Public Sector Governance and Decentralization in the Philippines

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Abstract

The paper specifically considers the inadequate tax powers of local governments and their uneven fiscal capacities as among the major challenges to effective decentralization and public sector governance in the Philippines. While major expenditure functions have been devolved to local governments, the national government continues to have exclusive authority over productive and broad based taxes. Consequently, government resources continue to be centralized, resulting in common pool problems, and local governments remain very dependent on national government transfers and the direct provision of devolved services. This undermines local autonomy and government accountability. The paper concludes by advocating for joint taxation by the national and local governments of productive broad based taxes, such as individual and corporate income taxes, motor vehicle tax, excise taxes, and possibly, the value added tax.

Introduction

Public sector governance lies at the core of the Philippines' weak economic performance and slow poverty reduction. Corruption issues do not only weigh down public expenditure management, there are also serious doubts about the allocation and operational efficiency of public expenditures. Moreover, the government has been in chronic budget deficit. It has accumulated a huge stock of outstanding debt largely due to weak revenue collection effort. Consequently, a significant portion of the annual national government budget goes to servicing of loans. Part of those loans financed over-priced programs and projects with doubtful socioeconomic returns. Meanwhile, the unmet demand for critical physical and social infrastructure remains huge. Thus, it seriously affects the country's economic competitiveness and poverty reduction efforts.

The dysfunctions in public sector governance consider a major factor the traditionally highly centralized government, which plunged the country into socioeconomic debacles. Consequently, the government adopted decentralization as one of the major reforms in improving public sector governance. Decentralization, particularly the perceived empowerment of local governments, was expected to strengthen government accountability, spur innovation, and make the government more responsive to the actual needs of the citizenry. Decentralization was likewise viewed as an instrument for promoting more balanced urban-regional development. Centralization was associated with the concentration of economic development in the country's capital, often derisively referred to as "imperial Manila".

Government decentralization, marked by the passage of the Local Government Code of 1991, ushered in improvements and innovations in the delivery of certain devolved services. Some local governments have shown that with dynamic leadership and active civil society participation, they can respond more efficiently and effectively to the specific needs of their constituents. However, good governance programs and practices are still more of the exception rather than the rule. Indeed, the theme "islands of good governance" instead of "archipelago of good governance" more appropriately describes public sector governance reforms in the Philippines.

This paper specifically considers the inadequate tax powers of local governments and their uneven fiscal capacities as among the major challenges to effective decentralization and public sector governance in the Philippines. While major expenditure functions were devolved to local governments, the national government continued to have exclusive authority over productive and broad based taxes. Consequently, government resources continue to be centralized leading to common pool problems. Local governments remain very dependent on national government transfers including the direct provision of devolved services. This results to the undermining of local autonomy and government accountability. Furthermore, national government transfers and spending hardly contribute to equitable provision of vital government services, more so, to a balanced and inclusive economic growth.

Geography and government structure

The Philippines is a South East Asian archipelago of more than 7,100 islands. It has a land area of about 300,000 square kilometers, and has the second longest coastline in the world. The country's population of 89 million consists of 110 different ethnic groups. Its' official languages are Filipino and English, although, it has more than 170 spoken dialects. About 92 percent of the population are Christians, 5 percent are Muslims, and the remaining 3 percent include Buddhists and animists.

The Philippines has a presidential unitary government system. The national government has three independent branches, namely, the executive, the legislature, and the judiciary. A popularly elected president heads the executive. It is functionally organized into sectoral departments, each headed by a cabinet secretary appointed by the president. The legislature, or Congress, is bicameral and composed of the Senate and the House of Representatives. The Senate consists of 24 senators, who are nationally elected for a six-year term. The House of Representatives is composed of not more than 250 members elected for three-year terms, representing legislative districts and party-list organizations. The judiciary is composed of the Supreme Court and the lower courts.

As of September 2008, the political subdivisions are composed of 81 provinces, 136 cities, 1493 municipalities, and 41,945 *barangays*. They are collectively referred to as local government units. The *barangay* is the lowest tier of local governance. A group of *barangays* comprise a municipality. The more urbanized and developed *barangays* comprise a city. A city is classified either as component, highly urbanized, or as independent city — the latter being independent of the province. A cluster of municipalities or municipalities and component cities, comprise a province. Directly elected officials comprised of a chief executive and a legislative body oversee each local government.

A group of contiguous provinces with a common history, cultural heritage, socioeconomic structure, or natural resource, form a region. The country currently has 17 regions. Except for the Autonomous Region of Muslim Mindanao, regions are not political units; and they do not have elected officials. Mainly for administrative deconcentration purposes, they serve as focal points for some planning and administrative functions of the national government, with each executive department having regional offices.

Economic growth and poverty reduction

Philippine economic performance pales in comparison with its neighbouring countries in Southeast Asia. While the latter have experienced long periods of sustained economic growth, Philippine economic performance has been lackluster characterized by periodic booms and busts. The 1980s, in particular, was a difficult and tumultuous period for the Philippines. In 1983, it had a debt crisis that turned into full-blown economic crisis. Real gross domestic product (GDP) recorded a negative growth rate of 7.3 percent in 1984 and 1985. As a result, real output per capita contracted by 0.44 percent in the 1980s: average annual real gross domestic product grew by only 1.8 percent during the period. This is way below the population growth rate of around 2.4 percent. The Philippines managed to recover in the 1990s; however, economic performance remained weak with negative output growth in 1991 and 1997. Real GDP grew at an average rate of 2.8 percent per annum, barely surpassing the population growth rate of 2.3 percent. Consequently, per capita real GDP grew by a mere 0.56 percent in the 1990s, inferior than those of other countries in the region that ranged from 3.26 to 5.51 percent.

The Philippine economy has performed much better in recent years. From 2000 to 2007, its real GDP grew at an average rate of 4.9 percent. In 2007, the Philippines registered its highest economic growth rate in the last 30 years at 7.2 percent. This

Table 1 Average growth of per capita gross domestic product, Southeast Asian countries, 1980s, 1990s and 2000s

(percent)

	1980s	1990s	2000sa
Indonesia	5.46	3.26	3.82
Malaysia	3.19	4.52	3.42
Philippines	−0.44	0.56	2.83
Singapore	5.29	4.47	2.79
Thailand	5.56	3.99	4.24
Viet Nam	2.14	5.51	6.30

Source: Hill and Piza, 2007.

translates to a real per capita GDP growth rate of 5.3 percent. However, with the onset of the recent global economic crisis, the Philippine GDP growth slowed down to 4.6 percent in 2008.

There were lingering doubts if the Philippines could sustain the level of economic growth it has achieved. The structure of the Philippine economy hardly changed over the years, and is not very competitive. Private consumption expenditures fuelled mainly the economic growth. Consumption has steadily grown especially with the growth of remittances from overseas Filipino workers. Private consumption accounted for 74 percent of the country's GDP in the 1990s, and for around 70 percent of GDP in the recent years. Together with government consumption of around 11 percent of GDP, more than 80 percent of the country's annual production goes to consumption.

Only a small fraction of the country's gross output goes to investment, notwithstanding investment's role in increasing the productivity and competitiveness of the economy. Gross capital formation accounts for only 17 to 22 percent of the country's GDP. The lower economic growth rate trajectory of the Philippines vis-a-vis its' fast growing neighbors can be largely attributed to the difference in the amount of capital formation or rate of investment. Other countries in the region spend between 23 to 36 percent of their GDP in gross capital formation. Additionally, the Philippine trade deficits also contributed to its weak economic growth. For much of the 1980s and 1990s, the contribution of trade balance to the country's GDP growth was negative, with imports exceeding exports. Weak export growth and small shares of foreign direct investment are indications of the low competitiveness of the Philippine economy.

Table 2 Expenditure shares in gross domestic product[a], Southeast Asian countries, 1990s and 2000s

(percent)

	Private Consumption		Government Consumption		Gross Capital Formation		Net Exports[b]	
	1990s	2000s	1990s	2000s	1990s	2000s	1990s	2000s
Indonesia	61.9	64.6	7.8	7.8	27.8	23.7	2.6	4.0
Malaysia	47.3	44.8	12.0	12.2	36.3	23.1	4.3	19.9
Philippines	73.8	69.5	11.3	10.9	22.4	17.0	−7.5	2.6
Singapore	43.4	43.0	9.4	11.3	35.1	23.0	12.1	22.7
Thailand	54.7	56.4	10.1	11.5	36.3	26.2	−1.1	5.9
Viet Nam	75.7	64.9	8.1	6.2	23.5	34.9	−7.3	−6.0

a) Unless otherwise indicated, GDP data are at current market prices.
b) Includes statistical discrepancy.
Source of data: ASIAN DEVELOPMENT BANK, Statistics and Data Systems Division, 13 September 2001. www.adb.org/statistics

With weak economic growth, it is not surprising that poverty incidence in the Philippines is high and its reduction has been very slow. The percentage of the population living on less than US$ 1 per day marginally declined from 22.8 percent in the 1980s to 18.4 percent in the 1990s and 15.5 percent in the early years of the current decade. This is a dismal showing compared to other countries in the region. Indonesia had a higher rate of poverty incidence, and Thailand had almost the same rate as that of the Philippines in the 1980s. In the course of two decades, Indonesia managed to reduce its poverty incidence by almost half from 28.2 percent in the 1980s to 17.4 percent in the 1990s. Thailand almost eradicated poverty from 21.6 percent to 2.2 percent in the same period. At the start of the 2000s, Indonesia's and Thailand's poverty incidence further decreased to 7.5 percent and 1.9 percent, respectively, leaving the Philippines in an unenviable position of having the highest poverty incidence with its comparator countries (Hill and Piza, 2007).

Unequal distribution of benefits from the already poor economic growth further contributes to the very slow poverty reduction in the Philippines. Income inequality in the Philippines is high relative to international norms (Hill and Piza, 2007). Among countries in the region, the Philippines ranks second to Malaysia in terms of high-income inequality. Moreover, Philippine inequality, as measured by the Gini ratio, has worsened over the years, from 41.0 in the 1980s to 46.1 in the early 2000s. Note that in spite of the stronger economic performance of the Philippines in the recent years, official estimates of poverty incidence[1] increased from 30 percent in 2003 to 32.9 percent in 2006. This translates to an additional 5.4 million Filipinos joining the ranks of the poor.

Table 3 Poverty and inequality figures, Southeast Asian countries, 1980s, 1990s and 2000s

	1980s	1990s	2000s
Proportion of population living on less than $1 a day			
Indonesia	28.2	17.4	7.5
Malaysia	2.0	1.0	0.2
Philippines	22.8	18.4	15.5
Thailand	21.6	2.2	1.9
Viet Nam	–	3.8	2.2
Gini ratio			
Indonesia	33.1	36.5	34.3
Malaysia	48.6	48.5	49.2
Philippines	41.0	42.9	46.1
Thailand	45.2	43.4	42.0
Viet Nam	–	34.9[a]	37.1[b]

a) Refers to 1995 based on ADB statistics
b) Refers to 2004 based on ADB statistics
Source: Hill and Piza, 2007.

More specifically, many observers have attributed the weak economic growth and persistence of poverty in the Philippines to the highly uneven economic opportunities and access to infrastructure and social services across regions and island groups (Balisacan, 2007). There is a widely held view that development efforts have largely been concentrated in Luzon at the expense of Visayas and Mindanao. Metro Manila and the adjoining regions of CALABARZON and Central Luzon account for more than half of Philippine GDP. Metro Manila alone accounts for an average share

Table 4 Gross regional domestic product and poverty, by region, Philippines, 2003 and 2006

	Population Census 2007	Gross Regional Domestic Product				Poverty			
		In Million Pesos		Percent Share		Poverty Incidence (%)		Poor Population Million	
	Million	2003	2006	2003	2006	2003	2006	2003	2006
PHILIPPINES	88.57	1,085.07	1,276.44	100	100	30	32.9	23.84	27.62
National Capital Region	11.55	332.10	414.29	30.61	32.46	6.9	10.4	0.74	1.16
Cordillera Administrative Region	1.52	26.11	28.34	2.41	2.22	32.2	34.5	0.45	0.51
Region I -Ilocos	4.55	32.40	38.14	2.99	2.99	30.2	32.7	1.26	1.46
Region II-Cagayan Valley	3.05	22.61	25.42	2.08	1.99	24.5	25.5	0.66	0.72
Region III-Central Luzon	9.72	97.79	107.39	9.01	8.41	17.5	20.7	1.54	1.91
Region IV-A-Calabarzon	11.74	140.75	157.41	12.97	12.33	18.4	20.9	1.90	2.21
Region IV-B-Mimaropa	2.56	30.44	34.53	2.81	2.7	48.1	52.7	1.16	1.40
Region V-Bicol	5.11	31.03	35.36	2.86	2.77	48.5	51.1	2.33	2.64
Region VI-Western Visayas	6.84	77.37	91.81	7.13	7.19	39.2	38.6	2.37	2.49
Region VII-Central Visayas	6.40	75.80	90.38	6.99	7.08	28.3	35.4	1.65	2.21
Region VIII-Eastern Visayas	3.91	24.55	27.98	2.26	2.19	43	48.5	1.62	1.95
Region IX-Zamboanga Peninsula	3.23	28.72	32.63	2.65	2.56	49.2	45.3	1.43	1.40
Region X-Northern Mindanao	3.95	52.26	62.56	4.82	4.9	44	43.1	1.57	1.66
Region XI-Davao	4.16	49.94	57.84	4.6	4.53	34.7	36.6	1.35	1.45
Region XII-Soccsksargen	3.83	38.70	44.73	3.57	3.5	38.4	40.8	1.32	1.48
Caraga	2.29	14.54	16.33	1.34	1.28	54	52.6	1.11	1.17
Autonomous Region in Muslim Mindanao	4.12	9.96	11.31	0.92	0.89	52.8	61.8	1.37	1.78

Source of data: NEDA, NSO and NSCB

of 31 percent of GDP, which is almost three times its population share. It also has the lowest regional poverty incidence, estimated at 10.4 percent in 2006. Central Luzon and CALABARZON rank next to Metro Manila with a poverty incidence of 20.7 percent and 20.9 percent, respectively. The Autonomous Region of Muslim Mindanao has the lowest GDP share of only 0.9 percent and the highest poverty incidence of 61.8 percent. Joining the tail end in the ranking are CARAGA and Eastern Visayas with 1.28 percent and 2.19 percent share of GDP, and 52.6 percent and 48.5 percent poverty incidence, respectively.

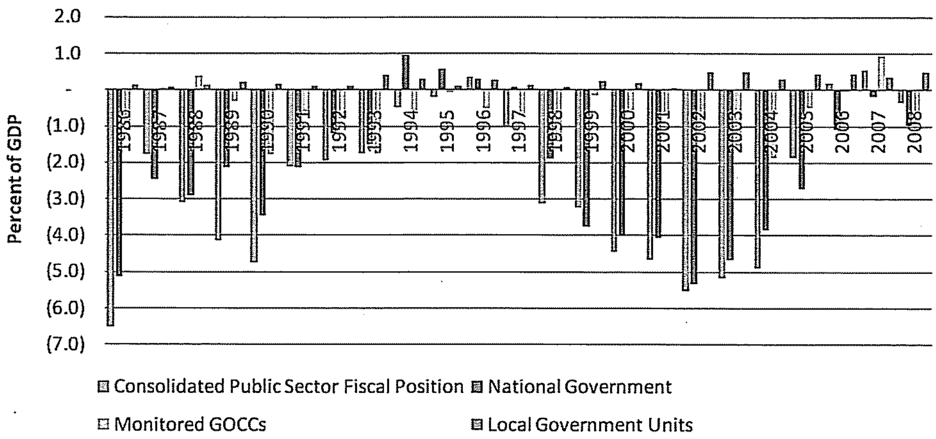
The relationship of poverty and income growth is likewise evident across provinces. Based on data of 77 provinces in the Philippines, Balisacan (2007) observed that while poverty reduction is closely linked to the rate of economic growth, the quality of economic growth also matters. In particular, he noted that infrastructure, human capital, economic climate, trade regime, and agricultural relation all contribute to provincial income growth and hence, to poverty reduction. However, the effects of infrastructure, particularly access to quality roads and electricity, and human capital, such as basic health and education on poverty reduction are much stronger. Unlike the other factors, which affect poverty only indirectly through their effect on income growth, infrastructure, and human capital also affect poverty reduction directly by affecting the distribution of benefits from economic growth.

Monsod and Monsod (2003) also noted that the Philippines' performance alongside the Millennium Development Goals (MDGs) significantly varies across regions and provinces. Regions and provinces that have better infrastructure, greater access to markets, and higher proportions of the population near the capital, have higher per capita income, lower poverty incidence, and better chances of meeting other MDG targets. On the other hand, areas with harsh climates, poor infrastructure, strong political dynasties, and peace and order problems, tend to have higher poverty incidence, and scored poorly in meeting MDG targets.

Public sector governance issues

Weak public sector governance is a major factor for the anemic economic performance and slow poverty reduction in the Philippines. The public sector, which includes the national government, local governments, major government owned and controlled corporations, and government financial institutions, has been in chronic deficit. From 1986 to 2007, the consolidated public sector financial deficit averaged at 2.6 percent of GDP per year, with peaks of 6.5 and 5.5 percent of GDP in 1986 and 2002, respectively. Figure 1 shows that the biggest contributor to the public sector deficit is the national government. The chronic fiscal deficit has dragged down the national savings and investment rate of the Philippines. As Sicat (2007) pointed out, public sector borrowing reduces the amount of loanable funds that can be used by the private sector for its own investment and operation. Consequently, the private sector's capacity to generate higher income and savings is stunted.

The chronic public sector deficit has also led to the stockpiling of the foreign debt. In 2006, total external debt of the Philippines amounted to US$60.3 billion, 61 percent of which consisted of public and publicly guaranteed debt. The Philippines' external debt, as a percentage of gross national income averaged at 64.1 percent and 66.5 percent in the 1990s and 2000s, respectively. The country's huge external debt and its high dependence on foreign capital have made the Philippines highly vulnerable to currency speculation and financial and economic shocks arising from external sectors. These conditions of low national savings and macroeconomic instability have posed as major constraints to investment in the Philippines.



Source of basic data: Department of Budget and Management, Budget of Expenditures and Sources of Financing, Various issues

Figure 1 Consolidated public sector fiscal position, by major items, Philippines, 1986–2007

Other factors that have discouraged investments in the country are corruption and the poor state of infrastructure, which raises the costs and uncertainty of doing business. Corruption in the Philippines appears to be endemic. A World Bank (2008) study estimates that about P30 billion annually or an average of 20–30 percent of the every government contract is lost to corruption or inefficiency. The Executive Opinion Survey of the World Economic Forum (2008) ranked corruption as the most problematic for doing business in the Philippines, followed by inefficient government bureaucracy and inadequate supply of infrastructure. Public trust of politicians is very low and there are serious concerns about diversion of public funds and wastefulness of government spending. Out of 134 countries, the Global Competitiveness Report 2008–2009 ranked the Philippines 123rd on public trust of politicians, 120th on wastefulness of government spending and 117th on diversion of public funds.

Philippine infrastructure also rates poorly. The Global Competitiveness Report 2008–2009 ranks the Philippines 92nd out of 134 countries in terms of the quality of infrastructure, particularly transportation and communication. As the World Bank (2008) pointed out, inadequate funding is not the only reason for the low quality of the country's infrastructure. Infrastructure spending by the government is very uneven across regions, with the cities and urban areas getting much of the resources at the expense of rural areas. The poor state of infrastructure and public utility services in some regions of the country has kept the overall costs of domestic production and marketing high (Sicat, 2007).

Government decentralization

In 1986, the Philippines embarked on the restoration of democracy with government decentralization as one of its major pillars. The 1987 Constitution adopted local autonomy as a principle and policy of the state. Government decentralization was also viewed as a means to improve public sector governance. It is posited that decentralization can promote greater people participation and effective representation, which lead to a more democratic and accountable government. It is likewise held that decentralization can promote the dispersion of economic development to the regions and countryside. Local governments can be an effective partner of the national government in improving public service delivery through better matching of public services with local preferences.

Republic Act No. 7160, or the Local Government Code of 1991, is considered a landmark law in government decentralization. The Code devolved the responsibilities and powers over certain basic services and regulatory functions, including the corresponding assets and personnel, from the national government agencies to local governments. These basic services are: health (field health and hospital services and other tertiary services), social services (social welfare services), environment (community-based forestry projects), agriculture (agricultural extension and on-site research), public works (funded by local funds), tourism (facilities, promotion, and development), telecommunications services and housing projects (for provinces and cities), and other services such as investment support. Education, which receives the biggest budgetary allocation, remains to be a national government function. The only education-related function devolved to local governments is school building maintenance.

To enable local governments to carry out their functions, the Code increased the local tax rates, and local government shares in the internal tax revenues of the national government, from 11 percent to 40 percent. The Code also entitled local governments to a share in the gross collection of the national government from taxes and proceeds derived by any government agency or government-owned corporation in connection with the utilization and development of natural resources in their respective territorial jurisdictions. Finally, the Code authorized local governments to finance capital investment projects through borrowing and bonds issuance, and to enter into build-operate-transfer contracts with private firms.

The Code provided the legal and institutional infrastructure for strengthening civil society participation and promoting greater government accountability. It mandated the creation of special bodies, such as the local development council, local health board, local school board, and local peace and order council. It also provided for the representation of non-government organizations and people's organizations by allocating them specific seats in these special bodies. There are provisions for direct democracy, such as the system of recall, initiative, referendum, and mandatory public hearings. As provided in the Code, an elected local government official can be recalled from office for loss of confidence by its registered voters. Registered voters of a local government unit may also directly propose an enactment or amendment of a local ordinance. A referendum is mandated for any law or ordinance on the creation, division, merger, abolition, or alteration of boundaries of local governments. A referendum can also be held to approve, amend, or reject an ordinance enacted by local legislative councils.

The Code also encouraged cooperative arrangements among local governments towards the efficient delivery of services. They may consolidate or coordinate their efforts, services, and resources for purposes commonly beneficial to them. The creation of umbrella-type leagues at the various local government levels, i.e., league of *barangays,* league of municipalities, league of cities, and league of provinces, are mandated for the purpose of ventilating issues and forging common stands or solutions on the issues that affect the local governments at each level. The different local governments are represented in their respective leagues by their chief executives.

Mixed assessment of the government decentralization

Seventeen years after the passage of Code, however, scholars observe that government decentralization in the Philippines has mixed results. Balisacan and Hill (2007) succinctly stated that:

> Decentralization in the Philippines has been neither a notable success nor a disappointing failure. The reform has not delivered what some of its proponents might have expected: a decisive shift of power and resources out of the center, a vibrant, efficient and responsive system of local government, and a general shift in the quality of governance through the competitive 'voice and exit' accountability mechanisms. Conversely, the reform can hardly be termed a failure. It has broadly 'worked' in the sense that some administrative and political authority has been transferred to the regions, and some local governments have performed well.

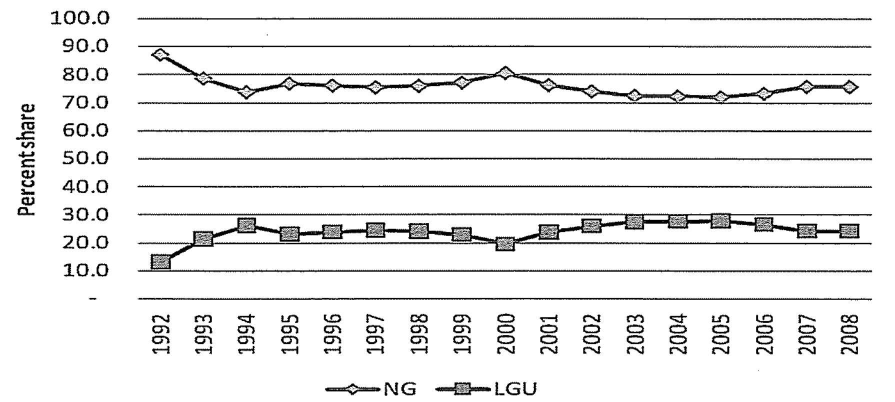
The *Gantimpalang Panglingkod Pook or Gawad Galing Pook*[2], an awards program on innovation and excellence in local governance has given recognition to a number of programs initiated by local governments in the delivery of devolved functions ranging from the provision of health services, and management and improvement of the environment to alternative ways of generating local revenues. However, in spite of efforts to popularize and promote their adoption by other local governments, good governance programs and practices are still more of the exception rather than the rule.

Decentralization has not significantly improved the quality of local governance as indicated by progress in human development[3]. Capuno (2007) notes that improvement in human development across provinces has been very slow. Moreover, the list of the richest and poorest provinces has remained largely the same over the years. Of the 74 provinces with available data, he observed that only eight provinces showed notable improvement in the human development index between 1990 and 2000. The scores of 63 provinces remained almost the same, and even deteriorated for three provinces during the period.

Manasan and Chatterjee (2003) also observed that decentralization did not have pronounced effects in reducing interregional and interprovincial equity in the Philippines. The dispersion or variation in the provincial-level per capita household income consistently increased between 1988 and 1997 before declining in 2000. They also noted that the speed at which poorer provinces caught up with richer ones was faster during the pre-Code period (1988–90) compared to the early post-Code period (1991–1997). The speed of convergence hastened in 1997–2000, but this could be attributed to the slowdown in the growth of the richer local governments that were more adversely affected by the Asian financial crisis.

Expenditure decentralization

If one looks at the fiscal ratios, as indicated by the shares of local governments in total government expenditures and total government revenues, one would still see a highly centralized government. The national government continues to dominate government spending. Prior to devolution, the national government accounts for around 87 percent of general government expenditures net of debt service. With



	1992	1993–1999	2000–2007
National Government (NG)	87.0	76.3	74.70
Local governments (LGUs)	13.0	23.7	25.30

Source of basic data: Department of Budget and Management, Budget of Expenditures and Sources of Financing, Various issues

Figure 2 Shares of national government and local governments in general government expenditures net of debt service, Philippines, 1992–2007 the devolution, the share of national government to total expenditures net of debt-service marginally declined to around 75 percent. The share of local expenditures on the other hand, almost doubled from 13 percent to 25 percent. However, a 25 percent share in government expenditures is still very low to effect a decisive shift of power and resources from the national government to local governments.

Total government expenditures as percentage of GDP before and after devolution hardly changed. Thus, improvement in the provision of government services can only come from greater efficiency in government spending. However, available data are not very encouraging. Of the national government budget around 73 percent is earmarked to mandatory expenditures (e.g., interest payment, personnel services, and internal revenue allotment) leaving only around 27 percent that is allocable. Capital outlays expenditures of the national government averaged only 3.6 percent of GDP in the 1990s and further declined to 2.5 percent in the 2000s. On the part of local governments, it is estimated that 49 percent and 32 percent of their expenditures goes to personnel services, and maintenance and other operating expenditures, respectively; only around 19 percent are allocated to capital outlays. Combined national and local governments capital outlays expenditures amounts to only around 4 percent of GDP[4]. Thus, the poor quality of the country's infrastructure is not surprising.

The Code provides that as a general principle, national government agencies are mainly responsible for formulating policies and standards, and providing funding support and technical assistance. However, the Code also allows national agencies to implement devolved public works and infrastructure projects and other facilities, programs, and services funded under the annual General Appropriations Act and those funded from foreign sources. The Code further allows the national government to augment the delivery of local government services when the latter cannot meet the needs of the local inhabitants.

It appears that national government agencies and Congress would rather be directly involved in providing devolved services instead of providing local governments with additional transfers or grants for the latter to implement the devolved functions themselves. Capuno, Manuel, and Salvador (2001) estimated that between 1995 and 1999, the Departments of Education, Health, the Interior and Local Governments, and Public Works and Highways had annual total combined expenditures on devolved activities ranging from 7.4 billion to 34.0 billion pesos. Balisacan and Hill (2007) also noted that there has been no serious effort to downsize national agencies and abolish their regional offices in spite of the fact that many of their functions have been devolved to local governments.

Congress, for its part, has increased the annual allocation for the Priority Development Assistance Fund in the national government budget to fund projects identified by members of Congress. The Fund amounted to P11.4 billion in 2007. In addition, members of Congress are also known to make realignments in the budgets of national government agencies to accommodate their preferred local programs or projects. This practice has come to be accepted as the Congressional Initiative Allocation. The exact amount that finds its way to the annual national government budget is not known, but includes the school building funds and public works allocation. The pork barrel system of allocating resources to members of Congress has not helped much in promoting more equitable and efficient infrastructure spending. The Priority Development Assistance Fund is distributed equally by legislative districts regardless of their varying socioeconomic conditions, while the Congressional Initiative Allocation is accessed through political negotiation. The pork barrel system has likewise resulted in highly fragmented and ill-executed infrastructure projects, even though many of these are individually good rural projects (Sicat, 2007).

Revenue decentralization

The shares of the different government levels in total government revenues have defied decentralization to a higher degree. From 4.9 percent in 1990, the share of local governments in total government revenues increased to only 7.6 percent and 6.7 percent in 2000 and 2007, respectively. With regard to tax revenues, the combined share of all local governments amounted to only 3.8 percent in 1990 to 6.5 percent and 5.8 percent in 2000 and 2007, respectively. The national government continued to account for the lion's share of total government revenues, from 95.1 percent before the Code to an average of 93 percent after the Code took effect.

Table 5 Revenues of national government and local governments, Philippines, 1990, 2000 and 2007 (percent share and as percent of gross domestic product)

	Percent shares						As Percentage of GDP					
	1990		2000		2007		1990		2000		2007	
	NG	LGUs	NG	LGUs	NG	LGUs	NG	LGUs	NG	LGUs	NG	LGUs
Tax revenues	96.2	3.8	93.5	6.5	94.2	5.8	14.1	0.6	14.6	1.0	14.0	0.9
Non-tax	89.2	10.8	83.6	16.4	89.4	10.6	2.5	0.3	2.8	0.3	3.1	0.4
Total revenues*	95.1	4.9	92.4	7.6	93.3	6.7	16.8	0.9	17.7	1.3	17.1	1.2

* Excludes foreign grants
Source of basic data: DBM, Budget of Expenditures and Sources of Financing; COA, Annual Financial Report, Local Governments, Various years.

Centralization of government revenues can be attributed to the exclusive authority of the national government over the major taxes, such as taxes on income of individuals and corporations, excise taxes, value added tax, travel tax, motor vehicle tax, and international trade taxes. National Internal Revenue Code, as administered by the Bureau of Internal Revenue defines The tax bases and rates for the aforementioned internal taxes. The Bureau of Customs separately administers international trade taxes. The two bureaus are organized into regional and district offices, which do not coincide with the administrative regions or local governments.

The only major taxes assigned to local governments are real property and business license taxes, with allowable rates and exemptions prescribed by the Code. In addition to local taxes, local governments may also earn income from user fees and

Table 6 National government revenue collections, by tax type, Philippines, 2007

Particulars	Billion Pesos	Percent share
Tax revenues	932.94	82.08
Of which:		
Net Income and Profits	426.96	37.57
Excise Taxes	54.07	4.76
Sales Tax and Licenses	145.10	12.77
Import Duties and Taxes	209.44	18.43
LTO-Motor Vehicle Fees	8.33	0.73
Non-tax revenues	203.62	17.92
Of which:		
Collection from other Offices	107.89	9.49
Privatization Proceeds	90.62	7.97
Total revenues	1,136.56	100.00

Source of basic data: Department of Budget and Management, Budget of Expenditures and Sources of Financing

Table 7 Composition of total local government income, by level and by source, 2007

	Billion pesos				Percent share			
	Total	Prov	Cities	Mun	Total	Prov	Cities	Mun
Total Local Sources	81.71	9.94	56.19	15.58	34.89	18.47	55.43	19.71
Tax revenue	57.56	4.83	43.77	8.96	24.57	8.97	43.18	11.33
Of which:								
Property Tax	29.17	4.06	21.22	3.88	12.45	7.55	20.94	4.91
Business Tax	23.42	0.02	19.35	4.05	10.00	0.03	19.09	5.12
Community Tax/ Residence Tax	1.05	0.00	0.69	0.36	0.45	0.00	0.68	0.46
Amusement Tax	0.80	0.05	0.69	0.06	0.34	0.09	0.68	0.08
Fines/Penalties on Local Taxes	1.17	0.12	0.85	0.20	0.50	0.22	0.84	0.26
Non-tax revenue	24.16	5.11	12.42	6.63	10.31	9.50	12.25	8.38
Permit Fees	2.66	0.04	1.84	0.78	1.14	0.07	1.82	0.99
Hospital Fees	1.96	1.34	0.58	0.04	0.84	2.48	0.57	0.06
Income from Markets	2.84	0.00	1.39	1.44	1.21	0.00	1.37	1.83
From External Sources	152.51	43.87	45.18	63.46	65.11	81.53	44.57	80.29
Of which:								
Internal Revenue Allotment	146.59	43.01	43.04	60.54	62.58	79.93	42.46	76.58
Total Income	234.23	53.81	101.37	79.05	100.00	100.00	100.00	100.00

Source of basic data: Commission on Audit, Annual Financial Report; Local Governments, 2007 the operation of local enterprises, such as hospitals, public markets, and slaughterhouses. Each local government unit administers local taxes independently. The local and national tax authorities have no formal links and do not coordinate with one another in practice.

Overall, local governments generate only around 35 percent of income from own local sources; 65 percent of their income comes from national government transfers. Provinces, taken together, generate only 15.3 percent of their annual income from own local sources — 8.5 percent from tax revenues and 6.8 percent from non-tax revenues. Municipalities, on the other hand, raise only 19.9 percent of their income on their own: 12.1 percent and 7.9 percent from tax and non-tax revenues, respectively. Hence, both provinces and municipalities are highly dependent on national government transfers. Cities are the most financially independent among the different local government levels, but still locally generate just over half of its revenues. The main reason for the chronic public sector deficit is low tax effort. In the last 47 years (1960–2007), the Philippines' annual national government budgets were in deficit except for eight years. From 1988 to 2007, the national government revenue-to-GDP ratio averaged at only 16.7 percent while expenditure-to-GDP ratio averaged at 18.8 percent. The World Bank (2008) estimates that the number of registered individual taxpayers is 20 to 28 percent lower than the potential, while registered corporate taxpayers number 12 percent lower than the potential. At the same time, there are 130,000 inactive taxpayers in its tax registry. These taxpayers have not filed returns or paid taxes for three consecutive years. In 2006, less than 50 percent of the registered individual taxpayers filed income tax returns. It also noted that the Philippines has the lowest value added tax registration among countries. It is estimated that the national government can increase its current collection to up to 35 percent if it can plug the leakages in the income and value added tax systems.

The same low tax effort can be observed at the local government levels. Local government revenue-to-GDP ratio amounted to only 0.9 percent in 1990; it marginally increased to 1.3 percent in 2000 and declined again to 1.2 percent in 2007. It is observed that local governments loathe taxing their constituents, as this could be politically costly. Majority of local governments do not regularly update their valuation and assessment of real properties. A joint study of the World Bank and the Asian Development Bank (2005) also pointed out that local governments are weak in many areas of tax administration as evidenced by (a) the prevalence of non-filers, stop filers, and late filers, (b) infrequent exercise of audit and enforcement (temporary closures and property auctions) authority, and (c) limited availability of taxpayer services.

Nonetheless, it is also important to point out that many of the taxes assigned to local governments in the Local Government Code are "nuisance taxes," which cost higher to collect compared to the revenues that they generate. From a revenue-cost perspective, the local authorities may be justified in not collecting seriously these taxes, notwithstanding that doing so contributes to the culture of weak tax enforcement by local authorities and non-compliance by taxpayers.

National governmental transfers

Aside from the low fiscal ratios of the local governments, there is also the steadily increasing imbalance between the local government expenditure and revenue shares, pointing to increasing dependence of local governments on national government transfers. National government transfers to local governments consist of two major types, namely, general-purpose grants and specific-purpose grants. General-purpose grants include the internal revenue allotment, shares from the utilization of natural resources, and some special taxes. Law prescribes the total amount and local governments have wide discretion on their utilization. Specific-purpose grants, on the other hand, consist of national government assistance to the local governments; they are tied to the implementation of certain programs and projects classified as national government priorities.

The internal revenue allotment demands special attention because it accounts for the single biggest amount of transfer to local governments, averaging at 94 percent of the total annual national government transfers from 1992 to 2008. It represents the 40 percent share of local governments in the national internal revenue

Table 8 National government transfers to local governments, by type of transfer, Philippines, 1992, 2000, and 2008

PARTICULARS	In Billion Pesos			Percent Share		
	1992	2000	2008	1992	2000	2008
General Purpose	**20.30**	**115.68**	**218.70**	**92.10**	**95.27**	**94.37**
Internal revenue allotment	20.30	114.28	210.73	92.1	94.1	90.9
Special Shares of Local governments in the Proceeds of National Taxes	–	1.41	7.97	0.0	1.2	3.4
Special Purpose	**1.74**	**5.74**	**13.04**	**7.90**	**4.73**	**5.63**
Magna Carta for Public Health Workers	–	–		0.0	0.0	0.0
Local Government Empowerment Fund	–	–	–	0.0	0.0	0.0
Local Officials Insurance Premium Fund	0.03	–		0.2	0.0	0.0
Barangay Officials Death, Disability & Accident Benefits Fund	–	–	0.04	0.0	0.0	0.0
Metropolitan Manila Development Authority	–	0.70	1.77	0.0	0.6	0.8
Pasig River Rehabilitation Commission	–	–	0.25	0.0	0.0	0.1
Municipal Development Fund	–	3.50	0.93	0.0	2.9	0.4
Special Financial Assistance to LGUs	–	1.54	–	0.0	1.3	0.0
Financial Assistance from National Government	1.71	–	3.54	7.8	0.0	1.5
Premium Subsidy for Indigents Health Insurance	–	–	4.50	0.0	0.0	1.9
Kilos Asenso Support Fund			2.00	0.0	0.0	0.9
TOTAL	**22.05**	**121.42**	**231.74**	100.0	100.0	100.0
As Percent of GDP	1.6	3.6	3.0			

Source: Department of Budget and Management, Budget of Expenditures and Sources of Financing, Various Issues taxes collected by the Bureau of Internal Revenue, a national government agency under the Department of Finance. Its annual amount is computed on the basis of the tax collections of the third preceding year, and allocated to local governments based on a two-step formula provided in the Local Government Code. First, the total internal revenue allotment is divided by levels of government: provinces (23 percent), cities (23 percent), municipalities (34 percent), and barangays (20 percent). Second, within each level the amount is divided among the different local governments based on population (50 percent), land area (25 percent) and equal sharing (25 percent).

Some local governments also receive shares in the gross collection derived by the national government from mining taxes, forestry and fishery charges, and other taxes, fees, and charges from the utilization and development of natural resources in their respective territorial jurisdiction. These include local government shares in the tobacco excise tax and taxes from collected from the Special Economic Zones, and earnings of the Philippines Amusement and Gaming Corporation and Philippine Charity Sweepstakes. The total combined amount of the local government special shares from these sources has increased steadily from almost zero in 1992 to 3.4 percent in 2008. Unlike with the internal revenue allotment, not all local governments receive such shares since only those local governments where income or taxes from natural resource utilization originated are entitled to them. Their distribution is based on formula fixed by law.

Special purpose grants consist of motley of funds designed to provide financial assistance to local governments for the implementation of devolved functions in support of specific policies and programs of the national government. Because these change with changes in leadership, the list of special purpose grants consequently varies from one administration to the next.

Special purpose grants pursue three major goals. The first is to assist local governments in carrying out certain mandates of the national government, such as the Magna Carta for Public Health Workers and the Premium Subsidy for Indigents under the National Health Insurance Program. The second goal is equalization, like the Local Government Service Equalization Fund intended for local governments belonging to the fifth and sixth income classes, and the Local Government Empowerment Fund to assist the 21 poorest provinces and fifth and sixth income class local governments in putting up counterpart funds for foreign-assisted projects. The third goal is to encourage more spending on certain services deemed important by the national government. Special purpose grants under this category are usually designed as matching grants, such as the Department of Health's for the promotion of family planning program.

Assessment of fiscal decentralization and national government transfers

In summary, fiscal decentralization in the Philippines has been carried out by devolving expenditure functions to local governments without commensurate enhancement of their taxing powers. The expenditure-revenue imbalance or fiscal imbalance is addressed primarily through national government transfers and direct provision or augmentation of local services by the national government.

Among the local government levels, the province appears to have the biggest fiscal imbalance problem. As the highest and biggest tier of local government, the province is supposed to exercise general supervision over the lower tiers, and assume responsibilities over services that have economies of scale and wide geographic coverage, such as hospitals. Based on the actual expenditures of the national government on the functions devolved to different local government levels, Manasan (2007) estimated that the provinces absorbed 37.0 percent of the total costs of devolved functions, ranking next to municipalities, which absorbed 38.5 percent, yet provinces appear to have the least access to the most productive and broad-based local taxes. While they can levy a number of taxes, the only major tax they have access to is the real property tax. Cities and municipalities can only levy the other major local taxes, namely, the local business and community taxes. Cities, on the other hand, have the widest powers and most productive tax bases, yet absorbed a mere 5.7 percent of the total cost of devolved functions.

The imbalance in expenditure-revenue assignment between the national government and local governments (and among the latter) may be dealt with by adjusting the amount and distribution of transfers. However, many of the problems concerning public finance and public sector governance raised in this paper can be linked to the continued centralization of taxing powers and the perverse effects of national government transfers including the direct provision of devolved services by national government agencies.

(i) *Chronic public sector deficit.* National government transfers to local governments and/or direct provision of local services by the national government cause "fiscal illusion" or misperceptions of voter-taxpayers of their share of financing and costs of public spending. The benefits of local services are concentrated or confined to certain localities or groups of individuals but the entire citizenry, if funded by national government taxes, shoulders their costs. For example, mainly the municipality's families use a school building or health clinic constructed in a certain municipality; a provincial road or bridge mainly serves the residents of the province and nearby provinces. However, if funded out of national government taxes collected nationwide, the costs of these school buildings, roads, bridges, and other infrastructure are only partially shouldered by their beneficiaries. Fiscal illusion also applies to the internal revenue allotment and other national government transfers to local governments, which are sourced from national government taxes. Although the internal revenue allotment is sourced from taxes collected nationwide, it benefits specific localities.

This fiscal illusion or weakening of the link between the benefit and cost of public spending can undermine fiscal discipline. The demand for national government-funded local services and transfers by the different localities and constituencies tend to be high, relative to the amount of taxes normally collected. This partly explains the tendency to enact bloated budgets and the practice of impounding funds[5] to manage budget deficits.

(ii) *Weakening of government accountability and operational efficiency.* Aside from undermining fiscal discipline, national government transfers and provision of local services also weaken government accountability and operational efficiency. The long tradition of national government involvement in the direct provision of local public goods and services has resulted in unclear institutional arrangements and duplication of services. People look to the national government for the provision of the devolved services allowing the local governments to shirk from their responsibilities. This results in the lack of efforts at the local level to raise revenues from own sources and dependence on national government transfers. On the other hand, with the provision of devolved services being clearly the primary responsibility of the local governments, undue slack is provided in the national government's exercise of expenditure powers over devolved functions. After all, any breakdown in the delivery of the devolved services can be technically blamed on the local governments. Thus, while there is a huge demand on resources for the devolved functions from all government levels, the lines of accountability have also been rendered hazy and efficiency in provision, sacrificed.

(iii) *Tolerance of corruption.* Moreover, by weakening the link between the benefits and costs of public spending, national government transfers and provision of local services have contributed to corruption. Recipient local governments and their constituents easily tolerate substandard and overpriced government projects because only the benefits of these projects are considered. The high project costs that include the cost of inefficiencies and corruption are taken for granted by the recipient communities since they do not fully internalize the costs, i.e., the costs are paid by all taxpayers nationwide. A serious accounting of costs is conveniently foregone.

(iv) *Patronage politics and political dynasties.* The patronage politics that characterize governance in the Philippines is also perpetuated through centralization of government resources and the dependence of local governments on national government transfers. Centralized tax revenues form a common pool that can be used by national politicians to buy political support of certain groups in society. The President, in particular, has vast powers over appointments and fund disbursements, including impoundment of funds. The use of these powers and revenues damages the political culture in three specific ways. First, local officials resort to personal and collective dealings with national government officials as they compete with each other to obtain national government funds. This practice essentially transforms their revenue generating function into one of brokering, rather than mobilizing own sources. Second, because a local official needs connections and networks to succeed in this setup, these become the primary criteria for choosing a local leader. Leadership qualities and administrative skills become secondary or outright irrelevant. Third, family ties substitute for a weak party system in establishing political networks, giving rise to and perpetuating political dynasties (De Dios, 2007).

(v) *Assessment of the internal revenue allotment.* The internal revenue allotment has been designed to eliminate the need for local governments to lobby for national government transfers and minimize national government control over them. The distribution of internal revenue allotment follows a fixed formula. Still, there have been several attempts by the national government to control and influence the distribution. In particular, through the local Government Code provision that allows the reduction of internal revenue allotment in the event of an "unmanageable public sector deficit." Manasan (2007) pointed to several instances when the internal revenue allotment was not fully and automatically released to local governments. In 1998, over 4 percent of the internal revenue allotment was not released by the Department of Budget and Management as part of the fiscal austerity measure of the national government. In 2000, Congress set aside P10 billion of the mandated allotment as unprogrammed fund, which could only be released when the national government revenue exceeds the target. In 2001 and 2004, the mandated amounts were again not fully released because the national government failed to pass the budget, and had to operate on the basis of re-enacted budgets.

As the primary means of national government transfers to local governments, the internal revenue allotment has been critically assessed vis-a-vis different objectives. First, the amount is not sufficient to cover the costs of the devolved functions, including the unfunded mandates passed onto local governments by the national government. Second, the distribution tends to aggravate the imbalance in the expenditure needs and revenue sources at the different local government levels, in particular, favoring the cities over provinces and municipalities. This imbalance is manifested very clearly in the contraction of provincial infrastructure investments relative to gross domestic product and the concentration of province infrastructure outlay in small projects at the municipal and *barangay* levels leading to a "missing middle" in local government infrastructure provision. Third, the allocation of the internal revenue allotment does not promote equity. Local governments with higher per capita household income tend to receive higher per capita internal revenue allotment. Finally, the internal revenue allotment tends to substitute for own-source revenues. Per capita internal revenue allotment and per capita local tax collection across local governments show significant negative relationships, suggesting that units receiving higher allocation tend to be lax in their tax collection effort (Manasan, 2007).

Furthermore, while the internal revenue allotment of local governments depends on the amount of taxes collected by the Bureau of Internal Revenue, there is hardly any assistance given by the local governments to the Bureau in its tax enforcement and collection efforts. With the local governments' stake in the Bureau's internal revenue collection, they can provide assistance and valuable information in taxpayer registration and in the assessment and collection of the right amount of taxes. However, the internal revenue allotment system suffers from a common pool problem that does not motivate local governments to actively assist the Bureau. The share of a local government unit does not depend on the amount of taxes collected by the Bureau in its jurisdiction. For the same reason, the internal revenue allotment system does not encourage local governments to adopt public expenditure policies and programs that promote economic growth in their respective areas because the bulk of taxes is collected by the national government and shared by all local governments regardless of the latter's performance. National government transfers in effect, bail out local governments that engage in non-productive expenditure and corruption.

Way forward

There can be no genuine local autonomy without fiscal autonomy in the same way that there can be no genuine government decentralization without fiscal decentralization. Fiscal resources should be decentralized in a manner that promotes accountability and efficiency. This can only be done by giving local governments taxing powers commensurate to the expenditure functions assigned to them so that they will be publicly accountable and responsible for their policy decisions. This can be achieved through joint taxation by the national and local governments of productive broad based taxes such as individual and corporate income taxes, motor vehicle tax, excise taxes, and possibly, the value added tax.

To accommodate the additional taxes to be imposed by local governments without increasing the overall burden on taxpayers, national government tax rates could be commensurately reduced. The national government should cease to appropriate funds for the provision or augmentation of local services in the General Appropriations Act, except for the internal revenue allotment, and abolish all regional and district offices that duplicate functions of local governments. The amount of expenditures freed up by this measure will then allow the national government to reduce commensurately its tax rates to make room for local government taxation. With increased tax powers, local governments will subsequently be made responsible for the provision of local services largely from their own source revenues or taxes.

To effectively address the disparity in fiscal capacities of local governments, the internal revenue allotment needs to be reformulated with the primary goal of promoting fiscal equalization, explicitly taking into consideration revenue capacity and expenditure needs indicators in the allocation formula.

Notes

1 Poverty incidence is estimated based on an income threshold of PhP15,057 in 2006.

2 The *Galing Pook* website (http://www.galingpook.org) contains a list and description of the different awards-winning program of the various local governments from 1994 to present.

3 Local government policies, programs, and expenditures that affect social and economic enterprises also influence progress in human development. Thus, progress in human development (as measured by the human development index) provides an indication of the quality of local governance (Capuno, 2007).

4 Figures cited based on Commission on Audit data and Department of Budget and Management data for CY1990–2001. The series is discontinued with the adoption of a new national government accounting system.

5 This refers to the power of the President to withheld the releases of funds to implement

certain programs and projects in the General Appropriations Act.

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