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Measuring Fiscal Decentralization in the Philippines

Hiroko Uchimura[§] and Yurika Suzuki[†]

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This paper focuses on the fiscal decentralization in the Philippines after the 1991 Local Government Code. It first examines the intergovernmental fiscal relationship between central and local governments by using fiscal decentralization indicators, and then investigates its impact on local finance. After fiscal decentralization, the local expenditure responsibility is expanded while the local fiscal capacity is not strengthened in the Philippines. Local governments consequently comes to depend heavily on fiscal transfers from the central government, internal revenue allotments (IRAs), which has a substantial influence on local finance. The heavy dependence on IRAs makes local finance unpredictable and unstable. The distribution of IRAs also affects the horizontal balance between provincial governments.

Keywords: Fiscal Decentralization, Fiscal Decentralization Indicators, Horizontal Balance, the Philippines

[§] Inter-disciplinary Studies Center, Institute of Developing Economies, IDE-JETRO

[†] Area Studies Center, Institute of Developing Economies, IDE-JETRO

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INSTITUTE OF DEVELOPING ECONOMIES (IDE), JETRO
3-2-2, WAKABA, MIHAMA-KU, CHIBA-SHI
CHIBA 261-8545, JAPAN

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This paper focuses on the fiscal decentralization in the Philippines after the 1991 Local Government Code. It first examines the intergovernmental fiscal relationship between central and local governments by using fiscal decentralization indicators, and then investigates its impact on local finance. After fiscal decentralization, the local expenditure responsibility is expanded while the local fiscal capacity is not strengthened in the Philippines. Local governments consequently comes to depend heavily on fiscal transfers from the central government, internal revenue allotments (IRAs), which has a substantial influence on local finance. The heavy dependence on IRAs makes local finance unpredictable and unstable. The distribution of IRAs also affects the horizontal balance between provincial governments.

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1. INTRODUCTION

The current fiscal decentralization in the Philippines is based on the Local Government Code (LGC), Republic Acts 7160 enacted in 1991. Philippine decentralization is in the vanguard of that for developing countries in East Asia (World Bank, 2005; Balisacan and Hill, 2006).[1] The decentralization transferred various responsibilities or authority held by the central government to local governments. This study focuses on changes in the intergovernmental fiscal relationship between central and local governments after the decentralization based on the 1991 Local Government Code in the Philippines.

Generally, fiscal decentralization leads to an increase in the local expenditures responsibility; meanwhile in most decentralized developing countries, it is difficult to cover the expanded expenditures only through local own revenues (Bird and Rodriguez, 1999). Intergovernmental transfers therefore play an important role in bridging the fiscal gaps between a local government's own revenues and its expenditure responsibility. In the Philippines, a considerable number of personnel in the public sector were transferred from the central to local governments by the decentralization (Manasan, 2007; World Bank and Asian Development Bank, 2005). It brought about an increase in the local expenditure responsibility. However, as in other decentralized developing countries, local revenues cover only a small part of the expanded local expenditures.

To find out what characterizes the intergovernmental fiscal relationship in the Philippines more than fifteen years after the enforcement of the 1991 Local Government Code, this paper examines quantitatively the fiscal relationship between central and local governments of the Philippines using indicators which measure the degree of fiscal decentralization. It also

[1] World Bank (2005) examines China, Indonesia, the Philippines, Vietnam, and Cambodia, as the studies of decentralization of developing countries in East Asia.

considers how the present intergovernmental relationship affects the fiscal conditions of local governments in the country.

The next section summarizes the background of the current fiscal decentralization in the Philippines. It also describes the systems of Philippine local governments as well as the allocation of local taxes and intergovernmental fiscal transfers. Section 3 presents the indicators for measuring fiscal decentralization, while section 4 examines fiscal decentralization in the Philippines based on the measurement. Section 5 focuses on the impacts of fiscal decentralization on local finance, and the last section summarizes our conclusions.

2. BACKGROUND TO FISCAL DECENTRALIZATION IN THE PHILIPPINES

The current local government system and intergovernmental structure of the Philippines is based on the 1991 Local Government Code. Although the Code is perceived by many as a radical reform in terms of the extent of powers, responsibilities, resources, and personnel decentralized to the local governments, it is not the first decentralization law in the country. Looking at the history of intergovernmental relations, it can be seen that decentralization and the accompanying notion of local autonomy are not a new phenomenon. In fact, it is the result of a long struggle for decentralization and local autonomy (Atienza, 2006).

After the 1986 People Power Revolution, the Philippine government renewed its commitment to greater decentralization as a means of attaining its development goals and objectives. It was further reinforced by the extensive provisions for local autonomy set forth in the 1987 Constitution. And thereafter, following almost five years of debate in Congress, the 1991 Local Government Code or Republic Act 7160 was finally enacted. The formal basis for decentralization varies widely across East Asia, but the Philippines, as mentioned above, has a stronger and specific legal basis for local government (World Bank, 2005).

Currently the country has the following four subnational levels: provinces, cities, municipalities, and the village-level barangays. In the case of cities, however, certain higher-income cities are autonomous and classified as highly urbanized cities, while the remainders are component cities that, like municipalities, are under provincial supervision. As of 2008, local governments consist of 81 provinces, 136 cities,[2] 1,495 municipalities and 42,008 barangays.

One feature of Philippine intergovernmental structure in terms of fiscal decentralization is that each level of local government units (LGUs) is relatively independent.[3] Each one is an active player and there are almost no lines of fiscal subordinate relations between local governments. For instance, the central government directly allocates intergovernmental fiscal transfers to each level of local government. Such structure greatly differs from that of China where the central government first transfers subsidies to provincial governments, and from there, provincial governments become responsible for the further transferring to the lower levels. Philippine local governments, therefore, are less inclined to coordinate with each other on fiscal matters as well as on socioeconomic developmental policy and its implementation since each level of government is given a certain autonomy to pursue its own programs.

The 1991 Local Government Code devolved or transferred the delivery of various aspects of basic services and certain regulatory functions from the central government to the LGUs (Sibal, 1998; Tapales, Cuaresma and Cabo, 1998; Ursal, 2000). Regarding financial resources, there are nearly 10 types of local taxes such as property taxes, business taxes, franchise taxes and community taxes. Provinces, cities and municipalities are mostly

[2] Among 136 cities, 36 are considered independent from the province, of which 32 are highly urbanized and 4 are independent component cities (data as of July 2007).

[3] This paper basically focuses on intergovernmental fiscal relations of provinces, cities, and municipalities. No new functions were devolved to the barangays (Manasan, 1992).

responsible for collecting these taxes, but among them, cities are the most autonomous. They are authorized to impose the full set of local taxes, while provinces and municipalities can levy only subsets (World Bank, 2005). The scope of taxing powers of each level of government has not really changed since before the 1991 Code. Even in the old set up, cities were able to levy the taxes that the provinces or municipalities could impose. However, the assignment of revenues under the 1991 Code seems to have shifted more of the distribution of own-source revenue away from provinces in favor of cities and partly to municipalities and barangays (Manasan, 2007). For example, the maximum rate at which provinces are allowed to levy the real property tax, one of the two taxes that account for the bulk of local revenue,[4] is 1% which is half the 2% rate levied by the cities. In addition, the share of real property tax of all three higher levels of LGUs (provinces, cities and municipalities) was reduced in favor of barangays under the 1991 Code. The share for provinces is now 35%, down from 45% in the pre-1991 Code period, and it has remained even less than that for cities and municipalities (Manasan, 2007).

The 1991 Code also provides LGUs with intergovernmental fiscal transfers from the central government, i.e., Internal Revenue Allotments (IRAs). At present the total amount is based on the collection of national internal revenue taxes in the third year preceding the current one, at a rate of 40%. Prior to the 1991 Code, the share was 20%. The distribution of IRAs follows a certain formula and it is done in two steps. First, the total IRA is allocated to different levels of LGUs as follows: 23% to provinces, another 23% to cities, 34% to municipalities, and 20% to barangays. Second, the above share is further distributed to individual LGUs based on the following weights: population, 50%; land area, 25%; and equal sharing, 25%. Cities are less

[4] Another tax that accounts for the bulk of LGU own-source revenue is the Business Tax which is imposed by cities and municipalities but not by provinces. The 1991 Code introduced a new business tax on banks and non-financial institutions. The code even reclassified all types of businesses into eight categories (Cuaresma and Ilagao, 1996; Manasan, 2007).

numerous than municipalities and less populous than provinces but have an equivalent share of 23%, which shows that they are the most favored in the transfer of subsidies.

Prior to the 1991 Code, the share of IRAs to the different levels of LGUs was 27% to provinces, 22.5% to cities, 40.5% to municipalities, and 10% to barangays. According to Manasan (1992), barangays have been the biggest gainers in the reallocation of IRAs in the 1991 Code while provinces and municipalities seem to be the losers. The allocation to individual LGUs, again prior to the 1991 Code, was determined as follows: population was given 70% weight, land area 20%, and equal sharing 10%. The reduction in the weight accorded to population size in the 1991 Code tends to favor the less populous LGUs. Also, the increased weight given to equal sharing tends to equalize IRA shares across political subdivision within the same level of government (Manasan, 1992).

3. MEASURING FISCAL DECENTRALIZATION

Most studies empirically examining fiscal decentralization describe the extent of fiscal decentralization as the local share of total government expenditures (e.g., Oates, 1985; de Mello, 2000; Jin et al., 2005). This indicator measures the degree of local expenditure responsibility in the public sector. By the same token, the local share of total government revenue is also applied to measure the degree of fiscal decentralization. A vertical fiscal gap is defined as the local revenue deficiency caused by the difference between local government revenue capacity and its expenditure responsibility (Shah, 2007). In other words, a vertical fiscal gap captures the share of local expenditures covered by local own revenues.

Most local governments face vertical fiscal gaps in decentralized developing countries (Bird, 2000; Shah, 1994). In general there are four measures for bridging vertical fiscal gaps: (1)

expanding local own-revenue sources, (2) reducing local expenditure responsibilities, (3) adjusting the intergovernmental alignment of expenditure responsibilities, (4) providing fiscal transfers from central to local governments (Bird and Villancourt, 1998). Among those measures, fiscal transfers play a significant role in bridging fiscal gaps in developing countries (Shah, 1994). In the theoretical sense, a vertical fiscal gap is related to the issue of local fiscal autonomy that is a crucial factor for the efficiency of allocations in a decentralized country (Ebel and Yilmaz, 2003). Ignoring the degree of local fiscal autonomy brings about an overestimate of fiscal decentralization (Meloche, Villancourt and Yilmaz, 2004). In addition, fiscal transfers influence local fiscal discretion which is also an important factor for the provision of responsive public goods to local needs. A key to examine the degree of local expenditure discretion is the distinction between unconditional and conditional transfers (Meloche, Villancourt and Yilmaz, 2004).

Fiscal Decentralization Indicators

Based on the above discussion, we focus on the following five fiscal decentralization indicators: (1) the local share of total fiscal expenditure, (2) the local share of total fiscal revenue, (3) local dependency on intergovernmental fiscal transfers, (4) local fiscal autonomy, and (5) local expenditure discretion.

(1) Local share of total fiscal expenditure

$$RLE = \sum_i LE_i \Big/ \left(\sum_i LE_i + CE\right) \quad , \qquad (1)$$

where i denotes a local government, LEi is the expenditure of local government (i), and CE is the expenditure of the central government. Accordingly, RLE measures the ratio of local expenditure to total fiscal expenditure including local and central expenditures. This indicator hence quantifies the degree of local expenditure responsibility compared with the central government.

(2) Local share of total fiscal revenue

$$RLR = \sum_i LR_i \Big/ \left(\sum_i LR_i + CR\right) \quad , \qquad (2)$$

where *LRi* denotes the revenue of local government (*i*), and *CR* is the revenue of the central government. *LR* does not include fiscal transfers from central to local governments. Therefore, the denominator captures the total fiscal revenues without redundancy.

(3) Local dependency on fiscal transfer

$$DFT = \sum_i FT_i \Big/ \sum_i LTR_i \quad , \qquad (3)$$

where *FTi* denotes the fiscal transfer from the central government to local government (*i*), and *LTRi* is total revenue of local government (*i*). Accordingly, *DFT* measures the ratio of the fiscal transfer to local total revenue.

(4) Local fiscal autonomy

$$FA = \sum_i LOR_i \Big/ \sum_i LTR_i \quad , \qquad (4)$$

where *LORi* denotes the own revenue of local government (*i*). Thus, *FA* measures the ratio of local own revenue to local total revenue. Local revenue is generally classified into three categories, i.e., tax revenues, non-tax revenues, and fiscal transfers from the central government (OECD, 2001). In addition, OECD (1999) classified the tax revenues of local governments into eight categories based on the degree of local control over the rate and base of a tax. (a) A tax: local governments set its rate and base. (b) A tax: local governments only set its rate. (c) A tax: local governments only set its base. (d) Tax sharing revenues: local governments set revenue-split between central and local governments. (e) Tax sharing revenues: revenue-split can only be changed with the consent of local governments. (f) Tax sharing revenues: revenue-split is fixed in legislation and may be changed unilaterally by the consent of the central government. (g) Tax sharing revenues: revenue-split is set by the central government as a part of the annual budget process. (h) A tax: the central government sets both its rate and base. Local governments have total or significant control over the taxes in the first three categories (a-c) as well as categories (d) and (e), whereas local fiscal autonomy is limited or non-exist in the last three categories (f-h). Based on this classification, taxes included in *LOR* are those of categories (a) to (e). Non-tax revenues are included in local own revenues, while fiscal transfers from the central government are not included in local own revenues (*LOR*).

(5) Local expenditure discretion

$$FD = \sum_i GR_i \Big/ \sum_i LTR_i \quad , \qquad (5)$$

where *GRi* denotes general revenues of local government (*i*). *FD* measures the ratio of general revenues to local total revenues, which captures the degree of expenditure discretion of local governments. In addition to *LOR,* the above-mentioned tax sharing revenues of (f) and (g) are also included in *GR*. General-purpose transfers are likewise included in *GR*. In general, fiscal transfers are classified into two categories: general-purpose transfers and specific-purpose transfers (Shah 1994, 2007). General-purpose transfers are unconditional transfers that are provided to support the general budget of local governments. Specific-purpose transfers are conditional transfers that are provided for local governments to undertake specific programs. Therefore, local governments have discretion over the expenditure of general-purpose transfers but not over specific-purpose transfers. In this sense, general-purpose transfers are included in *GR*, but specific-purpose transfers are not.

Based on these indicators, fiscal decentralization is classified into the following three types.[5] First, when the local share of total fiscal expenditure as well as that of revenue is relatively high, the intergovernmental fiscal relationship can be considered as highly decentralized. Another type is where the local share of total fiscal expenditure is high, while that of total fiscal revenue is relatively low. In this case, the fiscal gaps between local expenditure responsibilities and revenue means are bridged mostly by intergovernmental fiscal transfers in decentralized developing countries. Therefore, this type of fiscal decentralization is further classified into two categories depending on the types of fiscal transfers. As mentioned above, there are two types of transfers: general-purpose (unconditional) transfers and specific-purpose (conditional) transfers. Accordingly, the second type of fiscal decentralization is where local expenditure responsibility is high and the fiscal gap, i.e., the difference between local expenditure responsibility and local own revenue, is filled by unconditional transfers. In this case, although local fiscal autonomy is limited, the discretion over expenditure is relatively high. The third type is where local expenditure responsibility is high and fiscal gaps are bridged

[5] Bird and Villancourt (1998), Meloche et al. (2004), and others also classify decentralization into three categories: devolution, delegation, and deconcentration. In devolution, central government transfers some authority to local government including the authority to raise taxes and form expenditure budgets. Delegation is defined as the condition under which central government transfers an authority/responsibility, mainly an expenditure responsibility, while retaining the authority to revoke the transferred authority/responsibility at any time. Deconcentration is where the central government provides regional branch offices with responsibilities for certain public services. The first type classified in the above discussion is relevant to devolution, whereas the second and third types are relevant to delegation.

mainly by conditional transfers, in which case both local fiscal autonomy and expenditure discretion are limited.

4. FISCAL DECENTRALIZATION IN THE PHILIPPINES

Before looking into the details of intergovernmental fiscal relationship, we briefly review the macro-trend of public finance in the Philippines. The ratio of total fiscal revenues to gross domestic product (GDP) had gradually risen since the early 1990s, which suggests that fiscal revenue collection in the Philippines had been improving (Table 1). The increase in fiscal revenues contributed to reducing fiscal deficits, and the fiscal balance of the central government became a surplus in the mid 1990s (Figure 1). However, the Asian financial crisis that erupted in 1997, significantly damaged the Philippine economy as well as its fiscal condition. In fact, the country's fiscal condition was more severely damaged than the economy. The ratio of total fiscal revenue to GDP was more than 20% in 1994 but fell to 19 % in 1998, and continued to fall to about 16% after 2000.

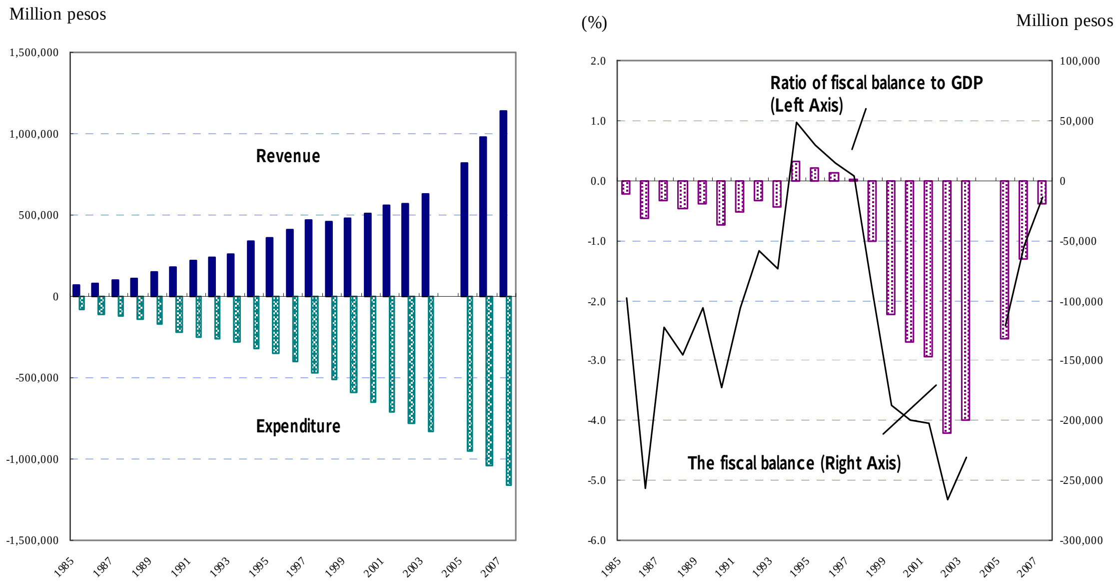
Table 1: Ratio of Total Fiscal Revenue to GDP (%)

1986	13.9	1992	18.8	1998	19.0	2004	15.5
1987	15.9	1993	18.7	1999	17.5	2005	16.0
1988	15.2	1994	21.2	2000	17.1		
1989	17.8	1995	20.3	2001	16.8		
1990	18.1	1996	20.3	2002	15.5		
1991	19.1	1997	21.1	2003	15.8		
average from 1986 to 1991	16.7	average from 1992to 1997	20.1	average from 1998 to 2005			16.6

Note: All figures are nominal value. The ratio is calculated based on the data from *the Philippine Statistical Yearbook*, *Fiscal Statistical Yearbook*, *Annual Fiscal Report COA* (Commission on Audit).

The reduction in fiscal revenue had a serious impact on the fiscal balance of the central government. The central fiscal balance has been in deficit again since 1998 (Figure 1). The fiscal deficit grew to about 5% of GDP in 2002. Since 2003 it has been gradually improving, but the fiscal deficit still amounted to about 19 billion pesos in 2007. Such fiscal deficit of the central government has a certain impact on the intergovernmental fiscal relationship between central and local governments in the Philippines.

Figure 1: Fiscal Balance of the Central Government



Note: Authors' compilation based on the data from *the Philippine Statistical Yearbook* and *Budget of Expenditures and Sources of Finance*. The data of fiscal revenues, expenditures and GDP are nominal values. Fiscal data for 2004 were not published because of the re-enactment of the budget in 2004.

4.1 Changes in the Fiscal Expenditure and Revenue of Local Governments

Table 2 summarizes changes in the share of central and local expenditures to total fiscal expenditure. Local governments, including provinces, cities, and municipalities, only financed around 10% of total fiscal expenditure before 1990. This suggests that the central government played a significant role as the public service provider at that time. Since 2000 the ratio of local expenditures to total fiscal expenditure has increased to about 20%. Among local governments, the share of city or municipality expenditure is higher than that of province. After fiscal decentralization, local government expenditure responsibility increased significantly in the Philippines.

Table 2: Share of Central and Local Expenditure to Total Expenditure (%)

	Central Govt	Local Govts			
		Total	Provinces	Cities	Municipalities
1985	89.9	10.1	-	-	-
1990	92.6	7.4	-	-	-
2002	80.6	19.4	4.7	7.3	7.5
2003	79.0	21.0	4.7	8.0	8.3
2004	80.6	19.4	4.2	7.7	7.5
2005	80.0	20.0	4.3	7.9	7.8
2006	79.3	20.7	4.5	8.1	8.1

Note: Figures for 1985 and 1990 calculated based on the data from *the Budget of Expenditures and Sources of Financing* (Department of Budget and Management, the Philippines); those after 2002 are from *the Annual Financial Report* (Commission on Audit, the Philippines). Fiscal transfers (IRAs) are not included in the expenditures of the central government.

Table 3 shows the share of central and local revenues to total fiscal revenues. The local revenue does not include transfers from the central government; therefore it captures the local own revenue. The trend of change in the share of local revenues to total fiscal revenues contrasts with that of expenditures. As observed above, local expenditure responsibility rose after fiscal decentralization, while the ratio of local revenue to total revenue has remained around 7% to 8% since before 1990. It indicates that the relative own revenue of local governments compared with the central government has not increased even after fiscal decentralization. Consequently, the vertical fiscal gaps expanded after fiscal decentralization in the Philippines.

Table 3: Share of Central and Local Revenue to Total Revenue (%)

	Central Govt	Local Govts			
		Total	Provinces	Cities	Municipalities
1985	91.1	8.9	-	-	-
1990	93.7	6.3	-	-	-
2002	92.3	7.7	0.9	5.0	1.8
2003	91.9	8.1	0.9	5.3	1.9
2004	92.3	7.7	0.8	5.1	1.7
2005	92.3	7.7	0.9	4.9	1.9
2006	93.0	7.0	0.8	4.5	1.7

Note: Local revenues in 1985 and 1990 include local tax revenues excluding IRAs and non-tax revenues. Local revenues after 2002 include local tax revenues excluding IRAs, non-tax revenues, shares and other income. Sources of the data are the same as for Table 2.

4.2 Fiscal Transfers from Central to Local Governments

In the Philippines, as in most decentralized developing countries, intergovernmental fiscal transfers (IRAs) are major sources for filling the vertical fiscal gaps. In fact, IRAs account for more than 60% of total local revenues (Table 4). They account for more than 70% of total revenues for provinces and municipalities, whereas IRAs account for less than 50% of total revenue for city governments. As mentioned above, local taxes are allocated unevenly among the tiers of local government. The allocations are skewed toward the city governments, and this has brought about the differences in the revenue structure between the tiers of local government.

Table 4: Share of IRAs in Total Local Revenues (%)

	Local Govts			
	Total	Provinces	Cities	Municipalities
1990	36.0	38.8	32.7	36.9
2002	66.8	82.0	47.4	78.0
2003	64.8	81.9	44.8	76.6
2004	63.1	81.0	42.8	75.9
2005	62.1	79.1	42.3	74.1
2006	63.1	80.9	42.6	75.5

Note: Figures calculated based on the data from *the Annual Financial Report* (Commission on Audit, the Philippines). Local total revenues are composed of local tax revenues including IRAs, shares, other income and other subsidies.

4.3 Fiscal Autonomy and Fiscal Discretion of Local Governments

Fiscal Autonomy

In the previous section, we found that the dependence on IRAs varies between provinces, cities and municipalities. It means that the degree of fiscal autonomy of local governments varies between the tiers of local government. This tendency is confirmed by the figures in Table 5, which summarizes the ratio of local own revenues to local total revenues. The fiscal autonomy of city governments is higher than that of provinces and municipalities. Provincial fiscal autonomy is particularly weak. Only about 15% of total provincial revenue is covered by the own revenue of the provinces.

Table 5: Ratio of Local Own Revenue to Total Local Revenue (%)

	Local Govnts			
	Total	Provinces	Cities	Municipalities
1990	47.8	36.1	61.1	44.3
2002	29.6	12.8	49.5	19.0
2003	30.5	12.6	50.7	18.9
2004	31.9	13.8	52.2	19.2
2005	32.3	14.6	52.6	20.1
2006	31.2	13.6	51.6	18.7

Note: Figures calculated based on the data from *the Annual Financial Report* (Commission on Audit, the Philippines). Local own revenues are composed of local tax revenues, fees of permission & licenses, and service & business income.

Fiscal Discretion

Quantitative analysis

As described in section 3, local fiscal discretion is measured by the ratio of local general revenues to local total revenues. In addition to local own revenues, revenues from tax sharing and unconditional fiscal transfers are also included in local general revenues. In the case of the Philippines, there is some tax-sharing between central and local governments, but it only accounts for a small amount of local total revenues.[6] Regarding fiscal transfers, 20% of IRAs should be allocated for the Local Development Fund (LGF). However, in practice, the purpose of the transfer is not strictly specified even for the LGF. For instance, it can be used for health and social issues, or even for cultural matters if local governments present a resume of projects to the Department of the Interior and Local Government (Bird and Rodriguez, 1999). In this context, the whole of IRAs, including the LGF, can be categorized as unconditional transfers. Therefore all of the intergovernmental fiscal transfers can be considered as unconditional

[6] As mentioned in section 2, some local taxes are shared among local governments.

transfers in the Philippines. Consequently, local total revenues, which include local tax revenues, non-tax revenues, and intergovernmental transfers, can be categorized as general revenues. It means that the denominator is equal to the numerator in equation (5) in section 3. Hence, local governments can use their own discretion in using 100% of total local revenues in the Philippines.

Qualitative analysis

The quantitative analysis indicates that the expenditure discretion of local governments is exceptionally high in the Philippines. However, when we take into account the qualitative aspects, the degree of local expenditure discretion lessens. One feature of Philippine decentralization was that the considerable number of central governmental officers were transferred to local governments (Wallich, Manasan and Sehili, 2007; Manasan, 2007). The size of the transferred personnel varied among sectors. The sectors most affected are health (Department of Health), agriculture (Department of Agriculture), and social security (Department of Social Welfare and Development). In fact, there was about a 60% reduction in the number of government officers in those sectors, and a significant amount of their budgets were also reduced at the central level (Wallich, Manasan and Sehili, 2007). Local governments consequently came to bear the financial costs of the transferred personnel. Several problems are pointed out regarding the transfer of personnel. Firstly, the personnel transfer from central to local governments did not necessarily correspond to local needs (Bird and Rodoriguez, 1999). Secondly, such a large-scale transfer has put a heavy financial burden on local governments; therefore the local fiscal capacity, after taking into account personnel costs, has been very limited (World Bank and Asian Development Bank, 2005).

Table 6 shows that personnel costs are actually heavy financial burdens on local governments. The financial burden is heavier on the provincial and municipal governments than on the city governments. As mentioned in section 2, the allocation of both local taxes and intergovernmental transfers is skewed toward cities, which strengthens the fiscal capacity of the city governments more than that of provinces or municipalities. The fiscal capacity of provinces and municipalities is further weakened by the heavy personnel costs. Table 7 summarizes the local financial burden of personnel costs in the most affected sectors. The personnel costs are particularly heavy in the health and agriculture sectors which account for about 60% to 80% of local expenditures in the sectors. This makes it difficult financially for local governments to implement their own policy programs.

Table 6: The Ratio of Personnel Costs to Local Expenditure (%)

	Local Govnts			
	Total	Provinces	Cities	Municipalities
2002	59.0	59.9	52.8	64.4
2003	56.6	59.4	50.0	61.3
2004	55.0	58.7	47.7	60.5
2005	53.0	56.9	45.6	58.3
2006	50.1	52.5	43.5	55.3

Note: Figures calculated based on the data from *the Annual Financial Report* (Commission on Audit, the Philippines). Personnel costs include wages, various subsidies including welfare subsidies. Local expenditures are local operating expenses.

Table 7: The Ratio of Personnel Costs to Local Expenditures by Sector (%)

Health Sector

	Provinces	Cities	Municipalities
2002	71.2	60.2	75.6
2003	65.8	61.8	72.7

Agriculture Sector

	Provinces	Cities	Municipalities
2002	86.7	77.1	83.9
2003	79.0	69.2	82.5

Social Security Sector

	Provinces	Cities	Municipalities
2002	48.3	59.1	61.8
2003	48.4	52.1	55.1

The note is the same as for Table 6.

The quantitative analysis indicates that local expenditure discretion is very high in the Philippines. However, when we take into account the local financial burden of the transferred personnel costs, the discretion over local expenditures appears to lessen significantly. This tendency is more intense for the provincial and the municipal governments, especially in the health and agriculture sectors.

Along with fiscal decentralization in the Philippines, the local expenditure responsibility increased, while their own fiscal capacity was not strengthened. Intergovernmental fiscal transfers (IRAs) hence came to be important sources for local governments to meet their expenditure responsibilities. The importance of IRAs in local finance varies among the tiers of local government. The dependence on IRAs is relatively low for city governments; consequently their fiscal autonomy is relatively high. Provinces and municipalities however depend significantly on IRAs to finance their expenditures, which means that they do not have much fiscal autonomy. Moreover, their discretion over expenditures is also limited when we take into account the financial costs of the transferred personnel.

5. IMPACTS OF FISCAL DECENTRALIZATION ON LOCAL FINANCE

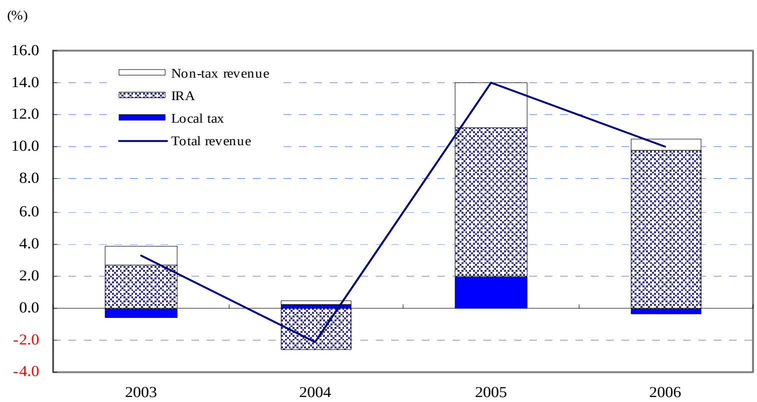
Changes in the intergovernmental fiscal relationship after fiscal decentralization substantially influence local finance. As observed above, local governments came to depend heavily on intergovernmental fiscal transfers (IRAs) in the Philippines. The function of IRAs would have a significant impact on local finance. In general, the major roles of fiscal transfers are to fill vertical fiscal gaps, and to adjust the horizontal balance between local governments at the same level (Shah, 2007; Bahl, 2000). As mentioned above, IRAs are a major source for filling fiscal gaps in the Philippines. However, such heavy dependence on IRAs poses a concern about local fiscal stability. Regarding horizontal balance, several studies point out that horizontal balance has become critical in the Philippines as fiscal decentralization has deepened (e.g., Manasan, 2007). However, not much is known about its quantitative aspects, particularly changes in the horizontal balance of each tier of local government *ex-ante* and *ex-post* decentralization. In the following section, we focus on these two issues, i.e., local fiscal stability and horizontal balance, and examine the impact of changes in intergovernmental fiscal relationship on local finance in the Philippines.

5.1 Stability of Local Fiscal Revenues

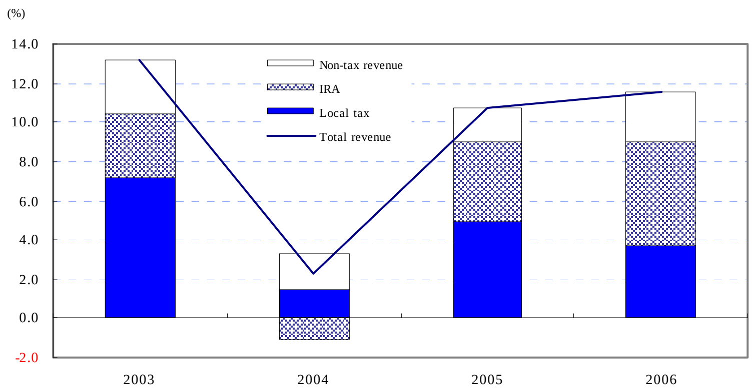
As we pointed out in section 4, local governments depend heavily on intergovernmental fiscal transfers (IRAs) in the Philippines. This is particularly true for provincial and municipal revenues, more than 70% of which come from IRAs. Figure 2 shows the changes in total local revenues and the percentage that each revenue source contributes to the changes. Total fiscal revenues of provinces and municipalities decreased in 2004, while those of cities increased. The contribution of each source to the changes in total city revenues differs greatly from that for provinces or municipalities. Changes in total revenues are caused mostly by those in IRAs in the case of provinces and municipalities. Changes in IRAs also affect total revenues in the case of cities, however the impact is much smaller compared with provinces or municipalities. The changes in total city revenues are affected much more by changes in cities' own tax revenues. The increase in total city revenues in 2004 was actually brought about by rising their own tax revenues. Due to the heavy dependence of provinces and municipalities on IRAs, the fluctuation in IRAs has a critical effect on the condition of provincial and municipal fiscal revenues. In other words, provincial and municipal governments do not have control over their own fiscal capacity.

Figure 2: Growth Rate of Local Total Revenues and % Contribution of Each Source

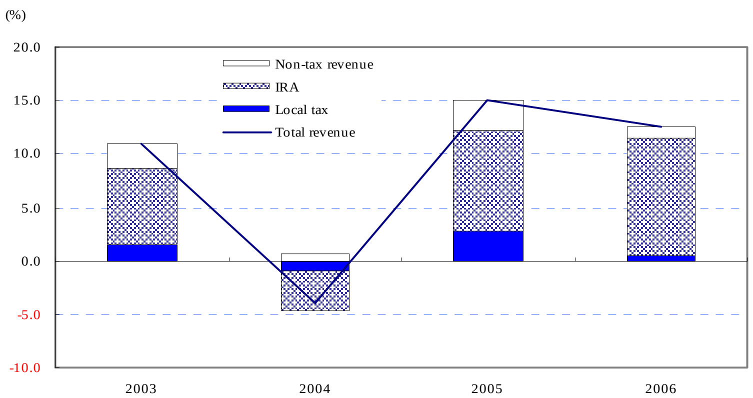
Provinces



Cities



Municipalities



Note: Authors' compilation based on the data from *the Annual Fiscal Report* (Commission on Audit).

The allotment of IRAs is calculated based on the formula stipulated in the Local Government Code.[7] Therefore it is considered that the allocation of fiscal transfers is more transparent in the Philippines than in other developing countries which frequently do not set defined formulas for the allotment of fiscal transfers to local governments. Based on the formula, local governments are supposed to be able to predict the mandated IRAs by themselves, and they are able to set their budget plans based on the predictions. However, IRAs are not

[7] The formula is described in section 2.

necessarily allotted to local governments regularly based on the formula. Manasan (2007) pointed out that IRAs came to be an unpredictable or unstable source for local governments after 1998. As pointed out in section 4, the fiscal balance of the central government seriously deteriorated after 1998, and it has been in deficit since then. As a result, the central government has frequently not allotted IRAs to local governments on a regular basis due to its severe fiscal constraints. For instance, in 1998 part of the IRAs was not allotted to local governments but held in reserve at the Department of Budget and Management, and in 2004 the actually operating IRAs were also reduced because of the re-enactment of the budget. In fact, there are significant differences between mandated IRAs and those actually operating (Table 8).

Table 8: Mandated IRAs and Operating IRAs

	Mandated IRA (Million pesos)	Operated IRA (Million pesos)	% ratio of non-allotted IRA to mandated IRA
2002	135,016	109,835	18.7
2003	142,808	115,735	19.0
2004	153,851	114,189	25.8
2005	156,201	122,194	21.8
2007	188,758	149,150	21.0

Note: Figures calculated based on the data from *the Budget of Expenditures and Sources of Financing* (Department of Budget and Management, the Philippines). Mandated IRAs calculated based on the formula in the Local Government Code. Operating IRAs are the amount of allotted IRAs to LGUs in the current operating expenditures of the central government.

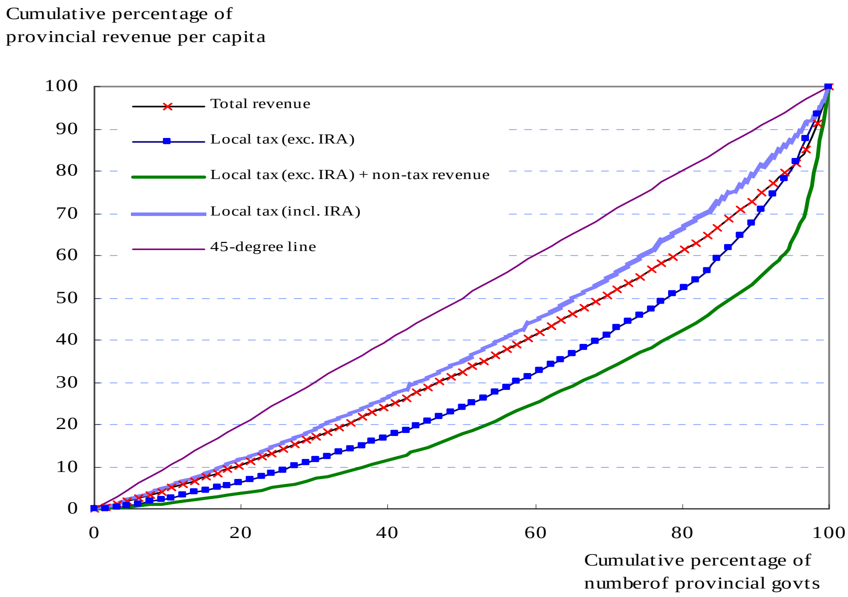
One feature of the intergovernmental fiscal relationship in the Philippines is the heavy dependence of local governments on intergovernmental fiscal transfers. It makes local finance unpredictable and unstable, and local governments, particularly provinces and municipalities, lose their own means of control over their fiscal capacity. Moreover, the irregular allotment of IRAs intensifies the unpredictability. An important condition in decentralized countries is to secure predictable and stable resources at the local government level so these governments can meet their expenditure responsibilities. The current Philippine intergovernmental fiscal relationship poses serious concerns regarding this condition.

5.2 Horizontal Imbalance between Local Governments

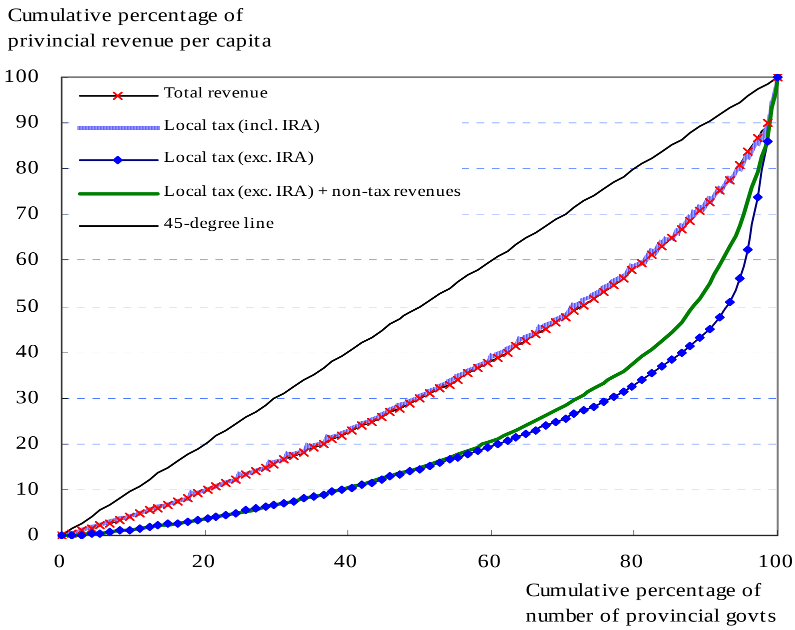
Horizontal imbalance is the issue of differences in fiscal capacity between local governments at the same level (Bird and Villancourt, 1998). This section examines the role of IRAs in the horizontal balance among provincial governments before and after fiscal decentralization.

Figure 3: Fiscal Revenue Gaps between Provinces:
Lorenz Curve of Provincial Revenue by Source

(1) 1990



(2) 2000

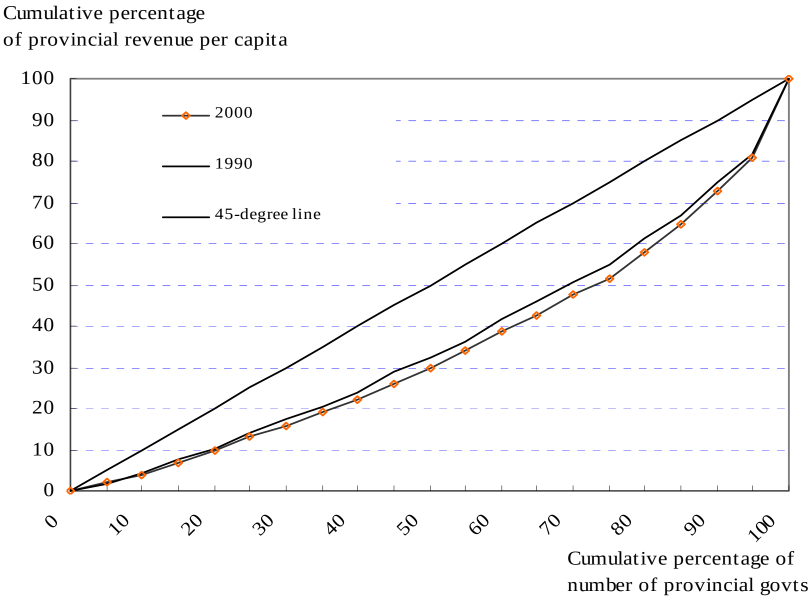


Note: Authors' compilation based on the data from *the Budget of Expenditures and Sources of Finance* (Department of Budget and Management, the Philippines) and *the Philippine Statistical Yearbook* (National Statistical Coordination Board, the Philippines)

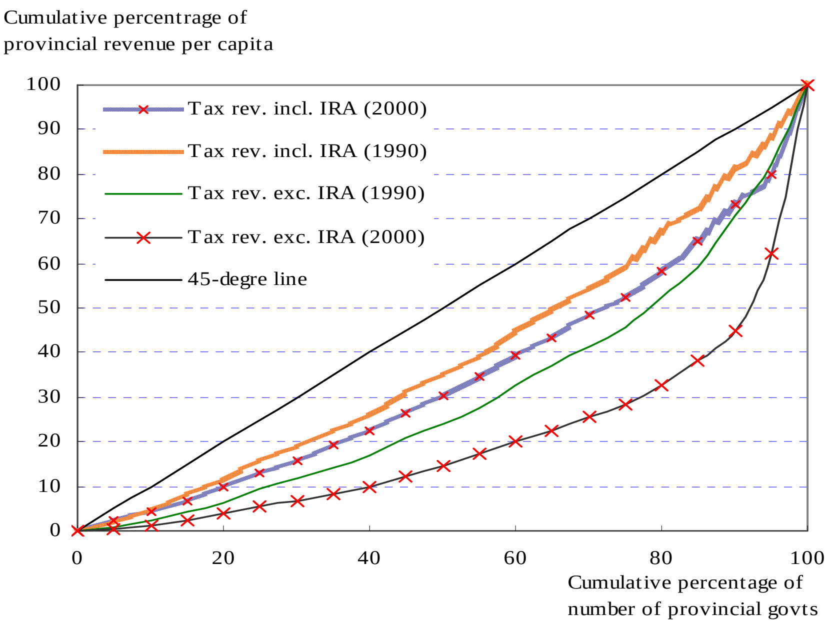
Figure 3 shows the Lorenz curves of provincial revenues by source. In 1990 the Lorenz curve of tax revenues including IRAs was located inside that of tax revenues excluding IRAs. It indicates that fiscal transfers from the central to provincial governments alleviated the own-revenue gaps between provincial governments. Moreover, the Lorenz curve of tax revenues excluding IRAs plus non-tax revenues was located in the outermost part. It suggests that the gap of non-tax revenues between provincial governments was wider than that of tax revenues in 1990. The Lorenz curve of tax revenues including IRAs was located inside that excluding IRAs in 2000, which indicates that IRAs also alleviated the own-revenue gaps between provincial governments in 2000. The Lorenz curve of tax revenues excluding IRAs was located in the outermost part in 2000. It turns out that the gap for tax revenues excluding IRAs between provinces was the widest among the sources of provincial revenues in 2000.

Figure 4: Fiscal Revenue Gaps between Provinces in 1990 and 2000

(1) Lorenz curve of total revenue



(2) Lorenz curve of tax revenues including and excluding IRAs



The note is the same as for Figure 3.

Figure 4 shows that the gap of total revenues between provincial governments in 2000 is wider than that in 1990; nevertheless, it is not much widening. Figure 4 also shows that the Lorenz curve of tax revenues excluding IRAs in 2000 is located outside that in 1990. The Lorenz curve of tax revenues including IRAs in 2000 is located outside that in 1990, which means that the gap of tax revenues including IRAs in 2000 also becomes wider than that in 1990, although the width is less than for tax revenues excluding IRAs. This indicates that IRAs becomes more important for alleviating the disparity of local tax revenues between provinces in 2000.

IRAs contribute to alleviating the local tax revenue gaps between provincial governments both before and after fiscal decentralization in the Philippines. Nonetheless, the local tax revenue gaps between provincial governments expanded greatly after the decentralization. Although IRAs do much to reduce the gaps in local tax revenues between provinces in 2000, the disparity of total fiscal revenues between provinces in 2000 is wider than that in 1990 due to the widening of the disparity in provincial own-tax revenues.

6. CONCLUSION

The present fiscal decentralization in the Philippines was carried out based on the Local Government Code, Republic Acts 7160, enacted in 1991. Under the decentralization, authority and personnel held by the central government were transferred to local governments which increased the expenditure responsibility of local governments. However, the local own revenues were not sufficiently strengthened to cover the expanded expenditures. Local governments hence came to depend heavily on fiscal transfers from the central government. The intergovernmental fiscal relationship after the decentralization based on the 1991 Code is characterized by increased local expenditure responsibility as well as increased local dependence on fiscal transfers from the central government. It has led to a weakening of local fiscal autonomy in the Philippines.

Following the decentralization, a considerable number of personnel were transferred from the central to local governments. It greatly increased the personnel costs borne by local governments which in turn decreased the discretion of local governments over expenditures, although most fiscal transfers from the central government are unconditional. Fiscal autonomy and expenditure discretion are both lower for provincial and municipal governments than for city governments.

Given the features of the intergovernmental fiscal relationship in the Philippines, the fiscal capacity of local governments is greatly influenced by that of the central government. The irregular allotment of IRAs increases the unpredictability and instability of local finance. Regarding the horizontal balance between provincial governments, fiscal transfers from the central government are allocated to provincial governments so that the gaps in their own fiscal capacity are alleviated. However, after fiscal decentralization, the disparity in local tax revenues between provincial governments expanded greatly; therefore fiscal transfers contributed to easing but not canceling the disparity. This paper focuses on the horizontal balance among provincial governments. A more comprehensive analysis is possible if the horizontal balance among municipal and city governments is considered. This is an important issue for the future study.

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