Decentralization in the Philippines After Ten Years: What Have We Learned? What Have I Learned?[1]

By

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1. Introduction

When Corazon Aquino took power and established a revolutionary government in 1986, she promised a wide-ranging package of public sector reforms including the devolution of political and administrative authority to local governments. That promise was kept through the passage of the Local Government Act of 1991 that resulted in a far-reaching devolution of both political authority and administrative authority of many services including many aspects of health care, agricultural extension, social welfare, and financial management.

The Local Government Code of 1991 is the most sweeping law changing intergovernmental structure and fiscal rules in the Philippines. By any standards, the devolution of authority in the Philippines was serious. The 1991 decentralization act significantly increased the assigned responsibilities and taxing powers of local governments in the Philippines. But more importantly, it drastically changed the intergovernmental grant system by raising substantially the financial transfers going to local governments, making the grants system rules-based, and its fund release automatic. These features have significantly improved the capability of local governments to provide essential local public services and the predictability of resources thus improving budget planning and implementation. But the local governments' gain has been offset by a potentially large cost in the form of growing fiscal imbalance and macroeconomic instability.

This paper will examine whether, after ten years, the present political, administrative and fiscal arrangement has resulted to better governance (specifically, more efficient and equitable service delivery), fiscal balance and macroeconomic stability. It will also discuss the effect of politics and weak institutions on the design, legislation, and actual implementation of the Local Government Code of 1991. Finally, I

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will spell out the policy framework needed to push forward decentralization in the Philippines.

2. Local Government Structure

Before the 'people power' revolution of 1986, the government structure in the Republic of the Philippines was highly centralized. One may argue that such a setup was a necessary arrangement for the totalitarian regime, with the national government selectively delegating powers to its layers of local governments.

The 1987 Constitution, ratified about a year and a half after the Aquino revolutionary government was installed, provides for a unitary form of government with multi-tiered structure.[3] The Philippines is a presidential republic with a bicameral legislature, consisting of the Senate with 24 members and the House of Representatives with 240 members. At the highest level is the central government operating through some 24 departments and other offices under the Office of the President. The country is divided into 15 administrative regions with most departments maintaining regional offices. In addition, there were two autonomous regions: the Autonomous Region of Muslim Mindanao (ARMM) and the Cordillera Autonomous Region (CAR).

The second tier of government is composed of local government units (LGUs) that consist of three layers: provinces, cities and municipalities, and barangays. The 79 provinces comprise the first layer. In turn, each province is fully subdivided into municipalities and component cities, each of which is further subdivided into barangays, the smallest political unit. The barangay has existed as a neighborhood unit of local government since the colonial Spanish regime. At of June 30, 2003, there are 79 provinces, 115 cities, 1497 municipalities, and 41,959 barangays.[4] The changing political subdivisions are shown in Table 1. As will be discussed below, the unusually high

Table 1: Philippines: Changing Political Subdivisions

	1981	1991	2003[b]
Provinces	75	76	79
Cities[a]	60	66	115
Municipalities	1,497	1,540	1,497
Barangays	n.a.	n.a.	41,959

Source: Philippine Yearbook 1981, National Statistics Coordination Board

Notes:

a. Including cities in Metropolitan Manila

b. As of June 30, 2003.

[3] Within the unitary state structure, two autonomous regions were created: the Autonomous Region of Muslim Mindanao (Republic Act 6734) and the Cordillera Autonomous Region (Republic Act 6766).

[4] These numbers fluctuate over time as new local government units are created while others are converted from lower level local government units to higher level ones, say from a barangay to a municipality or a municipality to a city.

conversion rate from a municipality to a city, in recent years, is a rational response to incentive structure embedded in the intergovernmental grant system as provided for in the Local Government Code of 1991.

Each level of local government unit is headed by an elected chief executive (provincial governor, city or municipal mayor, and barangay captain) and has a legislative body (composed of an elected vice-governor or vice mayor and council members). All elected officials have a three-year term of office and subject to a three-term limit. Each level of local government is autonomous. However, in areas like budgeting and legislation, higher-level government (say, a province) exercises some degree of supervision over lower level governments (say, component cities and municipalities).

The 1987 Constitution explicitly recognized local governments units as important components of the overall government structure. Article II, Section 25 provides that the "State shall ensure the autonomy of local governments" while Article 10, Section 6 provides that: "Local government units shall have a just share, as determined by law, in the national taxes which shall be automatically released to them." The latter has provided the intergovernmental grant system a solid legal bases and automaticity thus making it a transparent and predictable source of funding for the provision local public services.

3. Intergovernmental Transfer System

Before the Local Government Code of 1991 was passed, the share of local government units was, *at the maximum*, equal to 20 percent of internal revenue taxes. In practice, less than three-fourths of internal revenue taxes was appropriated and released to local governments. The fund release was discretionary on the part of the President and was subject to political bargaining.

The intergovernmental transfer system under the Local Government Code of 1991, called Internal Revenue Allotment (or IRA), is formula-based and mandatory. Moreover, its level is significantly much higher. To defray the cost of devolved expenditures, Section 284 of the Code provided for 40 percent of central government revenues collected three years before to be transferred back to local government units as internal revenue allotment. The IRA is divided among the individual local government units through a two-stage process. The first stage is to distribute the total IRA by level of local governments (province, city, municipality and barangays); the second stage is to distribute the share of each level of local governments among its individual units according to a formula based on population, land area, equal sharing.

Specifically, at the first stage, the IRA is divided among the different levels of local government as follows: provinces and cities receive 23 percent each, municipalities 34 percent and barangays 20 percent. At the second stage, the IRA share of each tier of government is then divided among the individual local government units on the basis of population (50 percent), land area (25 percent) and equal sharing (25 percent). In contrast, under the previous IRA formulation, the total amount was divided as follows: 27 percent to provinces, 22 percent to cities, 41 percent to municipalities and 10 percent to barangays. The IRA share of each level of local governments was then distributed among each local government unit according to the following factors and weights: population (70 percent), land area (20 percent) and equal sharing (10 percent).

As a result of the new formula, there was a sharp increase in the financial grants received by local governments, with the barangays as the biggest beneficiaries, followed by cities. The provinces, on the other hand, are the biggest losers considering that they absorbed almost half of the total cost of devolved functions while getting only 23 percent of total IRA.

The IRA is in the nature of an unconditional block grant, thus giving local governments wide discretion in its utilization. The only condition for the use of the IRA is that each local government unit shall set aside in the annual budgets amounts no less than 20 percent for local development projects that are embodied or contained in the local development plans.[5]

The Local Government Code of 1991 provides that the individual shares in IRA of each local government unit shall be automatically released, without need for any further action, direct to the provincial, city, municipal or barangays treasurer, on a quarterly basis but not beyond five days after the end of each quarter. However, the Central Government may adjust the IRA share of local governments in the event that an unmanageable public sector deficit is incurred by the National Government.

4. Assignment of Expenditure Responsibility

In the past, local government units were given limited taxing powers, and their expenditure responsibilities are limited to the issuance and enforcement of regulations governing the operation of business activities in their jurisdictions, and the operation of certain services and facilities like garbage collection, public cemeteries, public markets and slaughterhouses. The Local Government Code of 1991 devolves many functions and responsibilities to local governments. The Code mandates the transfer from national government agencies to LGUs the principal responsibility for the delivery of basic services and the operation of facilities in the following areas:

- agricultural extension and research;
- industrial research and development;
- social forestry, pollution control and protection of the environment;
- health services including hospitals and other tertiary health services;
- social welfare services;

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[5] In practice, this condition is treated rather loosely so that many "soft" facilities improvement projects (e.g. beautification of the plaza) and capacity-building programs (e.g. study tours of local officials) are considered as part of the menu of development projects.

- construction and maintenance of local infrastructure facilities, waterworks, sewerage and communal irrigation; and
- land use planning.

The devolution is serious both in terms of expenditure responsibilities and number of personnel transferred (Table 2). The staffing complement of four government agencies were significantly changed: Department of Agriculture, Department of Budget and Management, Department of Health, and Department of Social Welfare and Development. For a more detailed listing of expenditure responsibilities by level of local governments see Table A.1.

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

National Government Agencies	Estimated Devolved Budget (in million pesos)	1992 Agency Budget (in million pesos)	Share of Devolved Budget in Total 1992 Agency Budget (percent)	Number of Devolved Personnel	Number of Personnel Before Devolution[a]	Share of Devolved Personnel to Total Number of Personnel Before Devolution[a] (percent)
Agrarian Reform	9.4	1,842.4	0.51	-		
Agriculture	1,055.6	5210	20.3	17,673	29,638	59.6
Budget and Management	172.8	465.4	37.1	1,650	3.532	46.7
Environment and Natural Resources	167.7	1,941.8	8.6	895	21,320	4.2
Health	3,851.1	9,991.4	38.5	45,896	74,896	61.3
Public Works and Highways	1,096.3	27,109.3	4.0	-		
Social Welfare and Development	966.4	1,320.7	65.6	4,144	6,932	59.8
Tourism	2.8	207.7	1.4	-		
Transportation and Communication	0.1	7,563.9	0.0	-		
Philippine Gamefowl Commission	8.7	15.3	56.9	25	191	13.1

[a] Only for departments with devolved personnel
Source: Government authorities.

5. Revenue Assignment

Under the current tax structure, most major taxes are assigned exclusively to the national government. These are the individual and corporate income taxes, value added tax, excise taxes on alcoholic beverages, tobacco products and petroleum products, and customs duties. Under the Local Government Code of 1991, LGUs are allowed to collect real property taxes, local business tax and other taxes. A more detailed list of taxing power by level of government is shown in Table A.2. The base for each of these taxes is defined by national government legislation that also imposes limits on tax rates.

Nevertheless, the Local Government Code of 1991 expanded the tax base of local government units to include products, activities and sectors that used be outside the reach of local taxation. It also raised the allowable maximum rates at which most local taxes may be levied. On the other hand, by reducing the assessment levels for real property taxation of residential land, all types of buildings, and all types of machinery, the Code has effectively narrowed the tax base for real property taxation.

6. Local Government Borrowing

Even before the enactment of the Local Government Code of 1991, provinces, cities and municipalities were allowed to borrow from government financial institutions, such as the Philippine National Bank (PNB), the Development Bank of the Philippines (DBP), and the Government Service Insurance System (GSIS), to cover expenditures in advance of revenues and to finance the construction, installation, improvement, expansion, operation or maintenance of local infrastructure and other socio-economic development programs. However, local governments have borrowed very little to finance capital projects as a result of (a) operational and managerial problems, (b) inadequate information and conservative fiscal attitude of local officials, and (c) unrealistic loan standards.[6]

The Local Government Code of 1991 significantly expanded the power of LGUs to create indebtedness and enter into credit and other financial transactions. An LGU may do any of the following:

- Contract loans, credits, and other forms of indebtedness with any government or domestic private bank and other lending institution to finance the construction, installation, improvement, expansion, operation or maintenance of public facilities, infrastructure facilities, housing projects, the acquisition of real property, and the implementation of other capital investment projects.
- Issue bonds, debentures, securities, collaterals, notes, and other obligations to finance self-liquidating, income-producing development or livelihood projects, subject to the rules and regulations of the Central Bank and the Securities and Exchange Commission.
- Avail of loans from funds secured by the National Government for the purpose of financing the construction, installation, improvement, expansion, operation or maintenance of public markets and facilities, infrastructure facilities, or housing projects, the acquisition of real property, and the implementation on other capital investment projects.
- Enter into contract with any duly pre-qualified individual contractor, for the financing, construction, operation, and maintenance of any financially viable infrastructure facilities, under the build-operate-and-transfer (BOT) agreement, subject to applicable provisions of Republic Act 6957 authorizing the financing, construction, operation, and maintenance of infrastructure projects by the private sector.

[6] L. Kenneth Hubbell, "Local Government Credit Financing," in Roy Bahl and Barbara Miller (eds), *Local Government Finance in the Third World: A Case Study of the Philippines*, Praeger, 1983.

Despite the broad scope for credit financing, local governments have continued to borrow very little to finance their capital projects. In practice, their borrowing has been limited to government financial institutions and the Municipal Development Fund (MDF).[7] In the late 1990s, a few LGUs have successfully issued bonds.

7. Local Government Budgeting and Financial Mechanism

The Local Government Code of 1991 has paved the way for a truly decentralized local government budgeting and financial mechanism. One significant move was to transfer back the direct control and supervision of local budget officers to the local chief executives. During the early months of the Aquino revolutionary government, the local budget officers were placed under the direct control and supervision of the Department of Budget and Management, an arrangement that continued until the Code was passed. The 'nationalization' of local budget officers was clearly political since there were no strong economic or efficiency arguments for the move.

Before the Code was passed, the budgets of provinces and cities, including all local governments in Metropolitan Manila, were subject to review by the Department of Budget and Management (DBM), through their regional offices. This arrangement has become a major source of irritants between the National Government and local governments since the Commission on Audit would not allow disbursements from the local budgets unless there is prior review and approval by the DBM. Prior to the approval of the Code in 1991, this stringent requirement was relaxed through an Executive Order mandating that the local provincial and city budgets approved by the Council and the local chief executive are deemed approved though subject to post-review by DBM.

Under the Local Government Code of 1991, the budgets of provinces, highly urbanized cities, independent component cities, and municipalities with the Metropolitan Manila Authority (MMA) remain subject to review by DBM. The provincial board (Sangguniang Panlalawigan) reviews the budgets of component cities and municipalities. Such review is limited to ensuring that local governments comply with some limitations prescribed under the Code such as the proportion of the budget that may be spent on personal services[8] and on debt service and the requirement that 5 percent of the estimated revenue from regular sources shall be set aside as annual lump sum appropriation for unforeseen expenditures in case of natural calamities. If within ninety (90) days from receipt of copies of appropriations ordinances of component cities and municipalities, the Sangguniang Panlalawigan takes no action thereon, the same shall be deemed to have been reviewed in accordance with law and shall continue to be in full force and effect

[7] The MDF is a facility for relending to LGUs the proceeds of various loans and grants that the National Government has obtained from foreign governments and multilateral lending institutions.

[8] The Code limits the total appropriations, whether annual or supplemental, for personal services of an LGU for one fiscal year to not more forty-five percent (45%) in the case of first to third class provinces, cities and municipalities, and fifty-five percent (55%) in case of fourth and lower class provinces, cities and municipalities. The appropriations for salaries, wages, representation and transportation allowances and officials and employees of public utilities and local economic enterprises are not included in the annual budget and in the computation of the maximum amount for personal services.

Local government units are required to submit financial reports to the Commission on Audit (COA). As in all public funds, the financial transactions of LGUs are subject to audit by the Commission on Audit (COA). Such audit is designed to ensure that all financial transactions entered into by the local spending units are in accordance with existing budgeting, accounting and auditing rules and regulations.

8. Outcomes After Ten Years

The IRA has grown impressively at the expense of overall fiscal stability

By any standards, the growth of the internal revenue allotment to local governments has been impressive – in absolute peso value, as percent of total expenditures and in percent of GDP. But the policy questions are: Is this the desired result? What are the results and outcomes of higher IRA? Have local governments spent the grant consistent with national priorities?

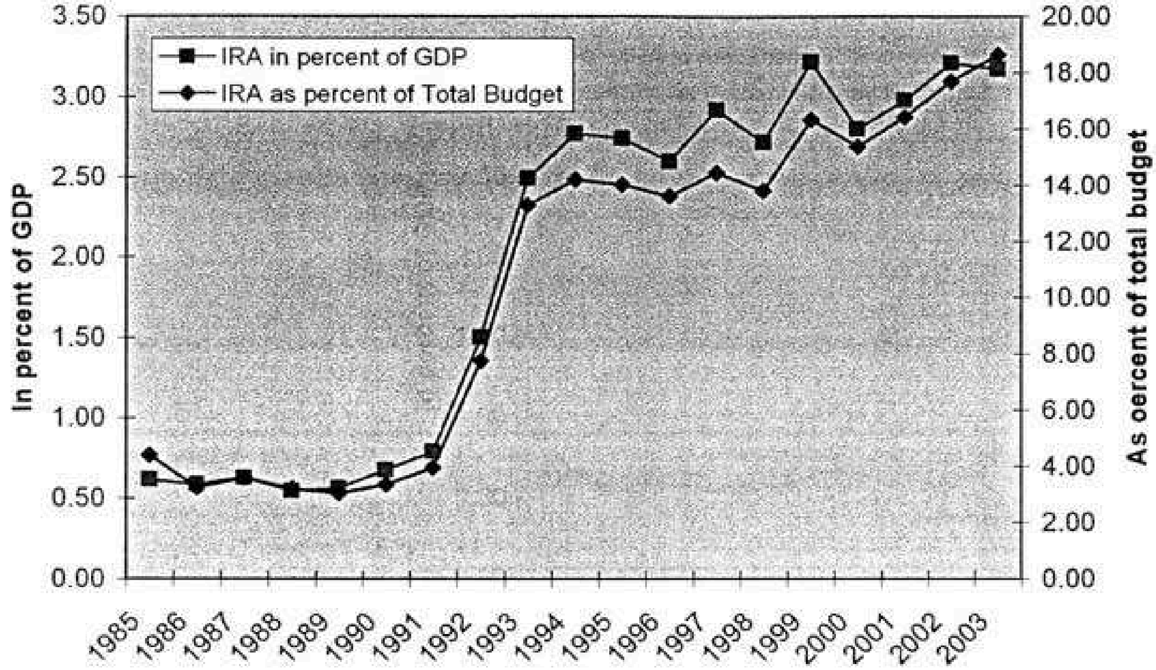
What is not generally known is that the size of the IRA as provided for in the Local Government Code of 1991 turned out to be much higher what was deemed reasonable and fiscally responsible by the Aquino administration. The original proposal by the Executive Department was an unconditional grant of 20 percent of national internal revenue taxes plus 5 percent conditional grant to be distributed on the bases of some indicators of tax effort. The outcome – 40 percent of national internal revenue taxes – was the result of political grandstanding by the Speaker of the House and Senate President at that time (see Box 1).

Box 1: Political Grandstanding Resulted to Higher than Desirable IRA

The original IRA proposal by the Executive Department was an unconditional grant of 20 percent of national internal revenue taxes plus 5 percent conditional grant to be distributed on the bases of some indicators of tax effort. The proposed new grant system was formula-based, automatically released and therefore predictable and not subject to political bargaining. It was deemed superior to the existing system that had the following characteristics: lower value (*a maximum of* 20 percent of national internal revenue taxes), subject to political bargaining, opaque, and unpredictable.

The outcome – 40 percent of national internal revenue taxes – was the result of political grandstanding by two political personalities -- the Speaker of the House and Senate President at that time – both of whom were vying (and did run) for the Presidency during the1992 national elections. Then Speaker Ramon Mitra proposed to raise, and the House approved, the Executive Department's proposal from 25 percent to 35 percent during the house deliberation of the proposed Local Government Code. Not to be outdone, then Senate President Jovito Salonga proposed to increase, and the Senate approved, the House approved IRA share of 35 percent to 45 percent of national internal revenue taxes. Because a presidential veto of the emerging Local Government Code was thought to be politically costly, the Executive Department during the Conference Committee deliberation, agreed to a 40 percent IRA share but subject to a phased implementation: 30 percent during the first year of effectivity of the Code (1992), 35 percent for the second year (1993), and 40 percent for the third year (1994) and thereafter. The rest is history.

Chart 1: Devolution Is Serious:
IRA has grown impressively



One of the strongest arguments against rapid decentralization (which presumably involves higher transfer of resources to lower level governments) is the risk of fiscal deficits and macroeconomic instability. What is happening to the Philippines now is one of the best arguments why countries which face chronic fiscal deficits should go slow in the decentralization process. There are three major reasons for the emerging fiscal crisis: first, the large and growing intergovernmental grant or IRA; second, the falling tax effort; and third, the large and rising debt service.

During the last few years, the various measures of fiscal imbalances -- the national government deficit, the consolidated public sector deficit and the public sector borrowing requirement – all point to a sharp deterioration in the country's fiscal health (Table 3). As percent of GDP, the national government deficit (excluding the cost of restructuring the defunct Central Bank) has ballooned to 3.7 percent in 1999 to 5.2 percent in 2002; it is projected to improve slightly to 4.7 percent in 2003. The primary budget balance has been insignificant: it was in the negative territory in 1999 (-0.2 percent of GDP) and 2002 (-0.6 percent) and has not reached even 1 percent during the period under review.

Table 2: Philippines: Consolidated Public Sector Financial Position, 1998-2003						
Particulars	1998	1999	2000	2001	2002	2003
	Actual	Actual	Actual	Actual	Actual	Proj.
I. Levels in billion pesos						
Public Sector Borrowing Req	**-111.3**	**-138.0**	**-179.09**	**-189.68**	**-268.29**	**-312.82**
National Government	**-50.0**	**-111.7**	**-134.21**	**-147.02**	**-210.74**	**-202.00**
CB Restructuring	-26.4	-20.5	-19.13	-23.48	-15.13	-17.86
Monitored GOCCs	-38.0	-4.6	-19.16	-24.54	-46.36	-97.04
Oil Price Stabilization Fund	0.7	1.9	0.01	0.82	0.00	0.00
Adj of NL and Equity to GOCCs	0.9	3.0	-6.60	4.54	3.94	4.08
Other Adjustments	1.5	-6.1	0.00	0.00	0.00	0.00
Other Public Sector	*28.1*	*37.5*	*22.67*	*17.44*	*34.00*	*28.00*
SSS/GSIS	17.8	36.4	15.45	9.31	25.60	20.20
Bangko Sentral ng Pilipinas	3.2	-3.9	-0.04	-0.05	1.21	1.00
Government Financial Institutions	5.4	3.3	2.83	3.89	5.39	4.45
Local Government Units	2.0	3.2	3.83	4.19	3.36	1.16
Timing Adjustments of IPs to BSP	-0.3	-2.3	0.52	-0.02	-1.56	1.19
Other Adjustments	0.0	0.8	0.08	0.12	0.00	0.00
Consolidated Public Sector Surplus/ (Deficit)	**-83.2**	**-100.5**	**-156.42**	**-172.24**	**-234.29**	**-284.82**
In Percent of GDP						
Public Sector Borrowing Req	**-4.2**	**-4.6**	**-5.3**	**-5.2**	**-6.7**	**-7.3**
National Government	**-1.9**	**-3.8**	**-4.0**	**-4.0**	**-5.2**	**-4.7**
CB Restructuring	-1.0	-0.7	-0.6	-0.6	-0.4	-0.4
Monitored GOCCs	-1.4	-0.2	-0.6	-0.7	-1.2	-2.3
Oil Price Stabilization Fund	0.0	0.1	0.0	0.0	0.0	0.0
Adj of NL and Equity to GOCCs	0.0	0.1	-0.2	0.1	0.1	0.1
Other Adjustments	0.1	-0.2	0.0	0.0	0.0	0.0
Other Public Sector	*1.1*	*1.3*	*0.7*	*0.5*	*0.8*	*0.6*
SSS/GSIS	0.7	1.2	0.5	0.3	0.6	0.5
Bangko Sentral ng Pilipinas	0.1	-0.1	0.0	0.0	0.0	0.0
Government Financial Institutions	0.2	0.1	0.1	0.1	0.1	0.1
Local Government Units	0.1	0.1	0.1	0.1	0.1	0.0
Timing Adjustments of IPs to BSP	0.0	-0.1	0.0	0.0	0.0	0.0
Other Adjustments	0.0	0.0	0.0	0.0	0.0	0.0
Consolidated Public Sector Surplus/ (Deficit)	**-3.1**	**-3.4**	**-4.7**	**-4.7**	**-5.8**	**-6.6**

Source: Budget of Expenditures and Sources of Financing, various years

Memo items:

Nominal GDP (in billion pesos)	2665.1	2976.9	3354.7	3673.7	4022.7	4310.6

Monitored GOCCs include the financial statements of the following: NPC, TRANSCO, PSALM, PNOC, MWSS, NIA, NDC, CRTA, NEA, NHA, PNR, PPA, NFA, PEZA, HGC. Excludes the proceeds from privatization of PSALM and TRANSCO assets

A more accurate measure of public sector fiscal performance is the consolidated public sector deficit (CPSD), which is the combined deficits/surpluses of the national government, government-owned and controlled corporations, and other public sector entities.[9] The CPSD has deteriorated sharply from 3.2 percent of GDP in 1999 to 6.6

[9] Also included in the CPSD are funds allocated to the Central Bank Board of Liquidators (CB-BOL) or the sinking fund that pays for the debts incurred by the old Central Bank. The 13 monitored corporations are the Philippine National Oil Company, Metropolitan Waterworks and Sewerage System, National Irrigation

percent in 2003. The associated public sector borrowing requirement has risen from 4.4 percent of GDP in 1999 to 7.3 percent in 2003, the highest in Philippine history.

Another major contributor to the ballooning fiscal deficit is the falling revenue effort, the outcome of a much emasculated 1996/97 Tax Reform Program. Again, since the tax reform program was acted upon by Congress too close to the May 1998 national elections, what emerged from Congress was not a real tax reform program. This experience and the IRA episode suggest an important policy lesson: real reforms are best done immediately after, rather than towards the end of, an election when the President or the Chief Executive has a new mandate.

An objective analysis of the IRA rules suggests that a politically strong leader is not totally helpless in withholding part of the IRA in the event of a fiscal crisis. The President may still mitigate the threat of a runaway deficit for as long as he is willing to invoke the following rules in the Local Government Code of 1991:

- In the event of an unmanageable public sector deficit is incurred by the National Government, the Secretary of Finance, the Secretary of Interior and Local Government, and the Secretary of Budget and Management shall submit to the President a joint recommendation that will institute necessary adjustments in the IRA of LGUs;

- Upon receipt of the joint recommendation of the Secretary of Finance, the Secretary of the Interior and Local Government, and the Secretary of Budget and Management and subject to consultation with the presiding officers of both Houses of Congress and the presidents of the leagues of LGUs, the President shall authorize the necessary adjustments of the total IRA to be distributed among LGUs for the given year, provided that in no case shall the adjusted amount be less than thirty percent (30%) of the national internal revenue tax collections of the third year preceding the fiscal year during which the reduction is to be made.

- Adjustments to the IRA share of LGUs shall be made only after effecting a corresponding reduction of the National Government expenditures including cash and non-cash budgetary aids to government-owned and controlled corporations, government financial institutions, the Oil Price Stabilization Fund, and the Central Bank.

In the face of the worsening fiscal deficit, the question is: why didn't the Government invoke these fiscal rules, which could have cut the deficit by P35.2 billion or 0.8 percent of GDP in 2003? Clearly, while the IRA rules provide an escape clause in the event of unmanageable public sector deficit, it requires strong political will to accept publicly that the government's finances have become unmanageable during one's watch – especially if one is facing a Presidential election.

Authority, National Development Corporation, Light Railway Transit Authority, Local Water Utilities Administration, National Electrification Authority, National Housing Authority, Philippine National Railways, Philippine Ports Authority, National Food Authority, and Philippine Economic Zone Authority.

This is not the first time that a public admission of a fiscal crisis was avoided. In December 1997, then President Fidel Ramos, through administrative fiat, attempted to withhold the amount equivalent to 10 percent of the IRA without going though the process described above to order to publicly admit that the public sector deficit has become unmanageable. The Philippine Supreme Court later rejected his unilateral act as: "bereft of any legal or constitutional bases"(Box 2).

Box 2: Balance of Power: The President Cannot Unilaterally Withhold a Portion of IRA – Supreme Court

On June 19,2000, the Supreme Court in its decision stated: "The Constitution vests the President with the power of supervision, not control, over local government units (LGUs). Such power enables him to see to it that LGUs and their officials execute their tasks in accordance with law. While he may issue advisories and seek their cooperation in solving economic difficulties, he cannot prevent them from performing their tasks and using available resources to achieve their goals. He may not withhold or alter any authority or power given them by the law. Thus, the withholding of a portion of internal revenue allotments legally due them cannot be directed by administrative fiat.

The facts: On December 27, 1997, the President of the Philippines issued Administrative Order 372 entitled: Adoption of Economy Measures in Government for FY 1998. *Section 4 of the Act provides: "Pending the assessment and evaluation by the Development Budget Coordination Committee of the emerging fiscal situation, the amount equivalent to 10% of the internal revenue allotment to local governments shall be withheld."* Note that there was no admission that "an unmanageable public sector deficit is incurred" and there was no prior consultation with the concerned parties as required by law. On November 17, 1998, Roberto Pagdanganan, then a provincial governor, national president of the League of Provinces of the Philippines and chairman of the League of Leagues of Local Governments petitioned the Supreme Court to enjoin the Executive Secretary and the Secretary of Budget and Management from implementing Section 4 of the Order which withholds a portion of their internal revenue allotments.

Issue raised: Whether or not the President committed grave abuse of discretion in ordering the withholding of 10% of the LGU's IRA?

Supreme Court decision: " Section 4 ...has no color of validity at all. The latter provision effectively encroaches on the fiscal autonomy of local governments."

The important policy question then is whether the existing fiscal rules on IRA are unreasonably hard to comply with so that no President, weak or strong, would be willing to publicly admit that a fiscal crisis has developed during his watch.

Many Municipalities are Converting to Cities

From 1981 to 1991, or ten years before the passage of the Local Government Code, only 6 new cities were created. In contrast, about 10 years after the Code was passed, 49 new cities were created (Table 1). What explains this unusually high rate of conversion from municipalities to cities? I would argue that it is a rationale response to the higher IRA share of cities. Put differently, the higher IRA share of cities has provided a strong incentive for conversion. This phenomenon has its own share of winners and losers. The losers are the old cities that have to settle for a lower IRA. The big winners are the newly converted cities. The old municipalities would benefit too, though to a lesser degree, since there would be less municipalities to share with the IRA share of municipalities.

Many Devolved Hospitals Are Being Nationalized

Among the devolved national agencies, the Department of Health (DOH) has experienced the severest adjustment pain. This is not surprising. The original Decentralization Plan of the Executive Department involved the devolution of basic education rather than basic health services. Again as a sign of weakness of the Executive Department, the then Education Secretary lobbied with Congress so that his Department was removed from among the list of agencies to be devolved.[10] When Congress agreed to the request, the DOH was promptly substituted for the Department of Education. Adding uncertainty to this abrupt substitution is the failure of the DOH to clarify it policy on devolution long after the passage of the Local Government Code. As of 1998, DOH has yet to restructure itself in order to complement the devolved system and help LGUs implement public health programs and services.[11] The Estrada government prepared a reorganization plan to improve the DOH's capability to support improvements in local government performance in carrying out health responsibilities devolved by the Local Government Code of 1991. Under the Arroyo government, the DOH reorganization plan has been held in abeyance.

The lack of clarity on the DOH policy on devolution has emboldened politicians to consolidate their desire to influence the way curative health care will be delivered. Because district representatives and provincial governors are natural political enemies, the latter group prefers a centralized health services delivery. To date (December 2003), some 72 devolved hospitals have been renationalized. The fiscal implications are clear: the move towards renationalization will add to the National Government's future budgets and its deficits; on the other hand, some local governments would benefit immensely because they would be relieved of the costs of providing basic health care to their constituents. Specially favored are local governments where these formerly devolved health facilities are located, mostly in urban centers. If so, there may be some efficiency gains as a result of scale economies in the provision of health services and greater

[10] Under a strong republic, the President should have fired the Secretary of Education, Culture and Sports for going against the President and the Executive Department's proposal.
[11] "Inter-LGU Cooperation: The Key Issues of a Devolved Health Care System, *PIDS Development Research News*, 16(6), November-December 1968.

catchment area. From the equity standpoint, on the other hand, the renationalization of health facilities is effectively a lump-sum transfer from the national treasury to the favored local community.

Has the Delivery of Devolved Services Improved?

This question is difficult to answer in the absence of a systematic performance monitoring system. There are a number of initiatives for measuring the performance of local governments. But the efforts are done on a pilot basis on a small sample of local governments through donor funding. More than 10 years after the Local Government Code of 1991 has been enacted, no government-wide effort to assess the performance of local governments is in place and is operative.

At best, one may conclude that while there has been no significant body of evidence to show that large efficiency gains from decentralization have been achieved, decentralization does not appear to have resulted in a deterioration of public services either. The Human Development Indicators by provinces suggest no deterioration of social services after the decentralization of 1992.[12] It was also observed that the local governments' social services expenditures (SSE) grew dramatically following the devolution law, growing at an average annual rate of 41 percent from 1991 to 1996. And the year immediately after the Asian crisis, SSE increased by 12.5 percent compared with an increase of only 7.9 percent for total local government spending.[13]

Has the National Government Become Leaner After Devolution?

A large and increasing share of total domestic taxes has been given up by the national government so that local governments can deliver their assigned public services. Ideally, the foregone resources should be partly offset by lower budgets and leaner staff for the devolved agencies. Here the numbers are mixed. A comparison of the budget shares of the devolved agencies (as percent of expenditures excluding interest payments) before and after devolution shows a significant decline in budget allocation for these agencies. The Department of Agriculture has shown the sharpest decline in budget share, though the decrease may be slightly exaggerated since there remains a huge lump-sum fund in the national budget for Agricultural Modernization. On the other hand, the Department of Social Welfare and Development has shown the least adjustment in terms of budget share. (Table 3)

[12] United Nations Development Program, *Philippine Human Development Report*, 2000, www.undp.org.
[13] Benjamin Diokno, "Local Governments' Expenditures for Social Services Delivery," in Asian Development Bank and World Bank, *The New Social Policy Agenda in Asia: Proceedings of the Manila Social Forum*, August 2000, pp. 115,116.

Table 3: Philippines: Budget Shares of Devolved Departments Before and After Devolution

National Government Departments[a]	1987	1988	1989	1990	1991	87-91	1999	2000	2001	2002	2003[b]	2004[b]
	Actual										Program	Proposed
	As percent of total expenditures											
Agriculture	2.83	2.60	2.74	2.73	3.12	2.80	3.37	0.67	0.71	0.84	0.60	0.52
Budget and Management	0.21	0.27	0.26	0.49	0.24	0.30	0.10	0.09	0.12	0.07	0.08	0.07
Environment and Natural Resources	1.75	2.10	2.67	2.58	2.40	2.30	1.24	1.22	1.31	1.18	1.12	1.00
Health	4.59	5.83	5.15	5.01	4.94	5.10	2.58	2.20	2.01	1.99	1.87	1.74
Social Welfare and Development	0.46	0.52	0.64	0.51	0.78	0.58	0.40	0.43	0.34	0.33	0.40	0.39
	Levels in million pesos											
Agriculture	2349	2349	3213	4009	5369		16302	3407	3796	4963	3315	3107
Budget and Management	178	246	309	725	416		471	459	623	437	421	416
Environment and Natural Resources	1454	1894	3126	3798	4125		6015	6182	7017	6988	6218	5982
Health	3811	5255	6038	7364	8510		12502	11167	10749	11770	10387	10376
Social Welfare and Development	382	465	751	754	1344		1958	2203	1812	1950	2242	2326
Memo items:												
Total Expenditures	119907	136067	171978	218096	247136		590161	648974	710756	777882	786062	869009
Interest Payments	36905	45866	54714	71113	74922		106290	140894	174834	185861	230697	271531
Total Expenditures excl interest payments	83002	90201	117264	146983	172214		483871	508080	535922	592021	555365	597478

a For Departments with devolved personnel only.
b Basod on the Budget of Expenditures and Sources of Financing FY 2004

Another way of evaluating the success or failure of the National Government in streamlining the bureaucracy of the devolved agencies after the 1991 decentralization act is by looking at the changes in their respective work force. One agency that has gone

Table 4: Philippines: Changes in the Size of the Central Government Bureaucracy Little Gain After 10 Years of Decentralization

National Government Departments[a]	Number of Personnel (1993) Before Devolution	Devolved Personnel	Net of Devolved Personnel	Total Permanent Positions 2003	Percent Change
Agriculture	29,638	17,673	11,965	11,908	-0.48
Budget and Management	3,532	1,650	1,882	1,298	-31.03
Environment and Natural Resources	21,320	895	20,425	22,154	8.47
Health	74,896	45,896	29,000	28,890	-0.38
Social Welfare and Development	6,932	4,144	2,788	2,720	-2.44

Source: Government authorities
[a]Only for Departments with devolved personnel

against the grain is the Department of Environment and Natural Resources, with its work force expanding rather than contracting ten years after the decentralization process started. One plausible explanation is that its mandate has been expanded because of the Clean Air Act.

The Department of Budget and Management has been the most successful in streamlining it its central office staff. After returning some 1,650 local budget officers to their respective local governments, DBM has progressively reduced its central office staff by 31 percent. On the other hand, the three big devolved departments – Health, Agriculture, and Social Welfare – have yet to pursue a more aggressive streamlining program. The Local Government Code of 1991 authorizes the abolition of the regional offices of these three Departments. This is one program that may have a large benefit in the long term.

9. The Challenges Ahead

The devolution process that was started in 1992 was massive and serious. Ten years after devolution, the results have been mixed. There are improvements. First, local governments have assumed greater spending responsibilities as they get more resources from the National Government. Second, fragmentary evidences suggest that some local governments have become more innovative in the delivery of local public services. Third, because the intergovernmental grants are large, predictable and transparent, local governments have better control of their finances.

But the new grant system has some drawbacks too. First, local governments have become more dependent on the National Government for their financing needs. The grant system has, by and large, been substitutive rather than stimulative. Rather than provide incentives for local governments to collect more local taxes to complement the IRA in order to finance new or improved programs and projects, many local authorities have become less willing to collect their own taxes. Second, the large IRA has now become a drag on the national budget. As trade taxes decline as a share of total tax revenues, a bigger proportion of total taxes will be distributed to local governments in the form of IRA. . With rising outlays for debt servicing and weakening tax-to-GDP ratio, the National Government may have an increasing difficult task of financing the central government expenditure responsibilities.

The immediate challenge to the Republic is clear: how to get back on track on the path of fiscal sustainability and macroeconomic stability. I suggest three concrete measures none of which would require legislation, though all would need strong political will.

- First, reduce the IRA shares of local governments from 40% of internal revenue tax collections to 30% for the next three years by explicitly recognizing that the current and prospective public sector deficit has become unmanageable.

- Second, cut administrative overhead expenses by streamlining the organizational structure of the devolved departments with focus on Agriculture, Health, Environment and Natural Resources and Social Welfare and Development. This simply means implementing Section 5 of Executive Order 503 that mandates national government agencies affected by devolution to adopt new organizational structure and operating systems responsive to decentralization imperatives.
- Third, develop and implement a strong performance evaluation mechanism for LGUs. The National Economic and Development Authority (NEDA) or the Department of Budget and Management (DBM) should undertake this activity rather than the Department of Interior and Local Government (DILG). Mandating the National Statistical Coordination Board to collect local fiscal statistics systematically and have them published as a complement to the national fiscal statistics should complement this.

The existing grant system can stand some improvement. This measure requires legislation since it involves the revision of the existing intergovernmental grant structure. The new grant system should have an unconditional grant component (similar to the present system) and a specific grant component, which would look at minimum basic needs and tax effort. The latter should be administered by a professional group of academics, businessmen and senior career officials, reporting directly to the Office of the President, but whose term of office should exceed that of the appointing authority.

Not surprisingly, the best way to push forward decentralization in the Philippines is by implementing the program as mandated in the Local Government Code of 1991, no matter how politically costly such move may be for an incumbent President.

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Table A.1: Philippines: Assignment of Responsibilities

Provinces	Cities	Municipalities	Barangays
a. Agricultural extension and on-site research services and facilities through: 1. prevention and control of plant and animal pests and diseases; 2. Establishment and maintenance of dairy farms, livestock markets, animal breeding stations, and artificial insemination centers 3. assistance in the organization of farmers' and fishermen's cooperatives and other collective organizations; and 4. transfer of appropriate technology. b. Industrial research and development services, as well as transfer of appropriate technology. c. Pursuant to national policies and subject to supervision, control, and review of the Department of Environment and Natural Resources, enforcement of forestry laws limited to community-based forestry, projects, pollution control law, small-scale mining law, and other laws on the protection of the environment; and mini-hydro-electric projects for local purposes; d. Subject to the provision of Rule XXIII on local health boards, health services which include hospitals and other tertiary health services; e. Social welfare services which include programs and projects on rebel returnees and evacuees, relief operations, and population development services; f. Construction and maintenance of parks and public assembly areas, and other similar facilities;	All services and facilties provided by the municipality and the province, and in addition thereto, the following: a. Adequate communication and transportation facilities; and b. Support services and facilities for education, police and fire protection.	a. Agriculture and fishery extension and on-site research through: 1.dispersal of livelihood and poultry, fingerlings, and other seeding materials for agriculture; 2.establishment and maintenance of seed farms for palay, corn and vegetables; medicinal plant gardens; seedling nurseries for fruit trees, coconuts, and other trees or crops; and demonstration farms; 3.enforcement of standards for quality control of copra and improvement and development of local distribution channels, preferably through cooperatives; 4.maintenance and operation of inter-barangay irrigation system; 5.implementation of water and soil resource utilization and conservation projects; and 6.Enforcement of fishery laws in municipal waters, including conservations and mangroves. b. In accordance with national policies and subject to supervision, control and review of the Department of Environment and Natural Resources, implementation of community-based forestry projects through: 1. integrated social forestry programs and similar projects; 2.management and control of communal forests with an area not exceeding fifty (50) square kilometers; and 3.Establishment of tree parks, greenbelts, and similar forest development projects.	a. Agricultural support services through a distribution system for agricultural and fishery produce collection and buying stations; b. Health and social welfare services, through maintenance of barangay health and daycare centers; c. Services and facilties related to general hygiene and sanitation, beautification, and solid waste collection; d. Administration and maintenance of the Katarungang Pambarangay e. Maintenance of barangay roads and bridges and water supply system; f. Infrastructure facilities such as multi-purpose hall, multipurpose pavement, plaza, sports center, and other similar facilities; g. Information and reading center; and h. Satellite public market, where viable

g. Construction and maintenance of infrastructure facilities funded by the province to serve the needs of the residents, including but not limited to: 1. provincial roads and bridges; 2. intermunicipal waterworks, drainage, and sewerage, flood control, and irrigation systems; 3. reclamation projects; and 4. other similar facilities. h. Planning and implementation of the programs and projects for low-cost housing and other mass dwellings, except those funded by the Social Security System, Government Service Insurance System, and the Home Development Mutual Fund. National funds for these programs and projects shall be equitably allocated to the regions in proportion to the ratio of the homeless to the population; i. Provision for investment support services, including access to credit financing; j.Upgrading and modernization of tax information and collection services through the use of computer hardware and software and other means; k. Provision of intermunicipal telecommunication services, subject to national policy guidelines and standards; and l. Planning and implementation of tourism development and promotion programs.		c. Subject to the provisions of Rule XXIII on local health boards and in accordance with the standards and criteria of the Department of Health, provision of health services thru: 1. implementation of programs and projects on primary health care, maternal and child care, and communicable and non-communicable disease control services; 2. access to secondary and tertiary health services; and 3. purchase of medicines, medical supplies, and equipment needed to carry out the devolved health services. d. Provision of social welfare services through: 1. programs and projects for the welfare of the youth and children, family and community, women, the elderly, and the disabled; 2. community-based rehabilitation programs for vagrants, beggars, street children, scavengers, juvenile delinquents, and victims of drug abuse; 3. livelihood and pro-poor projects; 4. nutrition services; and 5. family planning services. e. Provision of information services through investment and job placement information systems, tax and marketing information systems, and maintenance of public library; f. Provision of solid waste disposal or environmental management systems and services or facilities related to general hygiene and sanitation; g. Construction and maintenance of infrastructure facilities funded by the municipality to serve the needs of the residents including but not limited to:	

		1. municipal roads and bridges; 2. school buildings and other facilities for public elementary and secondary schools; 3.clinics, health centers, and other health facilities necessary to carry out health services; 4.communal irrigation, small water impounding projects, and other similar projects; 5. fish ports; 6. artesian wells, spring development, rainwater collectors, and water supply systems; 7. seawalls, dikes, drainage and sewerage, and flood control; 8. traffic signals and road signs; and 9. other similar facilities. h. Construction, maintenance and operation of municipal public markets, slaughterhouses and other economic enterprises; i. Construction, maintenance, and operation of municipal cemeteries; j. Construction, maintenance and operation of tourism facilities and other tourist attractions, including acquisition of equipment, regulation and supervision of business concessions, and security services for such facilities; and k. Provision of sites for police and fire stations and substations and municipal jail.	

Table A. 2: Philippines: Taxing and Other Revenue-Raising Powers of Local Governments

Provinces	Cities	Municipalities	Barangays
1. Tax on transfer of real property ownership – tax on the sale, donation, barter, or on any other mode of transferring ownership or title of real property 2. Tax on business of printing and publication 3. Franchise tax 4. Tax on sand, gravel, and other quarry resources 5. Professional tax 6. Amusement tax 7. Annual fixed tax for every delivery truck or van of manufacturers or producers, wholesalers of, dealers or retailers in, certain products	1. Taxes, fees, charges and impositions that the province and the municipality may impose. The rates the city may levy may exceed the maximum rates allowed for the province or the municipality by not more than fifty percent (50%) except the rates of professional and amusement taxes. 2. Percentage tax on any business not otherwise specified under (a) to (g) of the tax on business authorized for municipalities.	1. Tax on business, such as: a. Manufacturers, assemblers, repackers, processors, brewers, distillers, rectifiers, and compounders of liquors, distilled spirits, and wines or manufacturers of any article of commerce of whatever kind or nature; b. Wholesalers, distributors, or dealers in any article of commerce of whatever kind or nature; c. On exporters, and or manufacturers, millers,producers, wholesalers, distributors dealers or retailers of essential commodities. d. On retailers; e. On contractors and other independent contractors; f. On banks and other financial institutions; g. On peddlers engaged in the sale of any merchandise or article of commerce; h. On any business, not otherwise specified in the preceding paragraphs which the sanggunian concerned may deem proper to tax 2. Fees and charges on businesses and occupations; 3. Fees for scaling and licensing of weights and measures 4. Fishery rentals, fees and charges	1. Taxes on stores or retailers with fixed business establishments with gross sales or receipts of the preceding calendar year of P50,000 or less in the case of a barangay within a city, and P30,000 or less in case of a barangay within a municipality 2. Service fees or charges for services rendered in connection with the regulation or the use of barangay-owned properties or service facilities such as palay, copra or tobacco dryers 3. Fees for the issuance of barangay clearance for any business or activity located or conducted within the territorial jurisdiction of the barangay 4. Other fees and charges on: a. Commercial breeding of cocks; b. Cockfights and cockpits c. Places of recreation which charge admission fees; d. Billboards, signboards, neon signs, and outdoor advertisements e. Advertisements by means of vehicles, balloons, kites, etc.

Source: Republic of the Philippines Rules and Regulations Implementing the Local Government Code of 1991