of local public services, the centrally-provided ones are not the responsibility of local governments.

Hence, central fiscal transfers are intended to influence, augment, supplement, complement (and sometimes, inadvertently, crowd out) the provision of local public services assigned to local governments; the centrally-provided local public services, on the other hand, are supplied by the national government simply because they are assigned to the national government. This is not to say, however, that these services cannot be profitably assigned to local governments.

Following the proposed conceptual framework, an accounting relation between the two major types of resources may therefore be stated as follows:

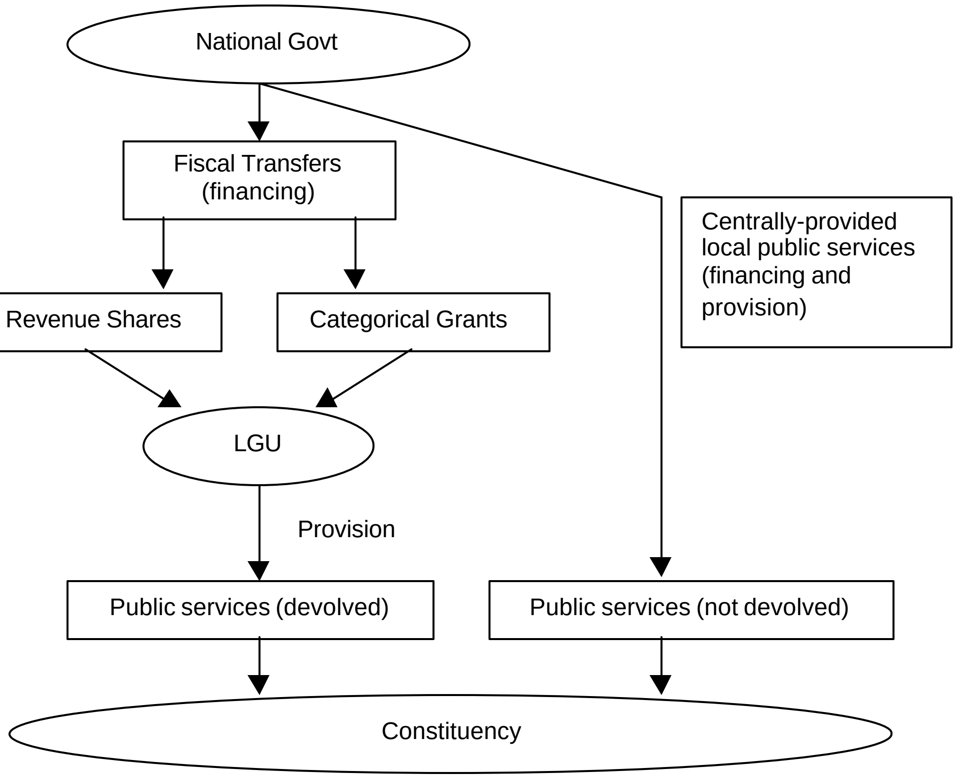
$$\mathrm{CRT} = \mathrm{CFT} + \mathrm{CPLPS} = \mathrm{RS} + \mathrm{CG} + \mathrm{CPLPS} \qquad (1)$$

Each of the variables in equation (1) may be indexed by year (*t*), by LGU level (i.e., *p* for province, *m* for municipality, *c* for city, *b* for barangay), and by each LGU within each level (*i*). With proper indexing, it is then possible to analyze the magnitudes and distribution of the different resources, both through the years and across areas or GU levels. With the estimates, it would then be possible to describe the extent and sources of fiscal imbalances among LGUs in the country.

Further, the estimates and the basic equation can be employed to simulate the fiscal implications of alternative distribution schemes, which may be classified in terms of (1) alternative allocations of CFT, while holding CPLPS as fixed, (2) alternative distribution of CPLPS, while holding CFT as fixed, and (3) a combination of the two previous types. In the Philippine context, the relevant policy exercise is in simulating the effects of RS formula (in particular the IRA), holding CG and CPLPS fixed, in pursuit of certain policy objectives (CRT*). The relevant policy objectives can be either to improve fiscal balance or minimize the financial losses of adjustments. That is, the problem is looking for the new revenue shares (RS^{N}), holding as constants the central grants (CG^{O}) and centrally-provided local public services ($\mathrm{CPLPS}^{\mathrm{O}}$) to achieve a new allocation of the total central government resources for local public goods (CRT*).

$$\mathrm{RS}^{\mathrm{N}} + \mathrm{CG}^{\mathrm{O}} + \mathrm{CPLPS}^{\mathrm{O}} = \mathrm{CRT}^{*} \qquad (2)$$

Figure 1 Measuring the Total Central Resources Used for the Provision of Local Public Services



IV. Data and Simulation Issues

This section outlines the main issues encountered in the measurement of the total central resource transfers for the provision of local public services. A detailed account of these issues is discussed in Capuno, Manuel and Salvador [2001].[4] Note that the labels of the different fund accounts found in Capuno, Manuel and Salvador [2001] are renamed here as revenue shares (for *cash transfers*) and categorical grants (for *in-kind transfers*), which together are referred to here as central fiscal transfers. The new names are adopted to conform to the slightly revised conceptual framework used in the present paper.

A. Scope and coverage

In this study, the revenue shares of local governments (RS) pertain to the two principal cash transfers to local governments in the Philippines, namely: Internal Revenue

[4] Further, this report contains a more detailed breakdown of the estimates presented in the present paper. The report also explains the similarities and differences in the estimates found in Capuno, Manuel and Salvador [2000], which contains the first preliminary estimates of the IRA Project.

Allotment (IRA) and other cash transfers, including the local governments' shares in national wealth. The latter are the proceeds from the sale of national wealth or natural resources, a portion of which according to the LGC must be granted to the LGU where these wealth or resources are located. For the years 1995 and 1997, the other cash transfers also include the LGU shares in the tobacco excise taxes; whereas in 1998 and 1999, the estimates include LGU shares in mining taxes, forest charges and energy resources production. Special laws cover these additional cash transfers.

The categorical grants, on the other hand, comprise mostly in-kind transfers. The estimates of categorical grants are limited to those provided by the five key national government agencies, namely: the Department of Education, Culture and Sports (DECS), the Department of Interior and Local Governments (DILG), the Department of Health (DOH), the Department of Public Works and Highways (DPWH), and state universities and colleges (SUCs). The estimates of the centrally-provided local public services (CPLPS) are also limited to the five aforementioned national government agencies, since these are the major providers of local public services.[5]

The estimates of the different fund accounts are based on actual releases (in the case of IRA and other cash transfers), whenever available, and on budget appropriations (for categorical grants and centrally-provided local public services). The estimation exercise covers a five-year period, from 1995 to 1999. The period coverage is intended primarily to determine the trends in central resource transfers.

B. Data sources

Data on the actual IRA and other cash transfers for each LGU in 1997, 1998 and 1999 were obtained from the Department of Budget and Management (DBM), which disburses these funds. The individual IRA shares for 1995 and 1996, however, were no longer available when the estimates were undertaken. As recourse, these were projected using as guide the DBM's Local Budget Memoranda for 1996 and 1997 and following the codal distribution formula. To minimize the possible discrepancies between the projected and actual IRA figures, the DBM data on population and land area were used.

The data on categorical grants and centrally-provided local public services were taken from the reports submitted by the five key national government agencies (particularly, DPWH, DOH and DILG), which contained the actual budget releases or actual implementation costs of their programs and projects for the period 1995-99. The data on the annual allotments of SUCs were culled from the 1995-99 Annual Financial Reports of the Commission on Audit. From the DPWH, the data for the 1995-99 DECS School Building Program were also collected. Budget appropriations based on the General Appropriations Acts were also used where actual expenditures were not available.

[5] Earlier estimates of the categorical grants and centrally-provided local public services of all the other national government agencies (i.e., excluding the five key ones) show that together they account for only about four to nine percent of the total annual estimates between 1995 and 1999.

Other relevant socioeconomic variables were used. Population figures were obtained from the National Statistics Office, while regional consumer price indices were sourced from the National Economic and Development Authority. The income class classifications of LGUs are based on the Department of Finance's Department Order No. 24-97.

C. Level of disaggregation

Estimates of the different fund accounts were made for all the 1,525 municipalities, 83 cities and 79 provinces including Metro Manila. However, no similar attempt is made for each of the more than 40,000 barangays (villages), as this proved to be not practicable within the time frame of the study. Further, two types of residual accounts were introduced to minimize the underestimation of categorical grants or centrally-provided local public services. These are the "national/inter-regional" and 'regional" accounts. The introduction of these accounts proved to be necessary since standard government accounting practice does not provide adequate information as to the exact recipient of in-kind transfers.

The "national/inter-regional" account includes programs and projects that were implemented on a nationwide basis or in two or more regions, but whose direct benefits are limited to the areas where they are administered. Examples of categorical grants or centrally-provided local public services that fall under this residual account are the community services conducted by the Philippine National Police (which is a regular budget item of DILG); and the "Lingap Para sa Mahirap" Project of the DPWH-Local Water Utilities Administration in 1999.

The "regional" account, on the other hand, includes those categorical grants and centrally-provided local public services whose beneficiaries, as reported, are the individual LGUs in the region. An example is the reported regional appropriation of DECS for the repair and maintenance of school buildings (which are local public goods).

D. Caveats

The estimates presented here have some notable limitations (although these are addressed in Capuno, Manuel and Salvador [2001]). First, the distinction between categorical grants and centrally-provided local public services, while clear in theory, may not be totally so in practice. The problem arises because of the ambiguities in government accounting and certain conditionalities attached to categorical grants. The DPWH, for example, continues to administer the "construction, improvement, rehabilitation of provincial, city, municipal buildings and facilities, including streets, waiting sheds, town marker and welcome arch", all of which should be under the responsibility of the LGU under the LGC. Following the conceptual framework, these DPWH projects should then be counted as categorical grants. However, the DPWH is also responsible for "urgent arterial/secondary roads and bridges, local farm-to-market roads and bridges and other infrastructure projects", which all can be classified as centrally-provided local public services except that they are general enough to also fall under categorical grants. Where such fine distinction is not possible, the joint estimates of categorical grants and centrally-provided local public services are presented.

This paper does not also include the Congressional Initiative Allocations, Countrywide Development Fund and other “pork barrel” funds. These are often used to finance the pet infrastructure projects of members of Congress who are able to get budget allocations for these projects in the course of the government budget process. Presumably, these projects are directed to the constituencies of congressmen and congresswomen, and should therefore count as either categorical grants or centrally-provided local public services.

Lastly, the transfers to regional governments and regional administrative bodies are not included. Unlike the other regular administrative regions, the Autonomous Region of Muslim Mindanao (ARMM), the Cordillera Administrative Region (CAR) and the National Capital Region (NCR) have their own regional governments or administrative bodies with regular budget appropriations or receive transfers from the national government. In the cases of ARMM and NCR, these transfers are used to augment the provision of local public goods and services in their respective areas (e.g., the Kabulnan Irrigation and Area Development Project in ARMM, and the Waste Disposal Program and Integrated Traffic Management Program for NCR).

V. Analysis of Estimates

This section provides the estimates of the total central resource transfers used for the provision of local public goods and services for the period 1995-99. The overall trends in magnitude and distribution of these resources are traced and their impact on fiscal balance is analyzed.

A. Overall trends

The total resource transfers have been increasing annually, from about 97.87 billion pesos in 1995 to 197.17 billion pesos in 1999, for a 78 percent increase in a span of four years (Table 1). The two major components of the total resources are the IRA and the centrally-provided local public services (CPLPS), which together accounted for 99 percent of the annual total during the period. While the IRA constituted the bulk of revenue shares, the CPLPS however comprised the bulk of the total resource transfers. Relative to these two fund accounts, categorical grants were minimal, amounting to not more than 0.7 billion pesos annually. On the average, the total resource transfers accounted for 6 percent of GDP and 30 percent of the annual government budget during the period.

The percentage increase in per capita terms between 1995 and 1999, however, was less dramatic. While the total resource transfers grew to 2,330 pesos in 1999 from 1,428 pesos in 1995, the growth was only 63.2 percent. This suggests that population pressure impinges on the ability of the local governments to finance local public services, even with the assistance of the national government.

Table 3. Estimates of Revenue Shares, Categorical Grants and Centrally-Provided Local Public Services: 1995-99

Types	1995	1996	1997	1998	1999
A. In billion pesos					
TOTAL	97.872	117.612	139.529	182.411	174.174
Revenue Shares	42.802	46.508	58.568	60.590	75.741
IRA	42.202	45.935	58.164	59.494	74.736
Others	0.600	0.573	0.405	1.096	1.005
Categorical grants	0.691	0.553	0.394	0.372	0.616
Centrally-provided local public services	54.379	70.551	80.567	121.449	97.817
B. Per capita pesos					
TOTAL	1,428	1,683	1,952	2,496	2,330
Revenue Shares	624	665	819	829	1,013
IRA	616	657	814	814	1,000
Others	9	8	6	15	13
Categorical grants	10	8	6	5	8
Centrally-provided local public services	793	1,009	1,132	1,1667	1,309

B. Patterns of distribution

The nominal share of provinces in the total central resource transfers appears to be increasing at a faster rate than either those of the cities or municipalities during the period 1995-99 (Figure 2). The total amounts that went to provinces, cities and municipalities in 1995 were 36.75 billion pesos, 25.29 billion pesos and 23.79 billion pesos, respectively. By 1999, the corresponding amounts were 89.1 billion pesos, 45.53 billion pesos and 34.53 billion pesos.

However, the distribution of the revenue shares, which are mostly IRA, is more favorable to municipalities (Figure 3). [6]This is due to the codal IRA formula that assigns a 34 percent share to municipalities and only 23 percent share to either the provinces or the cities. Despite the equal-sharing provision between provinces and cities, the revenue shares of provinces in Figure 3 are greater than that of the cities because the estimates include other cash transfers, like the shares in tobacco excise taxes.

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[6] There are no "national/inter-regional" accounts for revenue shares because the recipients of cash transfers are fully recorded. These accounts are introduced in the allocation of categorical grants and centrally –provided local public services since the actual recipients of these funds are not fully reported.

Figure 2. Distribution of Total Resource Transfers, by LGU Level: 1995-99 (in billion pesos)

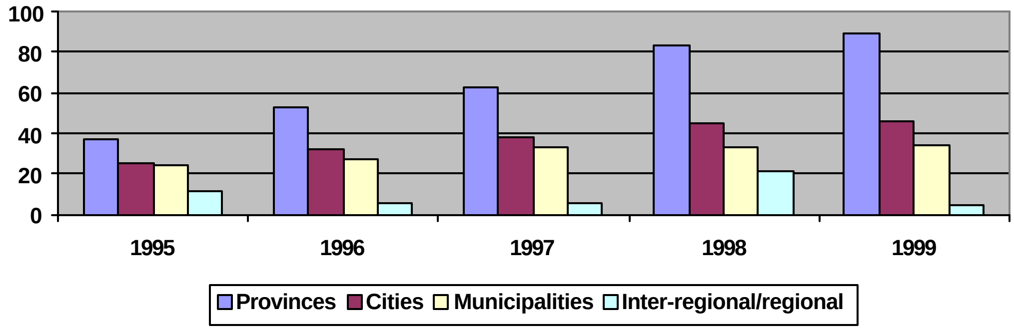
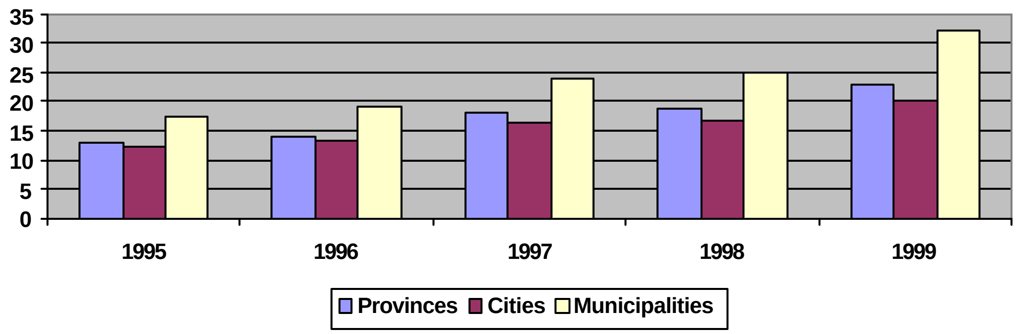


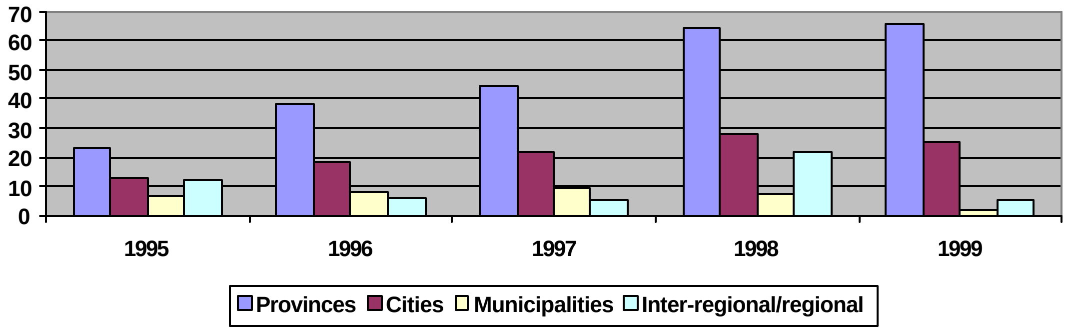
Figure 3. Distribution of Revenue Shares, by LGU Level: 1995-99 (in billion pesos)



The overall pattern of distribution across LGU levels appears to be driven by the allocation of CPLPS, which accounted for more than half of the total central resource transfers in any given year. This can be seen Figure 4, where it is shown that the share of the provinces in the CPLPS is greater than the combined shares of cities and municipalities, and including those which cannot be assigned to any LGU because of insufficient information ("inter-regional/regional" account). The total CPLPS of provinces rose from 23.06 billion pesos in 1995, which was 42.4 percent of the total CPLPS for the same year, to 65.56 billion pesos, or 67 percent of the total CPLPS, in 1999.

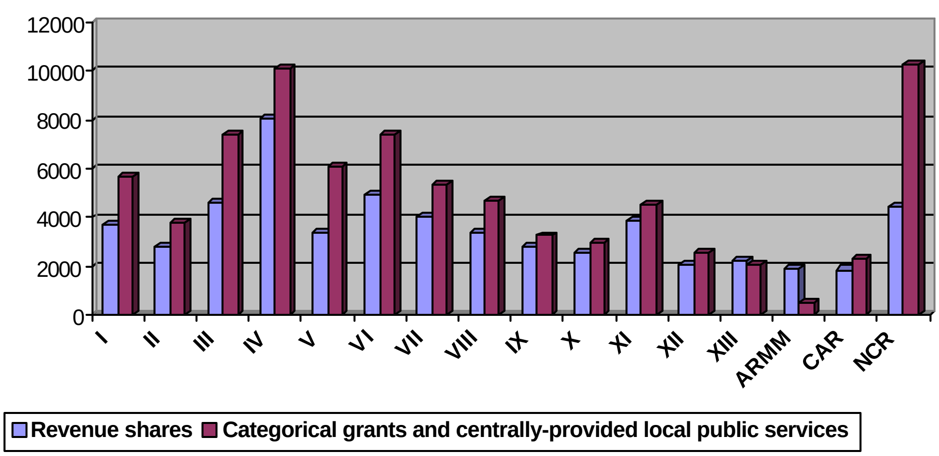
In per capita terms, however, cities appear to be better off than either provinces or municipalities. The total resource transfers to cities in 1995 amounted to 1,272 pesos per person, or 245 pesos more than the combined amount that was granted to provinces and municipalities for the same year. The disparity persisted throughout the period, with the extra amount received by cities totalling 247 pesos in 1996, 290 pesos in 1997, 327 pesos in 1998 and 230 pesos in 1999. This suggests that despite the apparent equity in the distribution of the IRA, that of the other central government resources leaves much to be desired.

Figure 4. Distribution of Centrally-Provided Local Public Services, by LGU Level: 1995-99 (in billion pesos)



The regional distribution of revenue shares, on the one hand, and, on the other, of categorical grants and CPLPS reveals two patterns. First, the two major types of resource transfers appear to be positively correlated. That is, regions with higher revenue shares also appear to have higher categorical grants and CPLPS. Secondly, the regions generally received more categorical grants and CPLPS than revenue shares. An apparent exception to this is the ARMM, whose average revenue shares for the period were greater than its receipt of other resource transfers from the central government.

Figure 5. Distribution of Total Resources by Region (Average for 1995-99; in million pesos)



C. Impact on fiscal balance

To determine the effects of the central resource transfers to fiscal balance, these resources are added to local revenues. Local revenues are the locally-generated incomes of the LGUs, such as real property tax revenues, user fees, fees for permits and licenses, incomes from economic enterprises and rentals. It should be noted, however, that the local revenues of most LGUs constitute a smaller proportion of their total revenues than the IRA, which usually accounts for more than half of the total LGU revenues (from internal and external sources). Hence, most LGUs are said to be IRA-dependent.

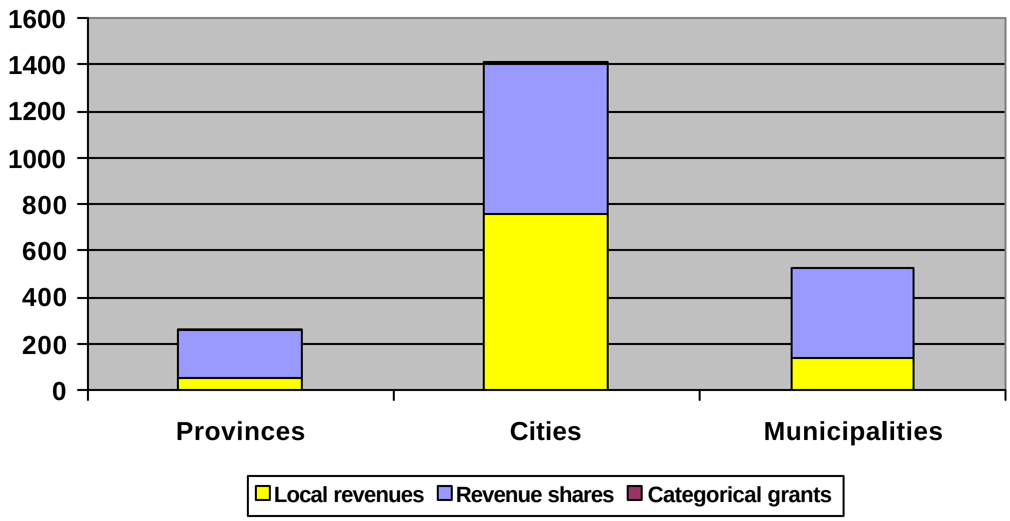
Together with the central resource transfers, local revenues determine the total available resources for the provision of local public services per area. A comparison of these resources across LGUs will therefore indicate the extent of fiscal imbalances, which can be either vertical or horizontal. The real extent of fiscal imbalances, however, will have to take into account differences in the assigned expenditure responsibilities across and within LGUs levels. Nonetheless, the estimates presented here at least suggest the financial capabilities of LGUs to carry out their assigned functions.

The vertical fiscal balance may be inferred from the differences in the total available public resources across LGU levels. As shown in Figure 6[7], for example, central resource transfers seem to aggravate the resource imbalances among provinces, cities and municipalities. During the period 1995-99, the average real per capita revenues of cities from local sources were 760 pesos, or 572 pesos more than what the provinces and municipalities were able to generate. On top of this, however, the cities received from the national government an average of 1,502 pesos per person, or 235 pesos per person more than the combined allotment to provinces and municipalities during the same period.

The horizontal fiscal balance, on the other hand, may be inferred from Figures 7[8], 8 and 9[9], where the total resources available to provinces, cities and municipalities, respectively, are shown for each income class within each LGU level. The allocation of the national government resources for local public services appears to be equitable for provinces, where lower income provinces appear to be favored more. Similar progressive allocation is observed in the case of municipalities. The allocation is relatively less progressive in the case of cities since the special cities or the highly urbanized ones found in Metro Manila appear to be favored more than others.

[7] The figures do not include the average 120 pesos per person under the "inter-regional/regional" account.
[8] Figure 7 does not include an outlier, a single 5th-class municipality whose average real per capita resource transfers amounted to 6,514 pesos during the period 1995-99.
[9] Figure 9 does not include those municipalities with unspecified income classes. The average real per capita resource transfers to these municipalities were 652 pesos during the period.

Figure 6. Local Revenues and Central Resource Transfers, by LGU Level (Average for 1999-95; real per capita pesos)



However, categorical grants and CPLPS are progressively allocated only in the case of provinces and cities, and regressively distributed in the case of municipalities. But what the lower income municipalities appear to lose in terms of their shares in the categorical grants and CPLPS, they seem to gain in terms of their higher allocations of cash transfers.

Figure 7. Local Revenues of and Central Resource Transfers to Provinces, by Income Class (Average for 1999-95; real per capita pesos)

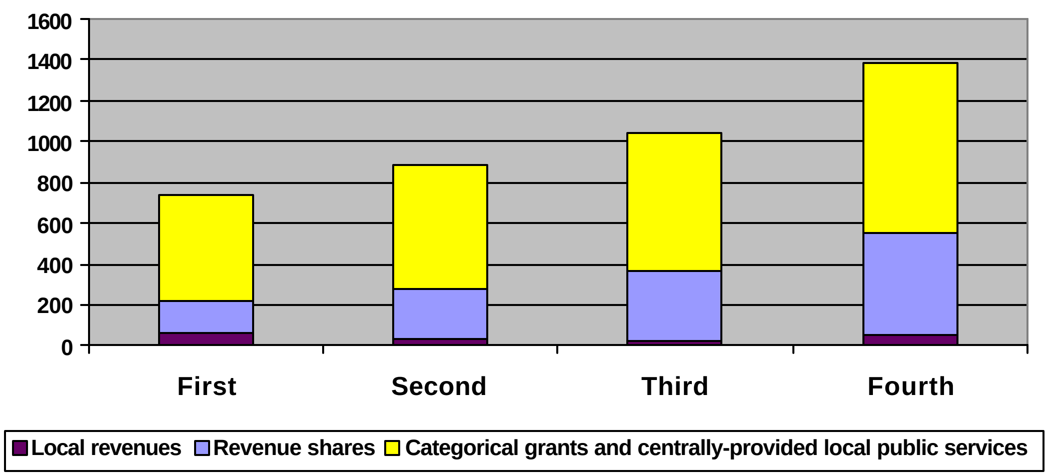


Figure 8. Local Revenues of and Central Resource Transfers to Cities, by Income Class (Average for 1999-95; real per capita pesos)

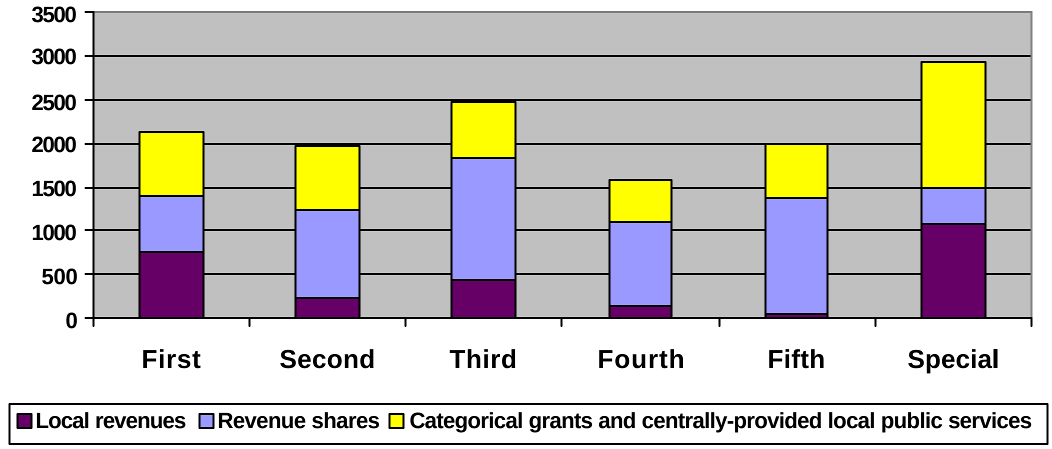
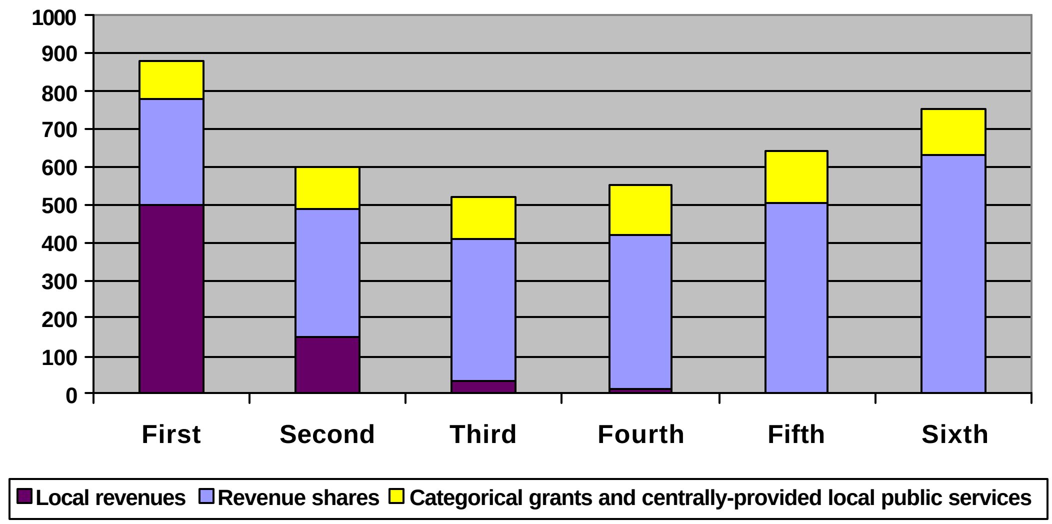


Figure 9. Local Revenues of and Central Resource Transfers to Municipalities, by Income Class (Average for 1999-95; real per capita pesos)



VI. Policy Simulations

The following policy simulation exercises are made to explore alternative transfer formulas to improve overall fiscal balance. Although only one of the many possible policy goals, it is certainly suggested by the results of the estimates presented in the previous section, which indicate that the distribution of central fiscal transfers and centrally-provided local public services may have worsened fiscal imbalances.

While there are many ways to achieve such policy goal, one particular class of transfer formulas are explored here: that of changing the IRA formula, while holding as fixed the current allocations of the other revenue share, categorical grants, centrally-provided local public services and local revenues. The focus on the IRA is partly motivated by the policy debate on this particular revenue shares and largely on the tractability of the results. Unlike the formulas or criteria used in the allocation of other central fiscal transfers and the centrally-provided local public services, the IRA formula is easy to follow and transparent. In a sense, therefore, the following simulation exercises explore the implications and limits of the IRA formula. Note however that the simulations are limited to 1999 and that they exclude the barangays (villages) and the CODEF in the computations.

It is important to note here that the simulation results are more for policy guidance rather than specific policy options for some reasons. One, the IRA formula is a politically-charged topic in the Philippines owing to the fact that it is the single most important source of revenue for most local governments. Further, adjustments in the other forms of central fiscal transfers and in the allocation criteria for the centrally-provided local public services may prove to be more equitable or efficient than any of the alternative IRA formulas investigated here. This is certainly possible since the impact of the IRA on the revenue mobilization or on expenditure allocations is not modelled nor investigated here, i.e., LGUs are assumed to passively adapt to changes in their IRAs.

The alternative IRA formulas here follows Equation (2), which takes as given the distribution of the other central fiscal transfers and centrally-provided local public goods in the specification of the new IRA formula intended to achieve certain policy goals. In addition to the primary goal of improving the overall fiscal balance, social acceptability is also considered as a secondary goal. Social acceptability is defined as the proportion of LGUs with positive financial gains as a result of the adoption of the new IRA formula to the total number of LGUs. The higher the proportion of financial gainers would therefore indicate the greater the number of possible supporters to the alternative IRA formula. This secondary goal then takes into account the IRA-dependence of most LGUs in the country.

The alternative transfer formulas are specified in Table 4. Four of these formulas are *revenue-sharing* formulas in that each takes the current IRA share as given, but reallocates the IRA across the different LGU levels (formula 1a and formula 1b) and among LGUs within each level (formula 2a and formula 2b) to improve fiscal balance. Essentially, therefore, these formulas maintain the current 60-40 sharing rule between the national government and the LGUs over the total internal revenues.

In contrast, the two other alternative formulas are *revenue-setting* formulas (formula 1c, formula 2c) in that the 60-40 sharing rules in favor of the LGUs. Essentially, therefore, these formulas impose on the national government the financial cost of adjustment towards improved fiscal balance and ensuring the widest support from the local governments.

Table 4. Six Alternative IRA Formulas

Formula	Specification*	Allowance for CPLPS and other transfers
Formula 1a	Each LGU level gets the same share in the total central resource transfers (CRT).	Full
Formula 2a	Each LGU level gets the same share in CRT, and each LGU-level share is allocated as follows among LGUs belonging to that level: 20% (high class), 30% (middle class), 50% (high class).	Full
Formula 1b	Distribute the incremental IRA (1999-2000) as follows: 50% to provinces, 30% to municipalities and 20% to cities.	Partial
Formula 2b	Distribute the incremental IRA (1999-2000) as follows: 50% to provinces, 30% to municipalities and 20% to cities. Then the LGU-level share is allocated as follows: 20% (high class), 30% (middle class), 50% (low class).	Partial
Formula 1c	Grant additional IRAs to provinces and municipalities such that their respective CRT is at par with the cities'.	Full
Formula 2c	Grant additional IRAs to all LGU levels such that the cities' IRA is 10% greater than their present share, while the provinces' and municipalities' IRAs are at par with the cities' new IRA. Then allocate the incremental IRA of each level as follows: 20% (high class), 30% (middle class), 50% (low class).	Full

* High class refers to first and second class LGUs; middle class refers to third and fourth class LGUs; and low class refers to fifth and sixth class LGUs. Special cities are classified under high class cities. Note that the total central resource transfers (old or simulated) are added to local revenues to determine improvements in fiscal balance.

The six alternative formulas are further differentiated by their degree of allowance for the CPLPS and other transfers. Partial allowance for the CPLPS and other transfers may be desirable because it minimizes the adjustment cost to some LGUs. Further, the six alternative transfer formulas may be contrasted on the basis of whether they are applied on the full amount of the IRA or only on the one-year increment in the IRA (i.e., difference between the IRA for 1999 and 2000). Applying the new formula on the incremental IRA may be desirable as it will ensure each LGU an IRA share under the new formula at least as much its share under the old formula.

Note that the two policy objectives are specified in slightly different ways to suit the various parameters used in each of the six formulas. As specified in formulas 1a and 2a, for example, "improvements in overall fiscal balance" is specified as a situation where each of the three LGU levels considered here (i.e., provinces, cities and municipalities) would have an equal amount of central resource transfers (CRT) under the alternative IRA formula. The same policy objective, however, is denoted in formulas 1b and 2b as a situation where the (projected) one-year incremental IRA for 2000, estimated to be about 11.998 billion pesos after the 20 percent share of barangays has been deducted, is allocated equally among the three LGU levels. The difference in the specification of "improvements in overall fiscal balance" is due to the allowance made for the other policy objective, to wit, to maximize social acceptability or support.

Table 5 shows the effects of the alternative IRA formulas on the per capita central resource transfers to the different levels of LGUS and on the percentage of LGUs with increased resource transfers within each level. Formulas 1a and 2a lead to the same amounts of incremental per capita CRT for each of the three LGU levels; the former formula however is likely to have higher social acceptability than the latter. This is not surprising since formula 1a, unlike formula 2a, is not biased towards lower-income provinces, which are fewer than the higher income ones. Note that formula 2a will only aggravate horizontal fiscal imbalances among provinces since, as shown in Figure 7, CPLPS and revenue shares are already biased in favor of low income provinces.

Table 5. Effects of the Alternative IRA Formulas

Formula	Total increase in central resource transfers (per capita)			Percent of LGUs with positive increments in central resource transfers		
	Provinces	Cities	Municipalities	Provinces	Cities	Municipalities*
Formula 1a	9,663	(109,970)	100,307	68	2	
Formula 2a	9,663	(109,970)	100,307	5	12	
Formula 1b	12,900	14,739	156,719	100	100	100
Formula 2b	221,004	30,987	189,803	100	100	100
Formula 1c	119,633	0	210,277	100	-	100
Formula 2c	148,631	28,998	239,276	100	100	100

Note: There were 1525 municipalities, 83 cities and 79 provinces as of June 30, 1999. * No estimates for formula 1a and formula 1b because of lack of data. The other figures in this column follow from the specification of the formula.

Different aggregate increments in per capita CRT, however, are obtained from formula 1b and formula 2b, although both proposals are equally likely to be supported by all LGUs. The reason for the difference is that formula 2b heavily favors the low income provinces, cities and municipalities, which are fewer in number than their high income counterparts. A detailed analysis of the results would show, for example, that the sole fifth class province will have an incremental IRA of 211,537 pesos under formula 2b and only 1,467 pesos under formula 1b. The lowest income cities, on the other hand, will have a 15,583-peso increase in their IRA under formula 2b and only 245 pesos under formula 1b. Therefore, formula 2b improves horizontal fiscal balance among cities but not among provinces.

As mentioned above, formula 1c and formula 2c impose the burden of adjustment on the national government. For this reason, of course, it has a better chance of getting a wide support from LGUs than the other four previous alternative transfer schemes. The extent of the extra burden to the national government, however, depends on the gravity of the fiscal imbalances. Formula 1c, for example, simply corrects for the vertical fiscal imbalances by increasing the IRA of provinces and municipalities to make their respective total resources (from local and external sources) at par with that of cities. This improves the relative standing of provinces and municipalities and worsens that of cities, although the latter will not have financial losses. In contrast, formula 2c improves the vertical fiscal imbalances and at the same time ensures financial gains for cities, thus ensuring the widest possible political support from the LGUs.

Arguably, the feasibility of the last two formulas will depend a lot on the financial condition of the national government. With its huge budget deficit and the precarious balance of the economy, however, the national government is not in a position to adopt either formula 1c or formula 2c, or any alternative transfer scheme that puts the onus of adjustment on the national government. The second-best alternatives, therefore, are formula 1b and formula 2b. These, however, will have to be refined further to account for the differences in horizontal fiscal balance within each LGU level.

VII. Conclusion and Policy Implications

Working within its limitations, the study yielded two major findings. These findings impinge on the current policy debate concerning the IRA and the need for a fiscal equalization grant scheme. First, CPLPS constituted the bulk of total central government resources transferred or granted to local governments. This implies that adjusting the IRA formula alone may not be sufficient to achieve overall fiscal balance. Adjustments in the criteria used in the distribution of CPLPS and other central fiscal transfers may also be necessary.

Second, both vertical and horizontal fiscal imbalances were noted, especially in the distribution of CPLPS and the IRA (in per capita terms). The results lent credence to the oft-repeated claim that cities, especially in Metro Manila and its neighbouring regions, appear to be favored with CPLPS more than other local governments and other regions. Also, the cities were found to have higher per capita IRA than provinces, despite the avowed intentions of the LGC. Fiscal imbalances were likewise found among different income classes of local governments within each level. Clearly, any proposed fiscal equalization grant scheme would have to take into account existing fiscal imbalances.

On the other hand, the evaluation of the alternative transfer schemes emphasized the potential trade-off between two policy objectives, namely: achieving greater fiscal balance and minimizing the adverse financial effects (i.e., social acceptability) of the proposed alternatives. The simulation exercises showed that some local governments would have higher central fiscal transfers but only at the expense of other local governments, even as the adjustment in the IRA formula improved fiscal balances. However, a wider social support for the proposed adjustment would be possible only with minimal improvements on existing fiscal imbalances. Nonetheless, incremental progress in fiscal balances can be achieved with minimal political opposition and the least burden to the national government if the adjustment were limited only to the annual increase in the IRA.

The politically difficult trade-off however can be avoided with any or a combination of the following policy suggestions:

First, the base year for the computation of the IRA can be moved from the third preceding fiscal year to the second preceding fiscal year prior to the year the allocations are made. The adjustment will enlarge the total internal revenue pie since tax collection normally increases yearly.

Second, the coordination among the different executive departments providing local public services and other transfers should be enhanced. Further, the IRA formula and the allocation criteria for CPLPS should be made more consistent.

Third, the adoption of a fiscal equalization grant scheme is opportune, potent and useful. Towards this, the Philippines has a lot to learn from the grant schemes adopted in other countries such as Canada, Australia and Germany (Ma 1997).

Finally, the devolution of CPLPS may also have to be undertaken to deepen local autonomy. Following the principle of subsidiarity, the CPLPS by definition are best administered by local governments, which have comparative institutional advantages over NGAs in the delivery of basic services. Inefficient local provision can be addressed with other forms of central transfers. The estimates provided here identify those LGC-specified functions that are only partially devolved.

It must be pointed out that this study needs further work to maximize its inputs to policy discussions. First, a more detailed analysis of the different central fiscal transfers has to be done, especially in the light of the various policy needs or requirements that spurred them. This will help assess the different policy constraints that will have to be considered in the design of an alternative IRA formula.

Further validation of the data is also required, in terms of breaking down the “regional/national” accounts, delineation of categorical grants and centrally-provided local public goods and services, and adding to the estimates other central fiscal transfers provided by other NGAs, “pork barrel” funds, and information on local outlay for the “unfunded mandates”. Detailed estimates for *barangays* will also be useful.

Lastly, other alternative transfer schemes, where both the IRA formula and the implicit allocation criteria used for the central resource transfers, have to be simulated as well. Additionally, other proposed IRA formulas contained in the different bills filed in Congress will have to be evaluated with the use of the database created in the project, if only to show the full implications of the proposals.

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