Report No. 26104-PH

# Philippines
# Decentralization in the Philippines
## Strengthening Local Government Financing & Resource Management in the Short Term

December 15, 2004

Poverty Reduction and Economic Management Sector Unit
East Asia and Pacific Region
The World Bank

Philippines Country Office
South East Asia Region
Asian Development Bank







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CURRENCY AND EXCHANGE RATES

Currency Unit – Philippine Peso

Exchange Rate (as of December 15, 2004): PhP56.30 = US$1.00

**WEIGHTS AND MEASURES**

The metric system has been used throughout this report.

**FISCAL YEAR**

(January 1 to December 31)

**In Memoriam**
**The joint ADB-World Bank team dedicates this report to the memory of Laura Walker, a valued and key team member. Laura passed away in December 2004.**

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## ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| ADB | Asian Development Bank |
| AIP | Annual Investment Plan |
| APEC | Asia Pacific Economic Cooperation |
| ASEAN | Association of Southeast Asian Nations |
| BAS | Bureau of Agricultural Statistics |
| BOS | Budget Operations Statement |
| BLGF | Bureau of Local Government Finance |
| BTR | Bureau of the Treasury |
| CCAGG | Concerned Citizens of Abra for Good Governance |
| CIDA | Canadian International Development Agency |
| COA | Commission on Audit |
| CPBO | Congressional Planning and Budget Office |
| CSC | Civil Service Commission |
| DAP | Development Academy of the Philippines |
| DBCC | Development Budget Coordination Committee |
| DBP | Development Bank of the Philippines |
| DEPED | Department of Education |
| DICT | Department of Information and Communications |
| DOE | Department of Energy |
| DOH | Department of Health |
| DOLE | Department of Labor and Employment |
| DPWH | Department of Public Works and Highways |
| DSWD | Department of Social Welfare and Development |
| GAA | General Appropriations Act |
| GFI | Government Financial Institution |
| GOCC | Government-Owned and/or Controlled |
| GPPB | Government Procurement Policy Board |
| GRA | General Revision of Assessment |
| GSIS | Government Service Insurance System |
| HDR | Human Development Report |
| IDF | Institutional Development Facility |
| IMR | Infant Mortality Rate |
| IRR | Implementing Rules and Regulations |
| LBP | Land Bank of the Philippines |
| LDC | Local Development Council |
| LGU | Local Government Unit |
| LFC | Local Finance Committee |
| LPPMS | Local Productivity and Performance Meas. Sys. |
| LGSP | Local Government Support Program |
| MDFO | Municipal Development Fund Office |
| MOU | Memorandum of Understanding |
| MTPIP | Medium-Term Public Investment Program |
| NEDA | National Economic and Development Authority |
| NGAS | New Government Accounting System |
| NLGAS | New Local Government Accounting System |
| OSR | Own Source Revenue |
| PMS | Performance Measurement System |
| PPB | Procurement Policy Board |
| PWI | Procurement Watch, Incorporated |
| RDC | Regional Development Council |
| RPT | Real Property Tax |
| TWG | Technical Working Group |
| AIM | Asian Institute of Management |
| AO | Administrative Order |
| ARMM | Autonomous Region of Muslim Mindanao |
| BAC | Bids and Awards Committee |
| BIR | Bureau of Internal Revenue |
| BOT | Build-Operate-and-Transfer |
| BSP | Bangko Sentral ng Pilipinas |
| CAR | Cordillera Administrative Region |
| CDF | Congressional Development Fund |
| CO | Collection Officer |
| CPAR | Country Procurement Assessment Report |
| CPPR | Country Portfolio Performance Review |
| DA | Department of Agriculture |
| DAR | Department of Agrarian Reform |
| DBM | Department of Budget and Management |
| DECS | Department of Education, Culture and Sports |
| DENR | Department of Environment & Natural Resources |
| DILG | Department of Interior and Local Government |
| DOF | Department of Finance |
| DOJ | Department of Justice |
| DOTC | Department of Transportation & Communications |
| DTI | Department of Trade and Industry |
| EO | Executive Order |
| GAAM | Government Accounting and Auditing Manual |
| GNP | Gross National Product |
| GOP | Government of the Philippines |
| GPRA | Government Procurement Reform Act |
| GRDP | Gross Regional Domestic Product |
| HDI | Human Development Index |
| ICC | Investment Coordination Committee |
| IFC | International Finance Corporation |
| IRA | Internal Revenue Allotment |
| JICA | Japan International Cooperation Authority |
| LCE | Local Chief Executive |
| LGC | Local Government Code |
| LGUGC | LGU Guarantee Corporation |
| LFF | LGU Financing Framework |
| LGPMS | Local Government Performance Meas. System |
| MDF | Municipal Development Fund |
| MOOE | Maintenance and Other Operating Expenditures |
| MTEF | Medium Term Expenditure Framework |
| NCR | National Capital Region |
| NGA | National Government Agency |
| NGO | Non-Governmental Organization |
| ODA | Official Development Assistance |
| PFI | Private Financial Insitutions |
| PO | People's Organization |
| PS | Personal Services |
| RA | Republic Act |
| RDP | Regional Development Plan |
| TTL | Task Team Leader |
| USAID | United States Agency for International Development |

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## EXECUTIVE SUMMARY

1. Almost a decade and a half after the enactment of the landmark 1991 Local Government Code (LGC), surveys to assess satisfaction with public services point to mixed results on local government performance in the Philippines. Local governments and communities confront a myriad of problems - uncertain access to potable water and electricity, declining literacy rates, environmental degradation, rising unemployment rates, lack of low-cost housing, and unreliable police and fire department services. The national government's straitened fiscal situation[1] has squeezed central transfers, and policies on municipal finance have hamstrung local government access to private capital. Local government investment in infrastructure and social services has been constrained, and operations and maintenance expenditures curtailed. However, a growing number of examples of excellence in service delivery seem to indicate that well-performing local governments may be distinguished by their ability to access resources more effectively, and manage them more transparently and accountably.

2. This report reviews two facets of decentralization currently engaging policy-makers: (i) the sources of financing under decentralization, and (ii) cross-cutting processes to strengthen the accountability of resource use. It does not assess whether decentralization is justified in the Philippines – it approaches the arrangements as they exist, and explicitly focuses on actions that could be feasibly completed within six to nine months[2]. The report's audience comprises public policy-makers, national government agencies, local governments, civil society and donor partners.

3. ***The context.*** The sub-national level in the Philippines comprises 80 provinces, 114 cities, 1496 municipalities and 41,945 barangays[3]. Between 1990 and 2002, sub-national expenditures more than doubled, as a percentage of GNP (1.7 percent to 3. 4 percent), and also relative to total general government expenditures (11.21 percent to 19.3 percent). The contribution of local government units (LGUs) to total general government revenues is low at about8.1 percent in 2002. For LGUs in the aggregate, own source revenue (OSR) accounted for 31.5 percent of total revenue in 2002. Tax revenue is the most significant contributor, accounting for 76 percent of OSR, with the real property tax comprising 40 percent.[4] However, since the mid-eighties, OSR as a proportion of total revenue has declined by more than 20 percent. At the same time, revenue from national government transfers has increased by twenty percent, from roughly half of LGU revenues to 63 percent.

4. In the pre-LGC period, municipalities accounted for 40 percent of total LGU direct spending responsibilities. They were overtaken by cities in 2001. Provinces are the most prominent form of local government only in the health sector. On the revenue side, too, the distribution of OSR has shifted toward cities: the share of provinces and municipalities in OSR fell from an average of 19.9 percent and 37.1 percent, respectively, in 1985-1991 to 13.2 percent and 29 percent in 1992-2002. By 2002 cities were generating 65 percent of OSR, 70 percent of tax revenue and 50 percent of local non-tax resources. Cities' total OSR effort has doubled, while that of municipalities has remained constant and that of provinces has contracted.

5. ***Administrative actions in two key areas could improve local government performance in the short term: (a) enhancing LGU ability and capacity to access resources, and (b) strengthening key resource management processes, in the first instance those relating to planning, budgeting, procurement and financial management.***

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[1] See, for example, the Philippines Development Policy Review (World Bank, 2003) and the 2003 Public Expenditure, Procurement and Financial Management Review (Government, World Bank, ADB).

[2] Issues such as intergovernmental finances (including central transfers), local government borrowing, capacity-building, etc. - equally important but involving a longer time horizon – have not been examined in this report.

[3] The term "local government unit" or LGU is generically applied to all levels of sub-national government in the Philippines. In this report, the term "LGU" refers to provinces, cities and municipalities.

[4] Property taxes have maintained their relative role in the composition of OSR, while increasing in importance for provinces and decreasing for municipalities. They have declined as a portion of total revenue.

6. **Local government financing.** Since the enactment of the LGC, there has been little progress toward enabling LGUs to access private capital based on creditworthiness. The Municipal Development Fund Office (MDFO), the Development Bank of the Philippines (DBP) and the Land Bank of the Philippines (LBP) monopolize the LGU credit market. Private financial institutions (PFIs) have no market presence. Their inability to become depository banks for LGUs is the chief structural impediment to their entry. With hardly any mobilization of domestic capital, almost all long-term credit to LGUs is sourced from Official Development Assistance (ODA).

7. The need is to develop a framework for private sector participation in infrastructure at the LGU level. This requires opening LGU depository functions to PFIs, specification of alternative forms of collateral for LGU credit; strengthening the LGU Guarantee Corporation (LGUGC); and examination of new models of ODA support to leverage private sector funding. Important objectives of a revised financing framework could include increasing LGU use of Build-Operate-Transfer (BOT) arrangements; development of an LGU bond market; removing impediments to LGU access to private banks; optimizing the involvement of Government Financial Institutions (GFIs) in the LGU credit system; strengthening LGU capacity and incentives to raise own revenues; and more effective use of ODA technical assistance and financing.

8. Inconsistency in implementation of the loan-grant-equity matrix prescribed by the 1996 LGU Financing Framework (LFF) is a significant limitation. Though recent cost-sharing schemes constitute significant progress in rationalizing LGU grant policies, much more remains to be done, including inventorying all budgetary resources going to LGUs[5]; developing a transparent formula for matching grants for all eligible LGU projects, regardless of financial intermediary and funding sources for the rest of the projects; and clarifying the grant-making mechanism for LGUs. Government would need to be consistent in applying the policy, and development partners would need to play by the rules.

9. ***Recommendation 1. Raising LGU access to credit by private financial institutions (PFIs) requires removing bottlenecks to PFI participation in LGU lending and rationalizing LGU grant policies.***

10. **Local government tax policy and administration.** Local revenue autonomy in the Philippines is limited, yet tax administration in the Philippines is highly decentralized. Local governments have own-source revenues both in terms of a share of the national wealth (the Internal Revenue Allotment, or IRA) and in terms of locally-raised taxes and fees. The Bureau of Internal Revenue (BIR) administers national taxes while each LGU administers its OSR. But there is little formal cooperation in practice. The BIR and local tax administrations operate independently of one another. At the same time local tax administrations mostly operate independently of one another. Moreover, there is little formal cooperation provided for by law.

11. Revenue assignments in the Philippines are consistent with generally accepted principles. However, LGU autonomy is circumscribed by the LGC to the extent that tax policy leaves little room for generation of marginal revenues by LGUs. This is important because if LGUs cannot generate marginal revenues, their autonomy is limited, as is their ability to design and implement expenditure policies that reflect their citizens' preferences. Nor is it common for the Code's level of detail on tax policy (including rates) to be found in framework legislation, since this makes relatively minor adjustments in the tax system very difficult to effect.

12. Local revenue codes provide for a tax system of great complexity. LGUs have created a panoply of taxes, fees, and charges, many of which are under-collected or simply uncollected. Lack of collection of some taxes and fees in local revenue codes undermines the integrity of the tax system and contributes to a culture of non-compliance. It would make more sense to focus on the fees that have high yield potential and to improve administration of those fees, essentially focusing limited resources where they

[5] Including funding from the MDFO, line agencies, and the Congressional Development Fund - this would indicate the actual amount of grants flowing to LGUs, and their fiscal impact on the national government.

are likely to have the most impact. Even core OSRs, such as the business tax, are complicated: the tax obligation depends on characteristics that are not easy to judge, exposing the system to rent-seeking. LGUs are under-performing on OSR collection and administration, reducing the credibility of the local tax system and contributing to a culture of non-compliance. Presently, OSR constitutes 36 percent of total local revenues. Provinces and municipalities - most dependent on IRA - also show least progress in revenue mobilization. This is partly due to more limited revenue options, but also due to a hesitation to adequately use and administer those available.

13. Weak LGU administrative capacity in major tax administration functions - registration, collection and audit (enforcement) - constitutes the binding constraint on improving LGU revenue performance. The principal problems include: (a) the prevalence of stop filers, non-filers, and late filers; (b) infrequent exercise of LGU audit and enforcement (temporary closures and property auctions) authority; (c) limited availability of taxpayer services; (d) distorted performance incentives and low professional qualifications of staff; and (e) inadequate support from and coordination with national government agencies. The administrative shortcomings appear to be compounded by incentive problems: in some cases political executives are concerned that increases in tax collections may prove politically costly. For example, many LGUs have not undertaken revisions of assessed property values in line with market values, resulting in lower collections.

14. ***Recommendation 2. Local government own-source revenues could be significantly increased through LGU measures to increase collection of real property tax and business tax[6], and national government actions to assist LGUs.***

15. OSR collections could also be significantly improved if cities and provinces conduct the generalized revenue assessment every 3 years, and if cities and municipalities use minimum (presumptive) gross sales figures to calculate establishments' business tax liability.

16. **LGU planning and budget management.** Institutionalized planning is weak in LGUs. Only 30-50 percent of LGUs have local development councils (LDCs) in place. Moreover, the Regional Development Plan (RDP) formulated by the Regional Development Council is seldom, if ever, taken into consideration by the LGUs. RDPs tend to focus on inter-provincial projects rather than on local development plans. There is a disconnect between national and regional/provincial planning. LGU budget formulation and execution tends to be non-transparent due to: (i) poor income estimates used by LGUs for budget formulation; (ii) the practice of granting additional personnel benefits out of "savings"; and (iii) the lack of effective community participation or oversight in budget preparation, execution or monitoring.

17. Personal services (PS) expenditures constitute the largest LGU expenditure category. PS expenditure is formally capped at 45–55 percent of total LGU resources. In reality it is higher, since (a) it is common practice to charge some contractuals' payments to maintenance and other operating expenditures (MOOE) or against development projects, and (b) even for functions and positions whose PS costs are supposed to be funded entirely from the national budget, LGUs commonly supplement such allocations. The ratio of PS to LGU expenditure has not changed significantly in aggregate between 1991 and 2001, but there are variations across levels of local government: this ratio declined for cities and increased for municipalities and provinces. This has squeezed the capital outlays of provinces and both MOOE and capital outlays of municipalities. Furthermore, the civil service compensation and classification system has accentuated rigidities due to its all-embracing character, and created fiscal burdens for LGUs: the continuance of the 'Magna Carta' for public health workers has forced LGUs to realign wage rates for other staff, impinging upon their fiscal autonomy and encouraging them to circumvent salary and hiring constraints through the use of temporary personnel.

[6] E.g. through collection-based incentives for LGU revenue assessors and collectors, enforcement action against delinquent filers and payers, taxpayer registration drives, regular cleaning of taxpayer registries, investing in information technology, improving the quality and quantity of audits, and strengthening taxpayer services.

18. Limited capacity in the Department of Interior and Local Government (DILG) and the Civil Service Commission (CSC) has impeded the introduction of LGU establishment controls[7]. The Department of Budget and Management (DBM) has had to shoulder much of the burden of trying to control these expenditures. However, as some LGUs have demonstrated, reining in PS expenditures, and installation of personnel information systems linked to payroll, can control the wage bill. The CSC has begun to work with the DBM to help LGUs contain personnel costs.

19. ***Recommendation 3. Local government planning and budget management could be made more effective, transparent and accountable through administrative measures by local and national governments.***

20. LGU actions to strengthen planning and budgeting could include (i) public disclosure of plans and budget documents, (ii) improved estimates of income and (iii) greater civil society monitoring. The national government could: (a) issue guidelines to strengthen national and regional/provincial planning; (b) advise and provide incentives to class 1 cities to control personal services expenditures, (c) provide greater flexibility in LGU compensation in exchange for heightened accountability, and (d) improve the predictability of IRA transfers.

21. **LGU procurement and financial management.** Despite a growing number of innovations and examples of good practice, accountability and transparency in LGU procurement leave much to be desired. Administrative controls over procurement remain generally weak, and effective mechanisms to track LGU procurement are lacking. In many cases bidders and suppliers are not aware of delays and problems, and issues are unresolved for long periods of time. The persistent weaknesses and inefficiencies which characterize LGU procurement and jeopardize its integrity often result in undue procurement delays, higher costs and opportunities for graft and corruption. The 2003 Government Procurement Reform Act (GPRA) is expected to address key LGU procurement weaknesses – its effectiveness will depend on how well its Implementing Rules and Regulations (IRRs) are enforced. The systems improvements and capacity-building implicit in GPRA implementation can improve the transparency and accountability of LGU procurement, leading to increased competition, cost-efficiency of resource use and strengthened governance.

22. Financial management capacity in most LGUs is weak and based on manual systems. The LGU internal control environment is characterized by low financial management skills, lack of leadership and weak oversight by national government agencies. A new Local Government Accounting System (NLGAS) has been introduced from January 2002. Its implementation now needs to be carefully managed. Provision of adequate and timely technical support to LGUs from the Commission on Audit (COA) and other oversight agencies is clearly a priority but poses tremendous challenges, among them the need for strengthening the BLGF as the principal oversight agency for LGU financial management.

23. ***Recommendation 4. Actions to embed transparency and accountability within LGU procurement and financial management processes could improve these processes, promote effective resource use, and strengthen LGU governance over time.***

24. Actions to improve LGU procurement could include, for example: (a) publication by LGUs of unit cost/price for infrastructure, construction and goods procurement; (b) ensuring that GPRA IRRs address LGU issues, (c) clarifying the role of the Commission on Audit (COA) in procurement audit; and (d) adequate training for LGU bids and awards committee members and procurement personnel. LGU financial management could be improved by: (a) public disclosure of LGU accounts and COA audit reports; (b) establishing an internal audit unit for each class 1 LGU[8] and a standing audit committee with

[7] Total LGU employment is very roughly estimated at 250,000 permanent and 95,000 temporary staff. However, the number of employees actually working against authorized positions is unclear, as is the number of non-plantilla positions and actual employment against these positions.

[8] Administrative Order 70 of April 14, 2003 provides for such committees in each LGU.

civil society participation; (c) augmenting BLGF and COA capacity to provide technical support for NLGAS implementation; and (d) strengthening internal controls over cash and property management.

25. **Managing decentralization and generating consensus.** The management of the decentralization process at the national level is being re-examined by the DILG: its proposals to strengthen its own policy capacity, merge its bureaus to facilitate handling of LGU issues, and involve the LGU Leagues in strengthening LGU capacity, are moves in the right direction. However, there are wider issues that need consideration. Perhaps the most important is how to effectively address the political economy challenges through an institutionalized consultative process: the formation (or resurrection) of a national representative forum[9] for reviewing decentralization-related issues could provide the environment for relevant actors to play a positive and more catalytic role.

26. ***Recommendation 5. The national government should initiate a review of the institutional arrangements for generating consensus among stakeholders on managing the decentralization process.***

27. None of these suggestions are new or unfamiliar to Philippine policy-makers. Many are based on actual LGU experience. The success and sustainability of some actions will depend on effective technical assistance from the Philippines' development partners – who stand ready to offer such support.

[9] Such as the dormant Decentralization Review Commission, and including national and LGU political executives, administration officials, and other stakeholders.

## Decentralization in the Philippines

### Recommendations

| Level of Government | Administrative Actions | Legislative Actions |
|---|---|---|
| | **1. Local Government Financing** | |
| National government | Allow private financial institutions (PFIs) to be depository banks. (DOF) | |
| | Refine the LGU Financing Framework. (DOF) | |
| | Promulgate a transparent policy and grant-making mechanism for LGUs. (DOF) | |
| | **2. Local Government Revenue Policy and Administration** | |
| National government | Provide more effective incentives and technical assistance to strengthen core LGU tax administration functions--registration, collections, and compliance—through a major overhaul of the BLGF. (DOF) | Revise the Code such that LGUs not complying with the GRA requirement would have their GRAs performed by the national government. |
| | Revise the MOU between BIR and BLGF: BIR to routinely provide data--including tax returns and the results of audits--to LGUs. Ensure the MOU is enforced in practice. (DOF) | Allow LGUs to set their own tax rates, either under higher ceilings, or subject to approval by the national government under higher ceilings. |
| | Issue IRR enabling LGUs to provide fee based services for assistance provided to other LGUs in core tax administration functions. (DOF) | Abolish restrictions on changes in tax rates covering both the frequency and the rate of change. |
| | | Allow LGUs to levy excise taxes on motor vehicles. |
| | | Remove the prohibition in the Code on use of the private sector for assistance with the collection function. |
| Local governments | Conduct the GRA every 3 years as prescribed by the Code. (Cities and provinces). | Conduct the GRA every 3 years as prescribed by the Code (requires legislative approval by LGU council). |
| | Increase collection of real property tax and business tax by: (i) creating incentives for LGU revenue assessors and collectors; (ii) enforcement action against delinquent filers and payers; (iii) conducting taxpayer registration drives; (iv) cleaning taxpayer registries regularly; (v) investing in information technology; (vi) increasing the quality and quantity of audits; and (vii) improving taxpayer services. (All LGUs) | Eliminate very low yield taxes and fees in order to simplify local revenue codes and improve collections. (All LGUs) |
| | Use minimum (presumptive) gross sales figures to calculate the tax liability for establishments required to pay the business tax. (Cities and municipalities) | |

| Level of Government | Administrative Actions | Legislative Actions |
|---|---|---|
| | **3. Expenditure Management** | |
| | **3.A Planning and Budgeting** | |
| National government | On development planning, revising guidelines to strengthen linkage between national, regional and provincial planning. (NEDA) | Cease ad hoc funding of local projects and imposition of unfunded mandates by national government agencies. (All national government agencies, Congress) |
| | Revise 1993 Budget Operations Manual and align it with budget management practices and requirements of New Local Government Accounting System. (DBM, DILG) | |
| | Strengthen local budgeting by improving predictability of IRA and local revenue estimates, greater civil society oversight and participation and publication of local budget and project documents/information. | |
| | Provide incentives and technical assistance to Class 1 LGUs to design and install personnel management and information systems for more effective establishment control. (DILG, DBM) | |
| | Initiate review of LGU compensation and position classification system, with emphasis on greater flexibility in exchange for heightened accountability. (DILG, DBM, CSC) | |
| Local governments | Mandate publication of budget documents (including quarterly and annual budget execution reports) and projects proposed to be implemented. (All LGUs) | Issue legislative resolutions mandating publication of budget documents including budget execution reports. (All LGUs) |
| | **3.B Procurement** | |
| National government | | |
| | Clarify role of COA in procurement audit (DBM, COA) | |
| | Specify mechanism for facilitation and oversight of LGU procurement (could be located within the Government Procurement Policy Board). (DBM) | |
| Local governments | Issue standing rules requiring publication of unit cost/prices for infrastructure, construction and goods procurement. (All LGUs) | |
| | **3.C Financial Management** | |
| National government | Internal audit: Monitor establishment of internal audit units in class 1 LGUs per Presidential AO 70 of April 14, 2003. (DILG, DBM, COA) | Internal audit: Amend LGC to provide for mandatory establishment of internal audit unit in each LGU, specify an internal auditor for class 1 LGUs, and a standing audit committee. (DILG, COA, DOF, DBM) |
| | Accounting: Augment BLGF and COA capacity to provide technical support for NLGAS implementation. (DOF, COA) | External audit: Amend LGC to mandate publication by COA and LGU of audit reports in at least one local newspaper of wide circulation. (COA, DILG, DOF) |
| Local governments | Internal audit: Establish internal audit units in class 1 provinces and cities. | |

| Level of Government | Administrative Actions | Legislative Actions |
|---|---|---|
| | Public disclosure of accounts and COA audit reports. (All LGUs) | |
| **4. Other Issues** | | |
| National government | Establish a national forum/commission to review decentralization-related issues. (DILG) | |
| | Strengthen DILG policy capacity and expedite merger of DILG bureaus. (DILG) | |
| | Involve Leagues of LGUs in LGU capacity-building programs and replication of good practice. (DILG) | |

# 1. OVERVIEW

## Purpose and Scope of Report

1.1 More than a decade after the enactment of the landmark 1991 Local Government Code (LGC), surveys to assess satisfaction with public services point to mixed results on local government performance in the Philippines. Local governments and communities confront a myriad of problems - uncertain access to potable water and electricity, declining literacy rates, environmental degradation, rising unemployment rates, lack of low-cost housing, and unreliable police and fire department services. The national government's straitened fiscal situation has squeezed central transfers, and policies on municipal finance have hamstrung local government access to private capital. Local government investment in infrastructure and social services has been constrained, and operations and maintenance expenditures curtailed. However, a growing number of examples of excellence in service delivery seem to indicate that well-performing local governments may be distinguished by their ability to access resources more effectively, and manage them more transparently and accountably.

1.2 The central premise of this study is that decentralization is not an end in itself, but potentially a means to better outcomes such as improved service delivery. This report reviews two facets of decentralization currently engaging policy-makers: (i) the sources of financing under decentralization, and (ii) cross-cutting processes to strengthen the accountability of resource use. It does not assess whether decentralization is justified in the Philippines – it approaches the arrangements as they exist, and explicitly focuses on actions that could be feasibly completed within six to nine months[10]. The report's audience comprises public policy-makers, national government agencies, local governments, civil society and donor partners.

1.3 The report begins with an overview chapter. Chapters 2 and 3 review two topical themes in local governments' access to resources – municipal financing and local government tax policy and administration. Chapter 4 examines three core cross-cutting issues relating to management of local government expenditures: planning and budget management, procurement and financial management. Chapter 5 reviews the experience with LGU performance assessment. Chapter 6 outlines next steps[11].

## Overview

1.4 With a population of approximately 83 million spread over 800 inhabited islands and comprising diverse linguistic and cultural backgrounds, the Philippines is organized as a multi-tiered unitary government. Sub-national jurisdictions are conferred autonomy through constitutional and statutory provisions. The nation is divided into 15 administrative regions and one autonomous region, the Autonomous Region of Muslim Mindanao (ARMM). With the exception of ARMM, regions house deconcentrated administrative units of the national government and do not have elected bodies. Article X of the 1987 Constitution of the Republic of the Philippines confers general grants of "local autonomy" to provinces, cities, municipalities and barangays, within "prescribed powers" and with the president exercising "general supervision." Article X provides for an outline of governance structures (such as term limitations and lengths), but Congress establishes the local representational details and functional authority, and prescribes local own source revenue (OSR) powers and vertical tax sharing entitlements.

1.5 The sub-national level comprises 80 provinces, 114 cities, 1496 municipalities and 41,945 barangays. Each local government unit[12] (LGU) is headed by an elected local chief executive (LCE)

[10] Issues such as intergovernmental finances (including central transfers), local government borrowing, capacity-building, etc. - equally important but involving a longer time horizon - will be examined in separate reports.
[11] Each chapter is based on extensive background papers and materials.
[12] In the Philippines, the term "local government unit", or LGU, can refer to any of the tiers of sub-national government – province, city, municipality, or barangay.

and governed by an elected legislative body (Sangguniang). Each level of government exercises autonomy over its prescribed functions. Superior jurisdictions (e.g. provinces) exercise some degree of supervision over lower-tier jurisdictions (e.g. municipalities and component cities). Cities and municipalities are established by Congress, but must be ratified by local plebiscite. Barangays are established by the elected councils of cities (Sangguniang Panlalwigan) or municipalities (Sangguniang Panlungsod). Highly urbanized cities[13] are, however, independent of provinces, and barangays are subordinate to cities and municipalities. Boundary adjustment of local government units, once created, requires approval in a local plebiscite. Except for barangays, all LGUs undergo classification every four years (done by the DOF) based on their individual incomes. Classification ranges from first class, having the highest income to sixth class, having the lowest income.

**Local Government Responsibilities**

1.6 The primary legislative enabling act, the 1991 Local Government Code (LGC), represented a major step forward in decentralizing and deconcentrating expenditure responsibilities. Local autonomy was advanced by expanding local government taxing authority and devolving expenditure responsibilities.

1.7 Prior to the LGC, functions assigned to LGUs were limited to: (i) levying and collecting of local taxes; (ii) regulation of business activities; and (iii) administration of garbage collection, public cemeteries, public markets and slaughterhouses. The LGC devolved to LGUs the principal responsibility for the delivery of basic services and the operation of facilities in: (i) agricultural extension and research, (ii) social forestry, (iii) environmental management and pollution control, (iv) primary health and hospital care, (v) social welfare services, (v) repair and maintenance of infrastructure, (vi) water supply and communal irrigation, and (vi) land use planning. In general, provinces are assigned functions that require the inter-municipal provision of services, such as district and provincial hospitals whose catchments cover more than one municipality. Municipalities are generally responsible for basic services, such as primary health care, construction, repair and maintenance of public elementary schools.

**Box 1.1 The Autonomous Region of Muslim Mindanao (ARMM)**

The Organic Act of the ARMM (RA 6734)[14] shifts to the regional government all powers, functions and responsibilities previously exercised by the national government except: (i) foreign affairs, (ii) national defense, (iii) postal service, (iv) fiscal and monetary policy, (v) administration of justice, (vi) quarantine, (vii) citizenship, naturalization and immigration, (viii) general auditing, civil service and elections, (ix) foreign trade, (x) maritime, land and air transportation and communications that affect areas outside the ARMM, and (xi) issuance of patents, trademarks, trade names and copyrights. ARMM powers and responsibilities now comprise implementation of programs and projects on agriculture and agrarian reform; education; environment and natural resources; health; tourism, trade and industry; social welfare; industrial peace, protection of workers' welfare and promotion of employment; promotion of cooperatives; provision of assistance to local government units; and development and regulation of cooperatives.

1.8 The devolution is substantial not only in terms of the sheer number of functions that were shifted but more so in terms of number of personnel transferred (Table 1.1) and the corresponding reductions implied in the budgets of affected national government agencies (amounting to 33 percent of pre-devolution budgets of these agencies).[15] However, under Executive Order 507[16] the budget for

[13] Highly urbanized cities have a minimum population of 200,000 and a minimum annual income of PhP50 million.

[14] The Organic Act of the ARMM was enacted in July 1988.

[15] The national government agencies most heavily affected by devolution were the Department of Agriculture (DA), Department of Health (DOH) and the Department of Social Welfare and Development (DSWD).

[16] Executive Order 507 defined the actual implementation of the devolution program mandated under the Local Government Code. It provided specific guidelines as to which programs and activities would be "excluded" or "disallowed" from the budgets of devolved national government agencies post-devolution.

certain devolved activities was not devolved in the sense of being "disallowed" in the budget of NGAs - the national government continues to fund elements of such devolved activities. These include immunization, control of communicable diseases, provision of drugs and medicines to devolved facilities, the operation of hospitals in the NCR, the construction and repair of school buildings, and the construction and maintenance of local public works. Table 1.2 displays the extent of national government budgetary devolution.

**Table 1.1: Number of Devolved Personnel, 1992**

| | Number of Personnel Before Devolution | Number of Devolved Personnel | Ratio of Devolved Personnel to Pre-Devolution Personnel % |
|---|---|---|---|
| Department of Agriculture | 29,638 | 17,673 | 59.63 |
| Department of Budget and Management | 3,532 | 1,650 | 46.72 |
| Department of Environment and Natural Resources | 21,320 | 895 | 4.20 |
| Department of Health | 74,896 | 45,896 | 61.28 |
| Department of Social Welfare and Development | 6,932 | 4,144 | 59.78 |
| Other Executive Offices | 191 | 25 | 13.09 |
| Total | 136509 | 70,283 | 51.49 |

*Source: 1993 National Expenditure Program, Regional Coordination Staff.*

**Table 1.2: Agency Budgets and Devolution, 1992**
**(In thousand pesos)**

| | Budget Before Devolution a/ | Devolved Budget b/ | Budget to Pre-Devolution Budget % |
|---|---|---|---|
| Department of Budget and Management | 465,379 | 193,249 | 41.53 |
| Department of Environment and Natural Resources | 1,941,782 | 87,558 | 4.51 |
| Department of Health | 9,991,392 | 4,079,615 | 40.83 |
| Department of Social Welfare and Development | 1,320,708 | 742,665 | 56.23 |
| Philippine Game fowl Commission | 15,208 | 616 | 4.05 |
| Total | 18,944,497 | 6,264,406 | 33.07 |

a/

1.9 Section 17(b) of the LGC generally provides a clear delineation of functions across levels of governments. However, Section 17(c) allows national government agencies to continue to implement devolved public works and infrastructure projects and other facilities, programs and services provided these are "funded by the national government under the annual General Appropriations Act, other special laws, pertinent executive orders, and those wholly or partially funded from foreign sources." Section 17(f) allows the national government or the next higher level of local government unit to "provide or augment the basic services and facilities assigned to a lower level of local government unit when such services or facilities are not made available or, if made available, are inadequate to meet the requirements of its inhabitants." No formal mechanisms have, however, been established to implement this.

## Impact of the Local Government Code

1.10 The enactment of the 1991 Local Government Code (LGC) represented a major step forward in decentralization in the Philippines: it advanced local autonomy by devolving expenditure responsibilities and expanding local government taxing authority. LGUs' added responsibilities resulting from the 1991 LGC produced a significant shift in the location of public expenditures: LGU expenditures steadily increased from 1990 to 2002 relative to both GNP (from 1.7 percent to 3.4

percent) and general government expenditures (11.2 percent to 19.3 percent). The distribution of expenditures across levels of government has also shifted, with the sub-national share of general government spending increasing substantially. Across levels of local government, the share of cities in spending has dramatically expanded, up from 31 percent of LGU expenditures in 1991 to more than 40.9 percent in 2003. The share of cities' expenditure is especially dominant in education (58 percent), housing and community development (68 percent), and transport and communications (49 percent). Health is now the only sector where provinces are the most prominent form of local government.

1.11 Overall, the devolution of expenditure responsibilities to LGUs is consistent with the principle of subsidiarity[17], and few devolved activities have spillover benefits outside LGU territorial jurisdictions. Also, few of the devolved activities have benefits that spillover outside the territorial jurisdiction of the LGU. Moreover, the functioning of the decentralization theorem is enhanced by the provision in the Code which permits LGUs to regroup into larger cooperative units when they deem appropriate. To date, there are many cases of inter-LGU cooperation in coastal resource management, solid waste management, water supply development and distribution, and construction of inter-municipal roads (LGSP 1999). This development has contributed to the emergence of metropolitan arrangements in many places around the country (Mercado and Manasan 1999). An important exception to the application of the decentralization theorem in the Philippines is education. Although the construction and maintenance of school buildings was devolved to LGUs under the Code, the primary responsibility for the provision of education remains with the national government.[18] In contrast, experience from across the world shows that devolving education could probably improve production efficiency (Loehr and Manasan 1999).

1.12 Section 17 (b) of the LGC provides an unambiguous delineation of functions across levels of government. However, Sections 17 ( c) and (f) effectively encourage the existence of a two-track delivery system, where both national government agencies (NGAs) and LGUs can initiate devolved activities (Gonzalez 1996)[19], thereby obfuscating what initially was intended to be a clear-cut assignment of expenditure responsibilities[20]. Consequently, the budgets of devolved national government agencies have often grown disproportionately relative to internal revenue allocations (IRA) to local governments (Capuno et al 2001). Moreover, national controls often heavily prescribe local budget allocations, particularly in the area of personal services.

1.13 Because many of the devolved national government agencies are accountable for outcomes in their respective areas, they deem it their responsibility to direct LGU activity[21], and most tend to make full use of Section 17(f) of the Code. Congressmen employ Section 17(f) to provide pork-barrel funds through special provisions in the General Appropriations Act which specify that such funds can only be released for "projects that are identified by members of Congress." This has resulted in a coordination failure between Congress and LGU officials (Loehr and Manasan 1999). In addition to devolved functions, the national government tends to pass on to LGUs so-called unfunded mandates. The most important of these refer to the standardization of salaries in the public sector and the

[17] An important exception is education: although the LGC devolves construction and maintenance of school buildings to LGUs, the primary responsibility for the provision of education remains with the national government. One of the reasons for not devolving education can be traced to the fact that teachers serve on the Board of Election Inspectors. They man the precincts during elections and play an important role in the counting of votes. During debate prior to the enactment of the LGC, concerns were raised that devolving teachers could overly politicize elections at the local level.

[18] One of the reasons for not devolving education can be traced to the fact that teachers serve in the Board of Election Inspectors. They staff the precincts during elections and play an important role in the counting of votes. During debate prior to the enactment of the Local Government Code, concerns were raised that devolving teachers could overly politicize elections at the local level.

[19] The most notable example here is public works.

[20] The impact of this on service delivery will be examined in subsequent phases of this study.

[21] For instance, the DOH is accountable for the overall health status of the country in the same way that the DENR is accountable for overall environmental and natural resource management results.

provision of additional benefits to health workers under the Magna Carta for Health Workers. LGUs are also expected to provide budgetary support (either in the form of additional personnel benefits or outlays for MOOE) to many national government agencies operating at the local level such as the police, fire protection, and local courts.

1.14 A comparison of RA 6734 and RA 7160 shows that non-ARMM LGUs are treated on an almost equal footing as the regional government of ARMM in terms of expenditure assignment although the functions and responsibilities assigned to the regional government of ARMM are slightly broader than those given to non-ARMM LGUs.[22] On the other hand, asymmetry exists between ARMM-LGUs and non-ARMM LGUs in terms of the expenditure responsibilities that are assigned to them because the regional government of the ARMM has not devolved any of their functions to the LGUs within their jurisdiction even if RA 6734 allows them to do so. Thus, ARMM-LGUs did not receive any of the devolved activities that have been transferred to non-ARMM LGUs under RA 7160.

1.15 Available revenue sources are significantly restricted, producing excessive dependence on the internal revenue allotment (IRA) to meet local budgetary needs. Provinces and municipalities are most dependent on IRA (IRA allocations sometimes accounting for 95 percent of local revenues and, in at least one case, 114 percent of total expenditures).

**Local Government Service Delivery Performance**

1.16 For several decades after independence the traditional mode of service delivery prevailed, where a centralized agency provided public goods and services with little involvement of citizens or local governments. However, the 1986 People Power revolution introduced a significant transformation in governance style, with the 1987 Constitution being formulated specifically to enhance the role of the people to guide the State in expeditiously addressing inequities. Further, the existence of local governments as integral components of the unitary republic was guaranteed, and the automatic disbursement to these LGUs of a 'just share' of national taxes was specified as an obligation of the state. The enactment of the 1991 LGC was partly due to the need to address these Constitutional requirements, and led to the shifting of decision-making for specified public services to local governments. Since then, substantial progress has been made in improving the capacity and orientation of local governments to deliver specified public goods and services, including a responsibility for ensuring the 'general welfare' of citizens.

1.17 The challenge of measuring performance is made difficult by the fact that for many services, there is a mixture of national and local government inputs, and problems/constraints may arise as much from the national government side as from that of the LGUs. Hence, despite more than ten years of decentralization, it is difficult to undertake a rigorous analysis of local government performance, particularly in a comparative perspective, and to link this to local government inputs or management practice. A key constraint is the lack of suitable comparative nationwide data at a disaggregated level. Various surveys, both quantitative and qualitative, have been conducted, but it is still difficult to compare the relative performance of all LGUs in the country. Another complicating factor is the persistent complex relationships between national and local governments, even in devolved functions, such that it is difficult to apportion accountability for service delivery outcomes even where such data is available. The following paragraphs provide a brief overview of aspects of LGU performance based on publicly available data, but is by no means comprehensive.[23]

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[22] In particular, the regional government of the ARMM is charged with the provision of agrarian reform and education services, the promotion of employment and workers' welfare and the promotion of trade and industry while non-ARMM LGUs are not.

[23] The primary sources of data are the LPPMS database of DILG; the Philippines Human Development Reports; the Family Income and Expenditure Surveys conducted by the National Statistics Office and databases maintained by the National Statistical Coordination Board.

1.18 **Regional performance.** The most comprehensive and consistent comparative sub-national data is at the regional level, although this is simply an administrative level of government that has no responsibilities for delivery of services. More data is gradually becoming available at the provincial level, but not at lower levels which are at the frontline of efforts to reduce poverty. Nonetheless, regional data provides a flavor of trends in development between 1990 and 2000.

1.19 Available data suggests that while there have been modest gains in welfare, the regional patterns of development have not been influenced by decentralization and regional inequities persist. The Philippine Human Development Report (HDR) 2000 lists the top and lowest ranking ten provinces by HDI score[24] but does not provide a full regional listing for comparative purposes. Of particular interest in the 2000 HDR is the performance of the province of Bulacan, which took top place after ranking fourth in both 1994 and 1997. The outstanding performance of Bulacan in a number of surveys over the past three years, coupled with its innovative approaches to introducing reform, make it a candidate for further analysis as a provincial role model. Again consistent with poverty data, the provinces of the ARMM and Mindanao achieved the lowest HDI scores. The province of Sulu ranked last in all three years. The provinces of Tawi-Tawi (also in the ARMM) and Basilan experienced worsening HDIs between 1997 and 2000 although the net gains from 1994 to 2000 were positive. Of the ten lowest-ranked provinces in 2000, 8 were in Mindanao. The provincial rankings between 1994, 1997 and 2000 changed very little and the top ten and bottom ten have included the same provinces, with one or two exceptions across this time period, although in general the scores have improved slightly.

1.20 Regional economic growth seems to have had a positive impact on average family incomes and poverty, but does not appear correlated to employment. There is, as expected, a positive correlation between gross regional domestic product (GRDP) per capita, and average family per capita incomes, but no clear linkage to changes in employment[25]. Most regions did, in fact, experience a decline in employment rates. The data also suggests that those regions experiencing the most rapid decline in poverty incidence are not those with the most rapid economic growth. Analysis of relationships between key indicators is complicated by data limitations. As with all data series for the decentralization period, there are different data series owing to the creation of three new regions during this period – the Cordillera Administrative Region (CAR) in 1988, the Autonomous Region of Muslim Mindanao (ARMM) created in 1989 and subsequently expanded and most recently Caraga, in 1995. Thus, most time series data from 1990 to 2002 have to be adjusted to take into account the impact of these new regions.

1.21 **Cities' performance.** In 2000, the DILG conducted a self-assessment survey among the cities of the Philippines[26], to reflect the status of compliance by cities with LGC requirements. The findings point to mixed results on the performance of cities. City governments and their civil society partners face a myriad of problems from environmental degradation to declining literacy rates, rising unemployment rates, lack of low-cost housing units, protective services from the police and fire departments, and access to potable water and electricity. Performance-wise, cities in general appear to be most wanting in the area of development planning. Although they had annual development plans and annual investment plans, the mere presence of these documents did not reflect their quality, particularly their utility as management tools. Most cities did not have planning policies and guidelines and a reliable data bank: it appears that cities had no rational basis for formulating development programs and projects. The cities were well-equipped with information and communication facilities and other equipment necessary for day-to-day operations and management. Although most cities lacked operational human resource development plans, they had initiated training programs for their public servants. The findings also point to a weak system of local fiscal administration in the cities. Most cities had a Local Revenue Code, but not an Annual Revenue Plan.

[24] Please see tables in Annex 2, Section E.
[25] Please see tables in Annex 2, Section E.
[26] Selected findings by major area of self-assessment are at Annex 2, Section F.

Some cities reported delays in paying their loan amortizations and many failed to comply with budgetary requirements imposed by the Code, particularly those on the personal services (PS) cap.

1.22 On the other hand, the operation and maintenance of museums, rehabilitation centers, socio-cultural centers and traffic signals were lacking in most cities. An inventory of the health program beneficiaries likewise showed that regardless of geographical location, the largest number of beneficiaries were children. For environmental services, the cities did perform their mandate to collect and dispose of garbage. Nonetheless, they were not able to cope with the volume of garbage generated. A functional sewerage system was nonexistent in most cities.

1.23 In 2001, a Report Card Survey was conducted by the Development Academy of the Philippines, with funding from the Asian Development Bank. The survey evaluated citizen satisfaction on the delivery of five basic services by the nine cities of Metro Manila (Table 1.3). The scores for each service were aggregated to reach a composite "overall management" score. The ranking of cities based on their overall scores showed Marikina to be a winner but other cities' scores were relatively close.

**Table 1.3: Metro Manila: Citizen Satisfaction, Selected Public Services, 2001**

| City | Garbage mgt. | Public market | Permits & licensing | Public safety | Traffic Mgt. | Overall mgt. |
|---|---|---|---|---|---|---|
| Quezon | 60 | 57 | 63 | 56 | 63 | 59.8 |
| Manila | 71 | 61 | 70 | 58 | 62 | 64.4 |
| Pasig | 71 | 69 | 76 | 61 | 60 | 67.4 |
| Makati | 69 | 67 | 78 | 69 | 56 | 67.8 |
| Paranaque | 40 | 47 | 58 | 50 | 66 | 52.2 |
| Marikina | 84 | 82 | 82 | 73 | 53 | 74.8 |
| Pasay | 55 | 53 | 62 | 53 | 64 | 57.4 |
| Muntinlupa | 53 | 58 | 73 | 56 | 61 | 60.2 |
| Mandaluyong | 70 | 66 | 72 | 60 | 61 | 65.8 |
| **Overall** | **63.67** | **62.22** | **70.44** | **59.56** | **60.67** | **63.31** |

*Note: Higher scores indicate higher citizen satisfaction*
*Source: DAP, ADB*

1.24 The Asian Institute of Management and the Department of Trade and Industry conducted a Competitiveness of Cities (CoC) survey in 2002. The ranking was based on the cost of doing business, dynamism of local economy, linkages and accessibility, quality of human resources, infrastructure, responsiveness of local government to business needs, and quality of life. Only three Metro cities were in the top 10 (Davao, Cebu and Marikina) and two of those close to the bottom. Four were mid-sized cities (including the top-ranked city, General Santos City) and three (including the second ranked city, San Fernando Pampanga) were small cities. Table 1.4 reflects the results of both surveys. The results of the surveys are not directly comparable since they used different indicators. However, for cities covered by both surveys, it offers two interesting perspectives. Of the cities covered by both surveys, Marikina was the highest ranked in both, followed by Makati.

**Table 1.4: Rating of Selected Public Services**

| City | RSC Rank | CoC Rank |
|---|---|---|
| Quezon | 7 | 33 |
| Manila | 5 | 20 |
| Pasig | 3 | 23 |
| Makati | 2 | 15 |
| Paranaque | 9 | - |
| Marikina | 1 | 10 |
| Pasay | 8 | - |
| Muntinlupa | 6 | - |
| Mandaluyong | 4 | 19 |

1.25 Another trend is the constant upgrading or creation of new LGUs at all levels, especially cities. In 1991, there were 75 provinces, 60 cities, 1,543 municipalities, and 41,820 baranggays and in 2003 there were 80 provinces, 114 cities, 1496 municipalities and 41,945 barangays. The most noticeable feature is the increase in the number of cities. This is mainly driven by increased access to IRA: cities are eligible for two to three times higher financial resources than municipalities. As a result, municipalities constantly push for upgradation to cities. Political economy factors also play an important role (e.g. competition with neighboring LGUs, and more opportunities for dispensing

patronage). However, continued creation and upgradation of LGUs has strained national government ability to adequately finance such LGUs, while the still relatively small size of the LGUs prevents them from effectively generating their own resources.

**The Political Economy Context**

1.26 The institutional environment at the sub-national level mirrors that at the national level. Mirroring national trends, local governments display a subjugation of the public administration to the dominant political power, which – as at the national level - has led to (i) a loss of civil service status and morale, (ii) a complex and enduring web of connections between political executives, civil servants, and business interests[27], (iii) dramatic and turbulent changes during the transition from one administration to another and the institutionalization of 'courtesy resignations' at transition, (iv) a blurring of the distinction between career and non-career officials, and (v) civil servants' own inability and unwillingness to use the protection of the laws.

1.27 Formidable political economy challenges confront efforts to move to more transparent and accountable local government functioning: it would be desirable not to underestimate such obstacles in the quest for improvements, and to keep expectations realistic. While the LGC and secondary regulations established institutions, linkages between them, and rules of procedure that are coherent and that are also, in the main, familiar in other decentralized settings, enforcement is weak due to capture by dominant social groups. Either because of weak evolution over the last decade or persistent capacity challenges, some parts of the institutional structure governing LGU operations remain underdeveloped and exhibit vulnerabilities in transparency, accountability, efficiency and effectiveness[28]. The workings of intergovernmental (fiscal, administrative, and political) relations are particularly vulnerable to the instability induced by an excessively politicized system of rewards and allocations, and by uneven institutional strength and resourcefulness among national executive, congressional, provincial, and city or municipal actors. Cumulatively, however, there is evidence that some executives have tried to break from the dominant pattern of politics and taken risks outside the certainty of machine politics. More importantly, these executives have been rewarded by clear support from communities and interest groups, and especially by re-election.

1.28 Against the above backdrop, subsequent chapters examine two specific aspects of the Philippine decentralization experience: (a) local governments' access to resources, and (b) key processes that can contribute to greater accountability and improved performance.

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[27] E.g. a 1994 study by Gutierrez showed that congressmen had intimate linkages with the bureaucracy and the government system: 45 representatives had siblings who were public officials, 64 representatives had parents who were public officials, 30 representatives had grandparents who were public officials, 23 representatives had spouses who were politicians, 21 representatives had children who were politicians, and 55 representatives had close blood relatives who were politicians. Similar accounts of the business and economic interests of political officials have followed. *(Drawn from Prof. Leonor Briones' Background Paper for this report.)*

[28] Corruption is an issue, e.g. in tax policy and administration; procurement; personnel hiring (where the prevalence of patronage and family control is well known). While there is merit in being frank about corruption, it should be recognized that this report is not about corruption per se. Issues of corruption, especially informal payments related to service provision/access, may emerge more clearly when sectoral issues are addressed in subsequent phases of this work.

## 2. ADDITIONAL LOCAL GOVERNMENT FINANCING

2.1 A key issue for LGUs in their developmental efforts is their ability to mobilize financial resources in addition to national transfers and own source revenues. Such resources are referred to here as local government financing. This chapter reviews the experience with local government financing in the Philippines, and offers some suggestions for strengthening existing arrangements[29].

2.2 Prior to 1991, local governments were restricted to borrowing from GFIs for their capital financing requirements. Local government borrowing was never a substantial source of LGU financing, compared to traditional sources such as IRA, grants and local taxes. LGU borrowing on the average constituted a mere 1.25 percent of their total income for the period 1981-1993 (2.0 percent for cities, 0.5 percent for municipalities and 1.35 percent for provinces). This was partly due to the GFIs' decision to stop lending to local governments in the mid-1980s because of mounting loan arrears and loan defaults by LGUs. The national government instituted a first debt relief program for LGUs in the 1980s and a second one after the enactment of the LGC, giving the LGUs a clean slate vis-à-vis the government lenders (Llanto, 1992). The 1991 Code allowed local governments to float their own bonds, enter into build-operate-transfer arrangements and, in general, tap various sources of credit financing. LGUs were no longer confined to sourcing credit from GFIs and the Municipal Development Fund (MDF): there was now an opportunity for private sector participation in local government credit markets.

### 1996 LGU Financing Framework

2.3 The long-term government vision for local government financing is for the capital market, rather than government agencies, to play a dominant role. This entails the establishment of a sustainable LGU capital market that allows LGUs to access financing at competitive terms, ideally with a built-in 'graduation' program to induce creditworthy LGUs to readily migrate from government agencies to private capital. Thus, government LGU credit programs (i.e. GFI credit programs and the MDF) were expected to pave the way for greater participation by private capital markets in financing local development, with technical assistance (including grants) being provided to LGUs to improve their creditworthiness. In 1996, private banks had indicated that several key issues needed to be addressed satisfactorily for LGUs to access private capital markets. These included a more transparent LGU information structure; satisfactory LGU loan repayment capacity; collateral and loan safeguards and credit risk; and the establishment of a regulatory framework for LGU deposits and bond issuance. There was apprehension about the risk emanating from the short tenure of local chief executives.

2.4 The 1996 LGU Financing Framework (LFF) forms the cornerstone of current LGU financing arrangements, but local governments' access to private capital remains extremely limited. Developed by the DOF with World Bank assistance, the LFF led to reforms in local government financing, and provided for a segmented approach to LGU financing: lower-income LGUs would have access to the MDF, those in the middle tier could access GFIs, while upper-tier LGUs could access private commercial finance. To improve LGU access to private capital markets, the LFF recommended increased use of BOT schemes, development of an LGU bond market, improved LGU access to private banks, and the optimization of GFIs' role in LGU financing. Restructuring and reorientation of the MDF was also suggested, as were strengthening LGU capacity to raise own-source revenues and the use of ODA (loans and grants) to improve local government capacity.

2.5 The MDF, formerly under the Bureau of Local Government Finance, was reorganized into the Municipal Development Fund Office (MDFO), a separate unit under the Department of Finance. The DBP and some private banks organized the Local Government Unit Guarantee Corporation (LGUGC) to help develop the local government bond market. However, since the development of the LFF, while

[29] This chapter draws on a background paper by Dr. Gilbert Llanto, based on Llanto (1992), Llanto and Soriano (1996), and Llanto and others (1998). The basic arguments for the financing framework are explained in Gilberto M. Llanto and others (1998).

the LGU loan portfolio in the country has increased manifold, there has virtually been no progress on mobilizing private financing, as all the loans were made by GFIs and MDFO: GFIs have remained the major source for medium-term loans and the MDFO for long-term loans. A few local governments have also floated bonds and entered into BOT arrangements for local projects (Table 2.1). The status of implementation of the LFF, including key issues, is summarized in Annex 5.

**Table 2.1: Comparison of LGU Loans*, 1995 and 2000 (billion pesos)**

| | 1995 (billion pesos) | Share (%) | 2000 (billion pesos) | Share (%) |
|---|---|---|---|---|
| MDF | 0.3 | 5.4 | 0.4 | 6.5 |
| LBP | 4.7 | 85.5 | 4.4 | 71.0 |
| DBP | 0 | | 0.3 | 4.8 |
| Bonds | 0.5 | 9.1 | 1.1 | 17.7 |
| TOTAL | 5.5 | 100.0 | 6.2 | 100 |

** Refers to total peso value of new loans*

**Implementation Progress**

2.6 Some progress is being made in the involvement of the private sector in LGU infrastructure investments, mostly through management contracts[30]. The World Bank-financed LGU Urban Water and Sanitation Project requires LGUs to engage private sector operators in the management of water utilities funded under the project. So far, 12 LGUs have water systems operated by the private sector. Several feasibility studies are at various stages of completion for additional LGUs. The ADB has financed an innovative LGU Project Development Facility to support the preparation of feasibility studies for projects involving private sector participation. The Japan International Cooperation Authority (JICA) has also financed an Environmental Infrastructure Support Project to support private participation. The DBP provides sub-loans to qualifying private entities for municipal environmental infrastructure. The Coordinating Council for Private Sector Participation (CCPSP) has published guidelines and information documents on private participation in LGU projects.

2.7 Although efforts have been made to increase LGU use of BOT arrangements, very few LGUs have so far made use of BOT contracts for local development projects. Annex 4 shows the solicited and unsolicited BOT projects of local governments as of March 31, 2002. Most projects are for property development, except for two local infrastructure projects. Cabanatuan City currently has a BOT project for local market development under preparation. Lapu-Lapu City's previous administration had a plan for a reclamation project but this was not continued by the new administration. Mandaue City has an earlier experience with BOT schemes. The reclamation of 200 hectares of land before 1996 was under a BOT arrangement. The city obtained 20 percent of the total reclaimed area. The reclamation area was fully developed with a road network and sewerage. The private share of the reclamation is fully sold out for light industry and commercial use while the city government's share is under lease. Another BOT arrangement to reclaim another 300 hectares off the city's coastline costing approximately PhP2 billion has been awarded to a private developer.

2.8 LGUs hesitate to access private financing because the borrowing cost is perceived to be higher than from the GFIs or MDF. This is true for capital markets and for BOT schemes. However, apart from the issue of the higher cost of private sector financing, there are concerns about the capacity of local officials to enter into such financing arrangements and the amount of time and effort spent to arrive at closure. Experience so far seems to indicate that it will be some time before private participation in infrastructure development becomes significant.

2.9 There has been modest progress in this area, the most significant development being the creation of an LGU Guarantee Corporation (LGUGC) to guarantee debt issues of local governments

[30] The Consultants' Report states that "apart from the Manila water concessions however, most of the examples to date are not true BOT or concession schemes. Rather, they are predominantly management contracts".

financed from private sources. The LGUGC is the first privately-managed local government guarantee corporation established in a developing country in Asia. Since the inception of the LGUGC, six LGU bond issues have been floated, all with the backing of LGUGC.[31] The total amount floated to date with the guarantee of the LGUGC is PhP1.35 billion pesos - on par with the outstanding portfolio of the DBP but small compared to the outstanding LGU portfolio of Land Bank. A good example is Daraga Municipality of Albay Province, which issued PhP75 million in bonds in 2001 to develop a local market. The LGUGC helped the municipality to prepare, rate, process and issue the bonds.

2.10 Further progress is dependent on addressing institutional and regulatory issues. Bond issuance has not picked up for a variety of reasons, such as the lack of appreciation and understanding of local governments of this alternative financing mechanism and the presence of information asymmetry between potential issuers (i.e. local governments) and potential bond investors. In the near future there may be continued reliance by many LGUs on bank loans for credit financing - this is understandable in view of the high fixed cost of arranging bond flotation (these include the cost of preparing the necessary documentation, obtaining a bond guarantee and the professional fees paid to private entities arranging the bond financing). Larger LGUs, mostly those in the first two income classes, could conceivably use bond financing more extensively once the institutional and regulatory issues affecting bond issuance are sufficiently addressed. However, smaller or lower income municipalities would typically continue to opt for bank loans.

2.11 Institutional constraints continue to impede further development of a local government securities market. The major continuing constraints comprise: higher costs in issuing bonds than direct borrowing, lack of reliable information about LGUs, the possibility of political interference in project management or in debt servicing, uncertainty about management capacity at the LGU level, uncertainty about the quality of feasibility studies, lack of an independent rating agency, lack of a market for secondary trading, and lack of access to IRA as security for LGU obligations.[32]

2.12 There continue to be impediments to LGU access to private banks. The continuing lack of LGU access to private bank loans is in contrast to the progress made in developing an LGU bond market. Some private banks have purchased LGU bonds, but direct lending seems to be non-existent. The current situation of private bank lending is similar to the situation in 1996 when the LFF was established: private banks have not made loans to local governments. The inability of private banks to become depository banks for LGUs has been cited as the chief structural impediment to their entry into the LGU lending market. This seems to be confirmed by the use of GFIs as depository banks for LGUs, which has encouraged a lender-borrower relationship between GFIs and LGUs. In addition, an important element in co-financing schemes is the extent of risk-sharing between local governments and private banks. Credit risk can be covered by effective collateral such as the IRA intercept mechanism and hold-out on LGU deposits. Hence the proposal to allow LGUs to use private banks as depository banks.[33]

2.13 Under the 1996 LFF, the GFIs and the MDF were to be "catalysts to bring LGUs to the mainstream of the private capital markets." [34] As such, the GFIs were encouraged to: (a) lend to creditworthy LGUs that could not yet tap private capital, and adopt a built-in "graduation scheme" to move more creditworthy LGUs to private credit markets; (b) develop co-financing arrangements or project referral schemes with commercial banks; and (c) provide limited technical assistance to enhance LGU creditworthiness, particularly in the areas of financial and project management.

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[31] Prior to the creation of the LGUGC, only four LGU bonds had been floated (Cebu bonds plus three housing bonds). The Housing Insurance and Guarantee Corporation (HIGC), a GOCC, guaranteed the housing bonds.

[32] These same observations were made at the time the LGU Financing Framework was being worked out. See chapter 5 in Llanto and others (1998).

[33] Llanto and others (1998), pp. 152-153.

[34] Llanto and Soriano (1996).

2.14 Clearly, the intended "graduation" policy designed under the LFF has failed to work since GFIs remain the main financers for LGUs. LGU loans have now become an important and profitable part of the portfolios of the LBP and the DBP. The LBP uses both ODA and its own resources to lend to LGUs. The DBP exclusively relies on ODA resources for LGU loans. It is unclear how PNB will operate in the future given the recent changes in its management and ownership. The positive experience of GFIs in lending to LGUs is helping to provide a track record that may, if continued, demonstrate to private banks that the LGU market is a relatively secure and profitable one. Some private banks are monitoring the GFI experience. However, they are at a competitive disadvantage vis-à-vis the GFIs because of the depository privilege and the access of GFIs to ODA funds.

2.15 The foreseeable future seems to indicate continued dominance and monopoly by government lending programs for local governments unless the government, GFIs and MDFO take the graduation policy seriously. Private banks have expressed an interest in participating in local government credit markets but government intervention in the markets has been, and still remains, a major barrier to entry of private participants.[35]

2.16 Transforming the MDFO is now a priority and the restructuring is ongoing. The MDF was to service the financing requirements of less-developed and less creditworthy LGUs and finance projects with social and environmental objectives with typically long gestation periods or lower financial returns.[36] Most of its LGU borrowers belong to the first and second income classes. However, the 1996 LFF mandated the MDF to relinquish this market, initially to GFIs and eventually to private commercial banks. While the MDFO has helped to improve the access of local governments to capital financing, past experience reveals the severe constraints imposed by the organizational character of MDFO - a unit within the Department of Finance, dependent on national government budgetary allocation and budget ceilings imposed by DBM on government agencies. Since its creation in 1984, most subprojects funded by the MDF have been in urban areas.

2.17 The MDFO was hamstrung by lack of personnel, resources and capacity: one reason for the slow movement of on-lending funds to local governments is the failure of government to allow MDFO to have full-time professional staff. The MDFO management and staff were also subject to the salary standardization law which makes it difficult to hire and maintain capable individuals. Its ability to be effective remained highly sensitive to the national government fiscal situation, while its role in promoting private funding needed enhancing. Issues requiring attention include policies on matching grants; developing policy-based loans and grants; and developing a second tier funding entity for LGUs and a bond-pooling agency. These have been covered in chapters 3 and 5. The high level of dependence of local governments on IRA, among other things, lessens LGU officials' accountability for revenue and expenditure decisions: hard decisions on raising revenues to cover local expenditures and justifying to the public the need to raise taxes to finance public services can be avoided. This dependence may also impair the development of local government capital markets because loans to LGUs have been made essentially on the security offered by the IRA intercept.

2.18 LGU access to ODA technical assistance and financing has been uneven, compounded by widely varying cost-sharing arrangements between the national government and LGUs; the recent simplification of cost-sharing is a step in the right direction. The cost-sharing arrangement is dependent on the sector the grant is being provided for, and typically follows a certain percentage sharing between the national government and the LGU (see Annex 4). However, in some sectors (e.g. governance), the cost-sharing arrangement is not pre-determined. In the health sector, the LGU has to provide for fixed assets such as land, office space and personnel, although in some instances payment for taxes and such duties are supposed to be shouldered by the LGU. Where the national government takes charge of road construction, on the other hand, the LGU has to shoulder the right-of-of way in the rural and urban

[35] Llanto and others (1998).

[36] Higher-income LGUs which could obtain GFI loans for revenue-generating projects but not for these other types of projects would still be eligible for MDF funding under guidelines to be developed under each project.

development sector. Arrangements in the other sectors follow a percentage formula, e.g. 10-20 percent as equity by the LGU. Other longstanding constraints to effective use of ODA include non-consistency of policies, oftentimes unhealthy competition among ODA projects, and lack of leverage of domestic and private financing since almost all LGU lending is sourced from ODA.

2.19 The Policy Governing Board of the MDFO reviewed the cost-sharing policy to make it more effective and proposed a new set of guiding principles. This was subsequently approved by the NEDA-ICC on December 12, 2002. The National Government-Local Government Unit Cost Sharing Policy applies prospectively to projects submitted and approved by the NEDA-ICC effective January 1, 2003. The cost sharing scheme has been simplified by applying the formula to only three clusters of sub-projects and reducing the number of LGU income classes to three. This simplification is an appropriate first step and is likely to lead to some improvement in the situation.

2.20 The President issued EO 252 in December 2003 transforming the MDFO into a Municipal Finance Corporation (MFC). Documentation was prepared to make the MDFO an affiliate of the Land Bank of the Philippines, with initial capitalization from both DOF and the Land Bank. The question now is what happens to the grant-making mechanism when the MFC becomes operational, since the EO provides that the MFC will only be responsible for on-lending from the national government to LGUS.

**Debt Management**

2.21 Most LGUs tend not to borrow much, even from PFIs. Resource-rich LGUs may not need to borrow, while resource-challenged LGUs may not meet the requisite creditworthiness criteria. Fiscally conservative Local Finance Committees see borrowing as an instrument of last resort, to be tapped only when other means of raising resources have been exhausted[37]. LGUs may also find it difficult to obtain PFI loans on adequate terms because of the high costs of borrowing. LGUs may see borrowing as entailing excessive accountability, especially when grant financing may be available. Another important reason is the very low LGU capacity to prepare and implement projects.

2.22 For some local governments that have incurred loans, debt burden could become a major issue in the future in view of their weak own-source revenue collection and lack of debt management capacity. Debt service and interest payments sometimes account for a high proportion of total expenditures: for example, in Cabanatuan City, debt repayment and interest payment amounted to about 20 percent of total expenditures in 2002. Cabanatuan City mentioned that its lack of experience in debt management has also deterred bond financing.

**Congressional Allocations and Initiatives**

2.23 Congressional initiatives are budgetary reallocations made by Congress providing additional allocations for programs or projects or new items in the budgets of some agencies and for creation of special purpose funds[38]. Allocation of funds through congressional initiative can be made as a lump sum item or as a specific project. Regardless of where the allocation comes from (e.g. from the Priority Development Assistance Fund or the Department of Public Works and Highways (DPWH) Infrastructure Fund), such expenditures are identified by members of Congress but implemented by a national government agency, an LGU, or by a GOCC. Opacity renders the estimation of Congressional allocations and initiatives in all their forms extremely difficult, though rough estimates put them at PhP15 billion annually. Such a large amount of discretionary funds that do not pass through the normal budget process diminishes the credibility of Government's strategic allocation procedures and efforts to instill fiscal discipline. These issues may also be seen as part of a broader governance problem.

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[37] Cebu province currently enjoys a surplus and is not interested in loans for financing local projects.

[38] The release of these funds is subject to presidential approval pursuant to Section 25(5), Article VI of the Constitution, and in accordance with the requirements of Section 35, Chapter 5, Book VI of E.O. No. 292. The distortionary effects of Congressional allocations and initiatives have been discussed most recently in the Philippines Public Expenditure, Procurement and Financial Management Review (World Bank-ADB, 2003).

2.24 During the nineties, the budgetary allocation for the CDF was PhP2.2 billion.[39] In 1999, when the CDF was divided into three components, the amount increased to PhP5 billion. In 2000, when the PDAF came along, the amount was brought down to PhP3.3 billion although the allocations incorporated in the other agency budgets were increased. The 2002 PDAF amounted to PhP5.6 billion. Seen in the context of decentralization, an interesting pattern emerges from the Congressional reallocation data in FY2000 (further analyses would have to be done to determine whether this pattern holds over time). Funds were reallocated to locally-funded projects within departments (for example, DECS, DOH, DSWD and DPWH). Congress also created entirely new LFPs in the areas of infrastructure, local infrastructure projects, other national public works, and water supply projects. The concern is the effectiveness and efficiency of these expenditures, which were not vetted as part of the budget process. Requiring an evaluation of all LFPs would help to ensure that all expenditures were subject to evaluation standards.

**Recommendations**

2.25 The transition to a competitive financing system requires a set of sustained and concerted actions, many of which are not dependent on legislation and can hence be implemented fairly rapidly. The goal of LGU credit financing is to enable LGUs to access capital markets on competitive terms. This implies that LGUs have access to alternative financing sources such as private bank loans, bond flotation, grant financing, BOT type arrangements, and ODA funds at competitive pricing. Government credit programs through GFIs and the MDFO can act as catalysts to encourage private sector participation in local government credit markets. The transition to a competitive LGU financing system will need to: address outstanding policy reform issues in the capital markets; improve/strengthen the institutional and regulatory framework for local financing; implement the graduation policy through a transformation of the MDFO, a review of the GFIs' role in LGU credit markets and their lending policies to LGUs; remove PFI participation bottlenecks; rationalize the grant policy and grant-making mechanisms; and develop a new ODA financing model for LGUs.

2.26 In the long run, the LGU financing system could comprise loans from PFIs (rather than from the government or GFIs), municipal bonds (pooled or otherwise), private equity investment (through BOT or other forms of private sector participation), and grants from national government that promote the national interest (including equalization). Impediments to LGU borrowing from private banks could be removed by allowing selected PFIs to be depository banks for LGUs; developing a BLGF information base accessible to potential lenders; allowing LGUs to decide whom to bank with; and providing second-tier financing to LGUs by allowing the MDFO to lend to LGUs indirectly through PFIs. The use of BOT schemes could be facilitated through, for example, policy measures to develop the local government financial market and joint ventures; and permit private banks access to LGU deposits and IRA, i.e., make them depository banks[40]PFI participation bottlenecks require addressing: the private sector requires better information on LGU repayment capacity and own-source revenue generation, among others. From the regulatory standpoint, there is a need to reform policies and procedures that hinder private sector involvement in local government credit financing. Allowing the PFIs to be depository banks and reviewing the use of the IRA mechanism so as to minimize moral hazard and provide a level playing field between private lenders and GFI are first steps to encourage private bank lending to local governments. BOT-type schemes could be fostered when political risk concerns, risk-sharing arrangements and the financial capacity of local governments would have been sufficiently addressed. On the bond market, establishing an information system in the BLGF that is accessible to interested parties, establishment of a bond pooling system, development of a secondary market for local government securities, a substantial recapitalization of LGUGC, among others, would be important measures. The government has moved to transform the MDFO so that it can play a catalytic role in facilitating the mobilization of private financing sources during the transition from a national

[39] World Bank staff estimates.

[40] Actions on LGU revenue policy and administration are discussed in a separate chapter.

government-dominated financing system to a competitive LGU capital market. Executive Order 252 has started the transformation process of MDFO to an affiliate corporation of the Land Bank of the Philippines. A transformed and market-friendly MDFO could facilitate LGU access to domestic private capital markets, and more effectively leverage ODA and public funds. This could be done through, for example, loan discounts to PFIs, provision of initial guarantees to mitigate risk perception of LGU loans or bonds, capacity building activities to enable LGUs to better prepare and implement investment programs, and policy-based loans and grants to LGUs to promote reform and good governance. In the medium term, therefore, the MDFO could be transformed into a fully functional Municipal Development Bank, providing specialized service for LGU financing. Partial ownership of such a specialized financial institution by LGUs and the private banking sector could be a possibility worth considering.

2.27 It may be time to explore a new paradigm for ODA technical assistance and financing to facilitate private participation. Access to ODA funds through a transformed MDFO can enable private lenders to offer competitive terms to LGUs. ODA funds could also be used to facilitate the transformation of the MDFO: such an entity could initially rely on ODA sources for wholesaling to GFIs and PFIs. At a later stage the Municipal Bank can tap domestic (or even international) capital markets. Additionally, a major effort could be undertaken in helping local governments establish a pipeline of local infrastructure, social sector and environmental projects.

2.28 It is important that LGUs develop capacity to manage debt so that investment in the necessary infrastructure and other services for local development is not compromised. It would be desirable to expeditiously utilize the grant-based technical assistance available with the Department of Finance to (a) formulate a feasible debt management policy for local governments, and (b) establish a technical assistance policy to assist LGUs to strengthen their debt management capacity.

2.29 Intergovernmental reforms are beyond the scope of this report. However, unbundling grants and credits would facilitate the weaning away of LGUs from dependence on national government (GFIs) credit programs and could accelerate the implementation of the graduation policy[41]. A separate evaluation of grants and credit is important for enhancing LGU access to private capital markets. Linking grants with credit, as is currently the practice, effectively yields a subsidized credit package even if the credit component is priced at market rates. This encourages continuing dependence on government for credit and shuts out private sector loans. While the national government could be the sole supplier of grants to LGUs, credits could be provided by both private capital markets and GFIs. In general, the intergovernmental fiscal transfer system in the Philippines needs to become more transparent, equitable and performance oriented.

2.30 It would be desirable to shed more light on congressional allocations and initiatives, develop explicit guidelines for projects financed through such initiatives, and review CDF grants with a view to aligning them with local needs and priorities expressed through the planning and investment prioritization process.

[41] See Llanto and others (1998), pages 186-187.

## 3. TAX POLICY AND ADMINISTRATION

3.1 Local revenue autonomy in the Philippines is limited, yet the Philippines is highly decentralized with respect to tax administration. Local governments have own source revenues (OSR) both in terms of a share of the national wealth (the IRA and other national sources) and in terms of locally raised taxes and fees. From the perspective of economic efficiency, revenue assignment is consistent with generally accepted theory. However, local governments are limited in their ability to raise marginal revenues. On the administrative side, the Bureau of Internal Revenue (BIR) administers national taxes while each LGU administers its own-source revenues, but there is little formal cooperation in practice. Efficiency would argue for reducing total administrative and compliance costs by taking advantage of economies of scale and scope. Local governments do not need to have responsibility for administration of some tax-related functions as long as they are in control of how those functions are administered.

3.2 This chapter assesses revenue assignment and tax policy, collection performance, and OSR administration from the perspectives of autonomy and efficiency.

**Attributes of Local Tax Systems and the Philippines: Autonomy and Efficiency**

3.3 The autonomy criterion, which should be paramount in assessing decentralized systems, assesses the level of devolution of local government tax policy and administration (TPA), while the efficiency criterion assesses the appropriateness of revenue assignment in economic efficiency terms and the ability of LGUs to implement their assigned own source revenues (OSRs) in terms of administrative capacity.[42] A key element is the extent to which the local tax system is appropriately simple, given administrative capacity.

3.4 According to standard criteria, local revenue autonomy in the Philippines is limited. On the one hand the Philippines meets the first requisite: local governments have own source revenues both in terms of a share of the national wealth (the IRA) and in terms of locally raised taxes and fees. On the other hand, the Philippines does not fully meet the second requisite: local governments have limits on their ability to raise marginal revenues.

3.5 From the perspective of economic efficiency, revenue assignment in the Philippines is consistent with generally accepted theory. Benefit taxation, largely in the form of user fees and charges, is used for mobile economic units, both individuals and firms, while non-benefit levies, principally property taxes, are used to tax immobile factors. Thus there are no major economic efficiency shortcomings regarding revenue assignment in the Philippines.

3.6 According to administrative models the Philippines is highly decentralized with respect to tax administration, as each level of government administers its own tax system. The national government through the Bureau of Internal Revenue (BIR) administers national taxes according to the National Internal Revenue Code while each local government administers its OSRs according to the LGC. However, there is little formal cooperation provided for by law: the BIR and local tax administrations operate independently of one another. Moreover, local tax administrations for the most part operate independently of one another.

3.7 The efficiency criterion would argue for reducing total administrative and compliance costs by taking advantage of economies of scale and scope. In the Philippines there are hundreds and hundreds of small scale tax administrations collecting revenues throughout the country. Their ability to attract and retain qualified human resources is limited, as is their access to appropriate information technology. The limited capacity of these tax administrations also has direct consequences for taxpayers—higher compliance costs.

[42] For the purposes of this discussion OSRs are defined not to include IRA transfers.

3.8 Local governments do not, in theory, need to have responsibility for administration of some tax-related functions as long as local governments are in control of how those functions are administered. In the Philippines the civil servants are employees of the local government and, therefore, agents of local executives. The exception to this is the Treasurer, who is an employee of the Department of Finance (DOF). The point is that tax administrators do not need to be local government employees to ensure accountability. Devolved responsibility does not necessarily imply devolved administration, especially in the context of weak local capacity.

**Revenue Assignment and Tax Policy**

3.9 Revenue assignment in the Philippines is consistent with generally accepted principles in a vertical sense but less so in a horizontal sense. The national government is generally responsible for personal and corporate income taxes, the value added tax, excise taxes, and customs duties, while the LGUs are assigned property taxes, business taxes, fees and user charges, and poll taxes. In principle, vis-à-vis the national government, LGUs have been assigned taxes they are able to administer and which are not likely to cause distortions of consequence.

3.10 There is also a dimension of horizontal revenue assignment in the Philippines as local governments share revenue sources (Table 3.1). Taxation powers have been divided among different units of local government. Primary responsibility for taxation rests with provinces, municipalities, and cities (barangays are responsible for collection of a small number of taxes, fees, and charges). Cities are the most autonomous: they are authorized to impose the full set of local government taxes, while provinces and municipalities can only levy subsets. In some cases the revenues collected by provinces are allocated to municipalities.

**Table 3.1: Selected Tax Revenues Assigned By Local Government Unit**

| Revenue Source | Provinces | Cities | Municipalities | Barangays |
|---|---|---|---|---|
| Real Property Tax | ✓ | ✓ | ✓ 40% of provincial collections | ✓ 25% of provincial or 30% of city collections |
| Transfer of Real Property | ✓ | ✓ | | |
| Sand, Gravel & Other Quarry Resources | ✓ | ✓ | ✓ 30% of provincial collections | ✓ 40% of provincial collections |
| Amusement Tax | ✓ | ✓ | | ✓ 50% of provincial collections |
| Business Taxes | | ✓ | ✓ | ✓ |
| Franchise Tax | ✓ | ✓ | | |
| Community Tax | | ✓ | ✓ | ✓ 50% of collections by barangay |

*Source: Local Government Code 1991 (R.A. 7160).*

3.11 Inter-LGU revenue assignment is problematic from the standpoint of collection incentives. The fact that in many instances revenues are collected by one LGU and shared with others may weaken incentives to collect. In the case of the Real Property Tax (RPT), for example, provinces must transfer 65 percent of collections while cities must transfer 30 percent of their collections. It is likely that provinces decide to collect fewer revenues as a result of the fact that they only receive 35 percent of total collections, assuming that executives weigh the administrative and political costs of collection against the likely benefits. Moreover, the shared assignments also generate shared responsibilities for collection in some instances.

3.12 The Local Government Code provides a range of tax and fee options for LGUs, though some additional options should be considered. The Code affords LGUs the option to levy other taxes, fees, or charges provided they are not specifically prohibited by the Code. Some LGUs have used this authority to levy taxes and fees not specifically enumerated in the Code. For example, in the province of Bulacan, the governor and mayors jointly agreed with the legislators to levy garbage charges at the provincial level. Two significant limitations in the Code are the prohibitions on local excise taxes (Sec. 133 (h)) and levies on motor vehicle registration or driving (Sec. 133 (l)).

3.13 Tax policy rates are unduly circumscribed by the Local Government Code, reducing LGU autonomy and potential revenue collections at the same time. The main concern is that effective tax rate ceilings are set by the Code, leaving LGUs little control over one of the main levers of revenue mobilization. For example, the real property tax rate (including the Special Education Fund levy) is set at 2 percent for provinces and 3 percent for cities and municipalities in Metro Manila.[43] Currently all provinces (outside of the NCR) avail themselves of the maximum rate, while most cities, on the other hand, are under the maximum. Assessment levels for land and buildings and other structures are also fixed by the Code. It is not common for this level of detail to be found in framework legislation, because this makes relatively minor adjustments in the tax system very difficult to effect. The Code also fixes maximum rates for most other taxes, and in some cases fixes nominal per unit amounts (as in the case of the professional tax). LGUs can adjust tax rates only once in five years and cannot adjust the rate by more than 10 percent (Sec. 191). Small changes every five years might not even be enough to keep up with inflation, creating a system that builds in erosion of the real value of revenues.

3.14 On the valuation of real property, the DOF has prescribed procedures for LGUs to follow. However, in the case of the province of Nueva Ecija, it was estimated that if they follow these procedures, it would cost them P1.65 for every P1.00 collected. Quezon City devised a way to increase real property tax collection without resorting to revaluation of real properties as this becomes a politically sensitive issue, especially close to elections. Quezon City's via media was to include the value of the machinery attached to the real property, thus increasing the overall property value without having to undertake the difficult task of revaluing real property.

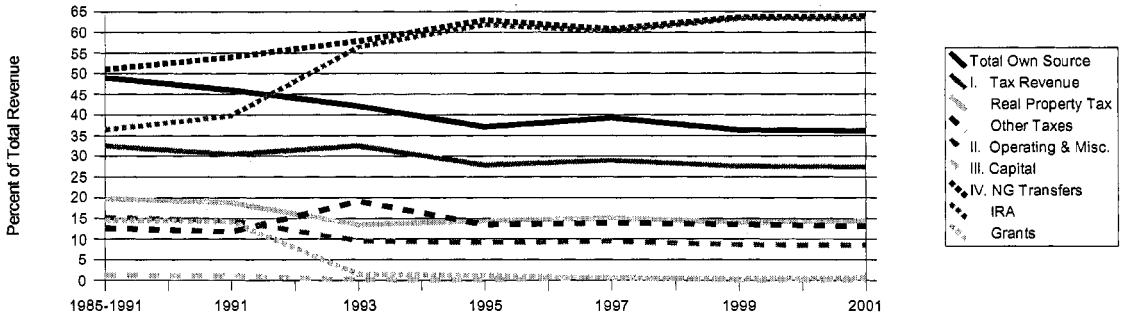
**Revenue Performance**

3.15 For LGUs in the aggregate, own source revenue accounted for 36 percent of total revenue in 2001. Tax revenue is the most significant contributor, accounting for 76 percent of revenue from own sources, with the real property tax comprising 40 percent.[44] However, since the mid-eighties OSR has declined as a portion of total revenue by more than 20 percent (figure overleaf). At the same time, revenue from national government transfers has increased by twenty percent from roughly half of LGU revenues to 63 percent. Other taxes have grown somewhat as a portion of own source revenue and cities in general show a more diversified tax base (Figure 3.1).

[43] Rates in other developing countries are higher. In Kenya, for example, the rates range from 2% to 13% depending on the type of local government (see Kelly, 2000).

44 Property taxes have maintained their relative role in the composition of own source revenue, while increasing in importance for provinces and decreasing for municipalities. Property taxes have, however, declined as a portion of total revenue.

Figure 3.1: Components of Total Local Government Revenue




3.16 Over the period 1992-2000, on average, the real property tax accounted for 41 percent of total LGU own-source revenues, while taxes on goods and services accounted for 31 percent, and operating and miscellaneous revenue raised 27 percent. These shares have remained very stable over time. As in many countries, property taxes account for the largest share of OSR.

3.17 Nominal collections have increased steadily for all major categories of OSRs: the property taxes increased nearly fourfold over the period while taxes on goods and services increased fivefold. The average annual increase in goods and services taxes was highest at 27 percent, followed by growth in the property tax (Table 3.2). Growth rates for all categories have, however, slowed in the latter part of the period. Nor have OSR growth rates kept up with growth in the IRA.

**Table 3.2: Annual Growth in Total LGU Own Source Revenues, 1993-2000 a/**

| OSR | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | Average |
|---|---|---|---|---|---|---|---|---|---|
| Property Taxes b/ | 30% | 31% | 19% | 17% | 24% | 6% | 9% | 14% | 19% |
| Taxes on Goods & Services | 128% | -11% | 24% | 27% | 19% | 7% | 15% | 10% | 27% |
| Operating & Miscellaneous Revenue | 31% | 29% | 8% | 22% | 17% | 5% | 7% | 14% | 17% |
| **Total** | **51%** | **15%** | **17%** | **22%** | **21%** | **5%** | **10%** | **13%** | **19%** |

*a/ Excludes grants, aid, and extraordinary receipts. b/ Includes collections due in preceding years and penalties paid.*
*Source: DOF.*

3.18 Collection of OSRs by LGUs is heavily weighted toward cities, with provinces and municipalities only generating 38 percent of total LGU revenue (Table 3.3). Cities generate more revenues in each of every single major category of OSRs, indicating that the local tax system highly favors cities. Higher tax rates and larger bases are likely to account for most of the difference. Whether or not this assignment of revenue shares is adequate depends on the relative responsibilities of each level of local government.

**Table 3.3: Selected Own Source Revenues by LGU Type, 2000 (%)**

| Sources | Provinces | Cities | Municipalities | Total |
|---|---|---|---|---|
| Real Property Taxes | 5% | 20% | 7% | 32% |
| Business Taxes & Licenses | 0% | 18% | 5% | 23% |
| Receipts from Eco. Enterprise | 1% | 3% | 3% | 7% |
| Grants and Aids | 0% | 1% | 1% | 2% |
| Borrowings | 3% | 6% | 3% | 12% |
| Others | 5% | 14% | 6% | 25% |
| Total | 13% | 62% | 25% | 100% |

*Source: COA (2001).*

3.19 Taxes on goods and services, which are dominated by local business taxes, account for the second largest share of OSRs. Business taxes accounted for fully 69 percent of total taxes on goods and services during the period 1999-2000. Licenses and other taxes account for the remainder. Table 3.4 shows the top five goods and services revenue generators, and makes clear that after the business tax, other sources yield considerably less, including the community tax.

**Table 3.4. Highest & Lowest Yielding Local Taxes on Goods and Services, 2002 a/**

| | PhP | % of Total |
|---|---|---|
| *Highest Yield Local Goods and Services Taxes* | | |
| Business Tax | 10,625,492,000 | 69% |
| Community Tax | 704,151,000 | 5% |
| Amusements Tax | 677,806,000 | 4% |
| Franchise Tax | 510,862,000 | 3% |
| Privilege Taxes | 460,339,000 | 3% |
| *Lowest Yield Local Goods and Services Taxes* | | |
| Tax on Peddlers | 3,407,000 | 0.02% |
| Tax on Fishing Vessels | 3,119,000 | 0.02% |
| Radio Fees | 3,015,000 | 0.02% |
| Tobacco Inspection Fees | 218,000 | 0.00% |
| Firearms Taxes | 87,000 | 0.00% |
| Total Taxes on Goods and Services | 15,387,387,000 | 100% |

*a/ Excludes NG transfers; includes fines and penalties*
*Source: COA (2001)*

3.20 A large number of taxes have very low yields. Elimination of low yield taxes, many of which are probably difficult to collect (e.g., the firearms tax) would free scarce administrative resources to focus on higher yield taxes, would improve the credibility of the tax system, and would reduce compliance costs for taxpayers. It is highly likely that the benefits perceived from elimination would greatly exceed the costs in lost revenue.

3.21 Operating and miscellaneous revenue yield the smallest amount of the major categories of OSRs for LGUs. These revenues may be disaggregated into three main types: government business operations, operating and service income, miscellaneous income, and income from public enterprises and investments, which, respectively, accounted for 59 percent, 33 percent, 5 percent, and 2 percent of total operating and miscellaneous revenue in 2000. Government business operations include receipts from markets and telephone systems. Total collections from each major source are relatively small, reflecting the dispersion of revenue sources.

3.22 However, the data also show that there are a large number of fees and user charges that generate less than 0.10 percent of total operating and miscellaneous revenues. These include irrigation fees, dog license fees, sheriff fees, and arrastre and customs charges, to name a few. These fees are likely among those that are most difficult to collect.

3.23 Overall, local revenue codes provide for a tax system of great complexity, both in terms of the type and number of taxes and fees. In the city of Bacolod, for example, there are over 200 different rates for the mayor's business permit fee, as rates vary by the type of establishment. Similarly, there are 24 fees for amusement places, depending on the type of establishment (e.g. automatic or non-automatic bowling alley). The vast majority of these fees, however, range from PhP100 to 500 per year. This fee structure could be greatly simplified.

3.24 LGUs have created revenue codes with a panoply of taxes, fees and charges, many of which are under-collected and some of which are simply uncollected (e.g., the idle land tax and the bicycle and dog license fees in some LGUs). Lack of collection of some taxes and fees in local revenue codes undermines the integrity of the tax system and contributes to a culture of non-compliance. It would

make more sense to focus on the fees that have high yield potential and to improve administration of those fees, essentially focusing limited resources where they are likely to have the most impact. Even core OSRs, such as the business tax, are too complicated in the sense that the tax obligation depends on firm characteristics that are not necessarily easy to judge.

**Local Tax Administration**

3.25 In general local governments' administrative capacity is weak, and weak administration is the binding constraint on improving OSR performance. Weak administrative capacity in all major tax administration functions—registration, collection, compliance—is due to unqualified human resources, inadequate automation of core tasks, and the lack of training. The principal constraints include: (a) the prevalence of stop filers, non-filers, and late filers, due to the low capacity to perform the taxpayer registration function, which results in delinquent payments and the accumulation of arrears; (b) infrequent exercise of LGU audit and enforcement (temporary closures and property auctions) authority, resulting in low compliance and erodes the credibility of the system; (c) the limited availability of taxpayer services, which increases taxpayer compliance costs; (d) the low professional qualifications of staff; and (e) inadequate support from national government agencies, including BLGF and BIR.

3.26 Principal constraints on taxpayer registration include: (a) the lack of regular maintenance/validation of RPT and business registries; (b) the lack of automated registries; and (c) low quality record-keeping. In some cases the number of registered business establishments seems to fluctuate considerably from year to year, both at the level of individual lines of business and in aggregate. These problems result in low levels of control over the taxpaying population (e.g. business tax registries are known to be incomplete), and the consequences ripple through the entire tax collection process, resulting in low compliance levels.

3.27 Property tax collection efficiency is very low, resulting in the hemorrhaging of the most important source of local revenues (Table 3.5). The difference between estimated and actual collections is due to delinquencies, some of which are eventually paid, and uncollectables, which lead to the build-up of arrears. LGUs seem to be in a weak position to collect the property taxes owed them.

**Table 3.5 Property Tax Collection Efficiency: Actual to Estimated Collections, 1995-2001**

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | Average |
|---|---|---|---|---|---|---|---|---|
| Aggregate | 62 | 65 | 67 | 61 | 60 | 58 | 55 | 61 |
| Provinces | 54 | 51 | 58 | 59 | 57 | 62 | 55 | 57 |
| Cities and Municipalities in Metro Manila | 70 | 77 | 75 | 63 | 63 | 58 | 57 | 66 |
| Cities outside Metro Manila | 56 | 58 | 59 | 55 | 57 | 51 | 50 | 55 |

*a/ Estimated collections are calculated as the product of the assessed value and the tax rate.*
*Source: BLGF.*

3.28 Another major problem undermining property tax collections is that property assessments have not kept up with changes in market values. The general revision of assessment (GRA), mandated to be carried out every three years (Sec. 219), has not been updated for many years in the LGUs visited. Most LGUs have not undertaken a GRA since 1991, resulting in declining collections in real terms and under-collection from inaccurate assessment. Even when carried out and approved, they tend to be lower than market values (comparisons with BIR zonal valuations in one LGU revealed that assessed values are considerably lower). Some LGUs, however, have used information technology to build up-to-date taxpayer property databases from which assessments can be carried out (Box 3.1). The problem with non-compliance of this important element of the Code is that it not only undermines the credibility of the tax system, but also has economic effects—out-of-date valuations mean overtaxing some areas and under-taxing others.

**Box 3.1 Good Practice in Property Tax Mapping**

Naga City developed a pilot geographic information system (GIS) at the request of Mayor Roco Suplicio and with the assistance of USAID's GOLD project. The project started out on a pilot basis with surveys of several central city blocks. The pilot data set was used to develop a DOS-based Fox Pro system called the Building Information Database System, in which each building is assigned a unique property index number so that all city information about that building—including whether the building has a permit—can be easily accessed.

Cabanatuan city's GIS system, based on aerial photography maps, doubled the number of registered properties and significantly improved revenues. The city has also assigned each building a unique number and undertaken a door to door campaign to register taxpayers under the leadership of Mayor Jay Vergara.

The municipality of San Fernando (Pampanga) kept it simple: an Operation "Suyod" (which translates to tax mapping operations) was launched; the Treasurer's office with the help of village officials identified business establishments and determined whether they had paid their property (and business) taxes or not. The list was organized into a database that is now regularly updated.

*Sources: Interviews, USAID (n.d.), and M. Guevara (2003).*

3.29 The compliance function as presently performed seems to be highly inadequate. Principal constraints include the infrequent exercise of: (a) LGU audit authority, and (b) LGU enforcement authority, in the form of temporary closures of firms and auctions of property. In some cases, LGU audit presence is virtually non-existent. The same holds for closures of firms for non-compliance, including lack of business licenses. Based on the fieldwork, few LGUs report auctioning property in the mid 1990s. Nor are staff trained to do audits. LGUs thus have no capacity to validate self-reported data from taxpayers. In one case it is likely that the audits that were conducted were of such poor quality that they may have promoted greater non-compliance (by demonstrating the weak capacity of the LGU to detect non-compliance). LGUs also have a problem calculating the "situs" aspect of business taxes, when firms have headquarters and branch offices around the country.

3.30 The Mayor and Treasurer of Quezon City pioneered an innovative approach in 2002: the use of minimum (presumptive) gross sales figures for numerous types of establishments required to pay the business tax (see Annex). By order of the Treasurer, minimum figures are used to calculate business tax obligations for establishments ranging from sari-sari stores to manufacturers and wholesalers. One recent reform in Kenya has gone even farther: local authorities are required to adopt one tariff structure among sixteen tariff set options provided by the Ministry of Local Government. The tariff structure is both progressive and presumptive. The combination of local selection of rate sets designed by the ministry assures autonomy over local rates, while also ensuring quality control over the calculation of presumptive rates (Devas and Kelly, 2001).

3.31 The consequences of non-compliance seem to be minimal. For example, business licenses are withheld until all tax obligations are satisfied. However, based on an ocular inspection of several individual tax accounts in one LGU, it was revealed that some firms, including a large MNC and a large national bank, operate without licenses (due to delinquencies). There seemed, however, to be no practical consequence of operating without a license.

3.32 Taxpayer services are virtually non-existent. The principal constraint is the very limited availability of taxpayer services. Taxpayer services take three basic forms: (a) direct question and answer time with officials, in LGU offices as well as in the field, (b) posting of information in public places, and (c) use of mass media such as radio and newspapers. No written materials are available. In some cases revenue field officers conduct informational sessions with taxpayers in the field (e.g., at barangay meetings). San Fernando City, for example, has tried to reduce taxpayer compliance costs by providing a "one stop shop" at city hall each January to simplify processing and reduce wait times. The lack of even the most basic taxpayer services means that taxpayer compliance costs are high.

3.33 Tax incentives and amnesties play a role, though it is not clear how important they are in overall revenue performance. All visited LGUs reported recent amnesty programs (e.g., one on RPT

penalties, another on RPT interest payments). Each LGU reported one amnesty since the LGC was implemented. It is not clear if taxpayers regard LGU amnesties as a regular feature of the tax system. Other incentives vary by LGU: one reported a 2 year tax holiday for foreign investment, another reported a proposed 5 year holiday for a particular retail firm. There are also discounts for early and on-time payment of RPT obligations, as provided by the Code, but these seem high and thus send the wrong message to taxpayers.

3.34 Weak administrative capacity, due largely to the low professional qualifications of staff, is one of the main causes of OSR underperformance.[45] OSR-related staff do not seem to have professional qualifications related to their jobs (in two cases, individuals responsible for business taxes rose to their positions after many years working in their LGUs, both starting out as casual laborers). Revenue officers have few vehicles or computers. Computerization is very limited. Nor do LGU staff seem to receive the specialized training needed to improve their performance of key tax administration functions. The weak administrative capacity is perpetuated by the lack of incentives imbedded in the collection process--collectors as a rule are neither punished nor rewarded for their collection performance.

3.35 Another major constraint is the lack of inter-governmental cooperation on OSR administration. The principal problems are: (a) inadequate coordination with BIR and (c) low levels of support from BLGF. BIR and the LGUs, possibly through BLGF, need to establish an information sharing protocol that respects confidentiality but that provides LGUs with basic taxpayer registration and declaration information, as is the case in other countries. Greater exchange of information is a two-way street: it would benefit both the NG and LGUs. Presently, there is a memorandum of understanding (MOU) between BIR and BLGF, which should allow for information-sharing between BIR and LGUs. In practice, however, such sharing does not take place frequently. BIR cites confidentiality concerns; these could and should be addressed through legal safeguards.

3.36 BLGF provides some useful support for LGUs, but its resources are limited. BLGF is currently updating the local treasurer's manual, which has not been updated since its adoption in 1954. BLGF also provides an RPT enhancement program that supports LGUs to improve collections through tax mapping, valuation techniques, and assessment support. Since 1992 about 2/3 of LGUs have received BLGF's support in this area, though it is limited (BLGF finances 70 percent of the program while LGUs cover the rest).

**Political Economy Challenges**

3.37 While administrative constraints are critical, political constraints also impact performance. Several LGUs reported that "political intervention" was the reason for little use of auction and closure powers. Another reported active opposition from the chamber of commerce to GRAs, and another reported intense lobbying from the private sector against increases in tax rates. Others have reported legal action against property auctions and increases to tax rates. Quezon City, for example, was sued on the grounds that proposed rate increases were "confiscatory." These actions, both realized and threatened, have the effect of intimidating LGUs and tying up their scarce resources in extensive negotiations and legal disputes, and seem to have the effect of dampening local government appetite for improvements in the local tax system.

3.38 The precise impact of political constraints on local taxation is unknown. However, a number of theories—focusing on incentives—may be posited. One likely possibility is that politicians simply weigh the net impact, or political trade-off, of higher revenues against greater expenditure. Simply put, the decision rule for the politician is to increase taxes (either through higher rates or improved administration), when the discounted benefits of greater expenditures are higher than the discounted costs of higher taxes. If this is the rule, many seem to decide that the political costs of higher taxation are greater than the expected benefits derived from increased spending. There are two possible reasons

[45] OSR-related staff seem to account for ½ to ¾ of total treasury department staff.

for this outcome. First, this could be because the expected marginal benefit of increase in OSRs is small compared to the expected political cost of unhappy constituents. If this were the case it would have to be that executives would not expect the revenues to translate efficiently into effective expenditures and improved service delivery.

3.39 Another possibility is that the incidence of benefits and costs—in terms of expenditures and revenues—might negatively affect local elites. Increases in property tax collections would most likely harm the wealthy from a distributive standpoint, while increases in service delivery would most likely favor the poor. However, politicians may not equally weigh the benefit/cost incidence impact of each group equally. Because of the power of local elites and the skewed distribution of income, and due to the important role of local elites in political parties and elections, it is likely that local executives assign a higher weight to incidence impacts on the wealthy vis-à-vis the poor. If so, one would not generally predict that local executives would use higher tax collections to fund pro-poor service delivery.

**Recommendations**

3.40 **Revenue assignment.** Rationalization of inter-LGU revenue assignment should be considered. Theory, as well as the Philippines experience, argues that the current assignment between LGUs could be improved. The idea would be to give provinces and municipalities a discrete assignment of revenue sources. It might make sense, for example, to assign the property tax and business licensing to municipalities and business taxes to provinces. Though such a reform would not be revenue-neutral, differences could be compensated by revising the apportionment of the IRA. Alternatively, if the provinces' role were reconfigured, it would be possible to reassign provincial-municipal revenues more comprehensively, though such reassignment would ultimately depend on expenditure responsibilities.

3.41 Allowing LGUs to impose excise taxes or fees on motor vehicle registration is a sensible and potentially important source of revenue, and would be relatively easy to administer. Allowing provinces to impose piggyback rates on certain taxes offers another option for increasing LGU autonomy, without further taxing local administrative capacity (assuming the tax would continue to be administered nationally). LGC restrictions on the frequency and rate of tax rate adjustment could be abolished: revisions to the Code would allow LGUs to set their own rates, either under higher ceilings, or subject to approval by the national government under higher ceilings.

3.42 **Revenue performance.** The criterion of efficiency, from the simplicity perspective, would suggest that low-yield taxes be eliminated in most LGUs. Simplifying and/or eliminating extremely low-yield fees would provide administrative savings and a more rational tax system. Improving just the efficiency of actual collections based on current assessed values has the potential to increase property tax revenues significantly.

3.43 **Property Taxation.** The property taxation system is not performing well in a number of different respects. A major overhaul is required to develop a system that is likely to perform more effectively in the country context. The experience of other countries suggests that property tax assessment could be effectively carried out by either regional or national governments. In many countries, from Colombia, in which the national government maintains the property register and updates property valuations (Vehorn and Ahmad, 127), to Cyprus, Estonia, Jamaica, Pakistan, and Malawi, in which the national government is responsible for property tax assessment and collection (McCluskey and Williams, 1999, cited in Mikesell, 7), though property taxes are assigned to local governments, national governments assist with core functions[46]. Alternatively, an independent local government property tax agency, which could perform valuations and assessments for all LGUs, could be established. A revision to the LGC could be enacted such that LGUs which did not comply with

[46] Thailand is also in the process of establishing a central valuation authority.

the assessment requirement would have their assessments performed by the national government, or the proposed local property tax agency[47]. If LGUs want to collect fewer revenues, they should reduce their rates, which is more transparent than under-assessing the tax base.

3.44 The difficulties confronted by LGUs in enforcing compliance would suggest a role for greater use of presumptive taxation in some cases. Given limited local capacity, presumptive taxation would make a great deal of sense for the business tax and for some fees and charges.

3.45 **BIR and BLGF support for LGU tax administration.** To strengthen inter-governmental cooperation on OSR administration, the MOU between the BIR and the BLGF could be expanded to provide BIR data—including tax returns and the results of audits—to LGUs as a matter of course. LGUs should not have to request the data taxpayer by taxpayer, as is currently the practice. BLGF needs to provide effective support for key administrative functions in order to improve local administration. This does not mean that BLGF would necessarily need to provide improved capacity building programs directly, as programs could be contracted out to academia or the private sector.

3.46 Serious challenges remain for improving local tax policy and administration. The major concern is that weak administration is undermining the local tax system by contributing to weak collections, due in part to high rates of non-compliance, high compliance costs for taxpayers, and high administrative costs for local governments. Consequently, the local tax system is inefficient on a number of important dimensions. At the same time the lack of autonomy afforded local governments undermines their ability to realize the benefits of decentralization by raising revenues to satisfy local preferences regarding the level and quality of service provision. Fiscal sustainability requires that OSR collection performance be improved significantly by LGUs, though the national government clearly should provide much more support—in terms of information sharing and technical assistance—than it currently does.

3.47 **Role of national government in revenue collection.** However, revenue collection is not only a concern of the DOF or its BLGF. There are other national government agencies whose services can be tapped to assist LGUs in enhancing revenue generation. For example, in the case of the province of Bulacan, the database of the Land Registration Authority could be linked to the Bulacan database system for better collection of real property taxes.

[47] If properties were revalued to market rates, some allowance would have to be made to phase in and cushion the impact, given the long lags since previous valuations, and restrictions on LGUs' right to adjust tax rates.

# 4. EXPENDITURE MANAGEMENT

## Expenditure Trends

4.1 ***The mix of added responsibility and direction from NGAs has produced a significant shift in the location of public expenditures: between 1990 and 2002, LGU expenditures as a fraction of GNP and relative to total general government expenditures more than doubled*** (Table 4.1). In line with the transfer of functions to LGUs mandated under the Code, total LGU expenditure expanded relative to GNP and relative to total general government expenditure. Total LGU spending doubled from an average of 1.6 percent of GNP in 1985-1991 to 3.5 percent of GNP in 1992-2002. Similarly, the share of LGUs in total general government expenditure net of debt service rose from an average of 11.0 percent in the pre-Code period to an average of 22.7 percent in the post-Code period.

**Table 4.1: LGU Expenditure Relative to GNP and to General Government Expenditure**

| | Ratio of LGU Expenditure to GNP | Ratio of LGU Expenditure to General Gov't. Expenditure Net of Debt Service % |
|---|---|---|
| 2002 | 3.42 | 25.23 |
| Average: | | |
| 1985-1991 | 1.61 | 11.00 |
| 1992-1996 | 2.95 | 20.26 |
| 1997-2002 | 3.67 | 23.7 |

4.2 Since the enactment of the LGC, the distribution of expenditures across levels of the government has also shifted. While devolved functions continue to be shared by LGUs and the national government, the sub-national share of general government spending increased substantially (Table 4.1). The most pronounced increases have occurred in the areas of housing and community development (from 33 percent in 1991 to 79 percent in 2002), health (from 10 percent to 53 percent), other economic services (from 53 percent to 91 percent) and general public administration (from 39 percent to 60 percent). Education also rose sharply, from 2 percent to 8 percent. In contrast, the LGUs contribution to general government spending on the social welfare and labor and employment sector declined (from 11 percent to 10 percent) despite the transfer of about 60 percent of pre-devolution DSWD personnel to LGUs. The same is true of the transportation and communication sector where the share of LGUs has grown only minimally (from 15 percent to 17 percent), although the Local Government Code calls for the devolution of the construction and maintenance of all local infrastructure facilities and the provision of local telecommunication services to LGUs.

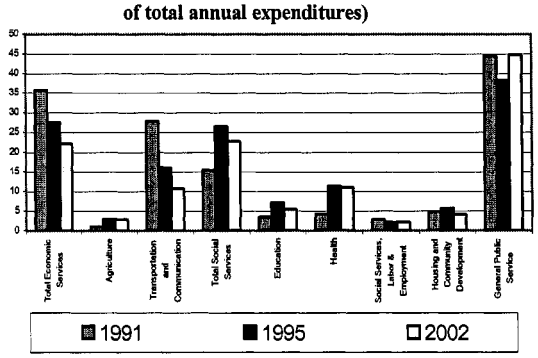
4.3 These hefty increases in LGU spending on health and social movements were largely due to the fact that the LGUs had very little discretion but to absorb the cost of devolved health and social welfare personnel who accounted for more than half the total cost of all devolved personnel. Meanwhile, it appears that higher LGU expenditures on education and housing/community development in the post-Code period largely reflect the higher requirement that local officials assign to these sectors in the more decentralized regime since no personnel were devolved in these sectors since 1992.

4.4 On the other hand, LGU spending on transportation and communication contracted from 0.5 percent of GNP in 1991 to 0.4 percent of GNP in 2001 despite the devolution of the responsibility for local infrastructure to LGUs. This decline masks even larger reductions in the infrastructure spending of provincial and municipal governments. These developments appear to be linked to the mismatch in the distribution of resources and expenditure responsibilities across levels of local governments.

4.5 *Distribution of LGU spending across levels of local government.* The composition of LGU expenditures varies with the level of local government. Prior to implementation of the LGC, municipalities were foremost among LGUs in direct spending responsibilities. By 2002, the relative roles were reversed and cities' total expenditure surpassed that of municipalities'. Indeed, the share of

both municipalities and provinces in total LGU spending contracted from 40 percent to 37 percent and from 28 percent to 23 percent, respectively, while that of cities expanded from 32 percent to 40 percent. This is so even though provinces and municipalities initially absorbed the vast majority of the cost of devolved function (at 47.5 percent and 48.14 percent, respectively). The role of cities is most pronounced in the natural resource management sector (82 percent), housing and community development (70 percent), peace and order (70 percent), education (61 percent), and transport and communication (48 percent). Municipalities are the most prominent actors in power and energy, water resources development, flood control, agriculture, social welfare, labor and employment, and general public services. Provinces are the most prominent form of local government only in the area of health. Given the relative importance of the provincial and municipal levels in terms of both pre-Code spending levels and the cost of devolved functions, the dramatic expansion in the share of cities and the corresponding contraction in the share of provinces and municipalities in total LGU expenditure is rather unexpected and is best explained by the resulting distribution of resources (both IRA and own source revenue) across levels of local governments. Moreover, this trend appears to have gained in intensity over time.

**Figure 4.1: Sectoral Distribution of Local Government Expenditures Across Years (as percent of total annual expenditures)**




4.6 *Distribution of LGU spending by function.* The mandated transfer to LGUs of functions previously discharged by national government agencies caused a major shift in the size and composition of LGU budgets. An expansion in the budget share of the social services sectors relative to the economic and general public services sectors is evident at all levels. Absorbing the bulk of health personnel, the share of the social services sector in total provincial expenditures expanded most significantly. Given the smaller number of health personnel devolved to cities, the share of social services in cities' budgets increased only slightly. As a proportion of total LGU expenditure; the economic services sector declined significantly, while the social services sector expanded and the general public services sector stayed fairly constant (Figure 4:1). General public services continue, however, to receive the largest portion of the budgets of municipal governments (54.5 percent) and city governments (41.5 percent).

4.7 The increase in LGU spending on social services between 1991 and 2002 went to health, education, housing/ community development and social welfare, in that order. Aggregate LGU expenditure on health quintupled from 0.08 percent of GNP in 1985-1991 to 0.42 percent in 1993-2002, while LGU spending on education more than doubled from 0.12 percent to 0.26 percent. As a portion of GNP, total LGU expenditure on housing/ community development and social welfare services in 1993-2002 were also about twice their 1985-1991 levels. These movements were largely due to the fact that the cost of devolved health personnel accounted for more than half of the total cost of all devolved personnel.

4.8 *Distribution of LGU expenditure by economic category.* In the aggregate, the share of personal services in LGU expenditures was fairly stable at 47 percent before and after the implementation of the Local Government Code. Although personal services comprise the single biggest expenditure item at all levels of local government, there are considerable variations as to its importance at different levels of local government. Due to higher revenue base of cities, the share of personal services in the LGU budget is smallest for cities (38 percent on average in 1993 to 2002), and has been contracting. It is largest for municipalities (56 percent), and has been growing due to the

more limited resources at their disposal. Because of these developments, there has been a squeeze on the capital outlays of provinces and both MOOE and capital outlays of municipalities.

4.9 The LGC restricts PS spending of LGUs (to 45 percent-55 percent of total regular income depending on LGU's income class), however, many exemptions are allowed. Aggregate PS spending averaged 56.8 percent of the previous years' total LGU regular income during 1992-2001. In municipalities, it averaged 64.4 percent. Reported PS expenditures likely underestimate amounts actually spent on compensation because salaries and wages of contractual employees hired under "job orders" or "service contracts" are charged against maintenance and other operating expenditures (MOOE) or capital outlays (CO) for development projects. Some LGUs (e.g. Aklan and Kalibo) report that this practice is no longer allowed under the New Government Accounting System (NGAS) but other LGUs report this practice to be still in vogue.

**Public Expenditure Management**

4.10 **Local development planning.** The LGC mandates each LGU to have a comprehensive multi-sectoral development plan formulated by its local development council (LDC) and approved by its Sanggunian. In this framework, the LDC assists the Sanggunian in setting the direction of economic and social development and in coordinating development efforts within its territorial jurisdiction. In more specific terms, the LDC is supposed to formulate long-term, medium-term, and annual socioeconomic development plans as well as the medium-term and annual public investment programs. It would be desirable to develop clear, simple, and updated guidelines to direct LGUs in preparation of local development plans. These can strengthen the linkages between national, regional and local governments.

4.11 Many cities and provinces report having long- and medium-term development plans as well as comprehensive land use plans. However, the only plan usually available in many of the smaller LGUs is the Annual Investment Plan (AIP). Most often, these plans consist of a simple listing of projects with corresponding budget estimates. For all intents and purposes, the AIPs in these places were put together to comply with the budgetary requirement that no appropriation under the 20 percent Local Development Fund can be made if the project is not listed in the LGU's AIP. In most cases, there is a limited view of the AIP with the list being confined to what can actually be accommodated within the 20 percent Development Fund. It gives no explicit consideration to the other resources available in the local community to support the AIP.

4.12 *Participation.* In some LGUs, the local development fund is treated like a 'pork barrel' fund. In the case of provinces, spending priorities are not based on the provincial development plan (PDP) and there is very little linkage between the PDP and the annual investment program as the former is ignored when the latter is prepared. There may be a need for greater participation of and oversight by local communities in the planning process, to enhance the transparency of the annual Investment Program and induce greater commitment of the local chief executive to the medium-term plan. The process exemplified in the formulation of the Executive Agenda in a number of areas assisted by the Local Government Support Fund Project of CIDA appears to have been useful. Another good example of how participation of civil society organizations has improved the local planning process can be seen in Infanta, Quezon Province.

4.13 However, in practice, many LGUs do not have active LDCs. Only 30-50 percent of LGUs have LDCs in place (IRIS 2000). Moreover, one survey found that less than a third of LGUs have development plans that benefited from meaningful NGO/PO inputs despite the LGC's requirement that 25 percent of the total number of members of the LDC should come from the ranks of NGOs and people's organizations (GOLD 2002). Anecdotes abound on how local chief executives have themselves created NGOs in their own image. Thus, although all sample LGUs report that they have constituted their local development councils, the extent of participatory planning appears to be uneven. Thus, it is not surprising that LGU officials do not fare well in predicting the expenditure preferences of their constituents. In a survey done in 2000, it was found that municipal officials correctly

anticipate household's first priority in 5 out of 10 cases while provincial officials cite the top preference of households in only 3 cases (IRIS 2000). This finding raises questions on the extent of the improvement in allocative efficiency that is forthcoming from fiscal decentralization.

4.14 *NG-LGU coordination in planning.* The actual investment and development planning process at the local level is typically mayor/governor-centric. The local chief executive starts the process by calling a meeting of selected members of the Sanggunian and barangay (or municipal) heads. The mayor/governor usually has a short list of favored projects to start with but may be still open to suggestions from council members and barangay heads, as they play an important role in garnering votes during election time. From such a meeting, a preliminary list of projects is collated and the local planning officer is then asked to prepare the project costing. The AIP is thus drafted and presented formally to the LDC and, subsequently, the Sanggunian for its approval. In many of the LGUs visited, investment programming is not based on a systematic evaluation of projects' costs and benefits. Instead, prioritization appears to be done largely on an ad hoc basis with the process being driven by the local chief executives. Nonetheless, some link is established between barangay plans, municipal plans and provincial plans.

4.15 In contrast, the Regional Development Plan (RDP) formulated by the Regional Development Council is seldom, if ever, taken into consideration by LGUs.[48] Conversely, RDPs tend to ignore local developments plans because they tend to focus on inter-provincial projects.

4.16 Many of the LGUs included in the case studies report that their development plans are formulated quite independently of regional and national development plans and vice versa. Also, many LGUs officials complain that national government agencies do not adequately consult with the LGUs in the planning and implementation of programs and projects that are located within their jurisdictions. Consequently, many of these projects are reported to be inconsistent with the needs of the LGUs. They suggest that the projects of all national government agencies at the local level should pass through the Local Development Councils. Projects and programs identified through effective planning are more likely to be implemented and stay on track during implementation. In addition effective planning leads to better investment programming and budgeting, essential for sound fiscal and financial management.

4.17 A number of innovative approaches have reaped benefits from inter-government coordination and cooperation. For instance, the construction of a circumferential road across Cabanatuan City and adjacent municipalities is a good example of horizontal cooperation in investment planning and project implementation among LGUs. This toll road, financed by contributions from LGUs, is expected to raise revenues once it is operational. A critical area of vertical coordination is expenditure management, particularly linking development and budget planning at different levels of government. Bulakan's development planning presents a good practice of vertical coordination. Its local planning process includes representatives of NG agencies that are operating in the local area in order to re-establish a link between the local plans and the national plans, and more importantly, to generate external funding for local projects. In Neuva Vizcaya, the establishment of a Barangay Assistance Fund in the budget of the province helped to create a linkage between Barangay priorities and the provincial planning and budget system. Both initiatives enhanced coherence among development plans prepared independently by respective LGUs in a region.

4.18 However, poor coordination between NG and LGU planning is common. This has resulted in a break in the planning chain, with the break occurring between the regional and provincial levels. While the RDCs appear to be the natural forum for integrating regional and local development plans, many LGU officials complain that the role of the RDC has been reduced to monitoring national government projects implemented at the local level.

[48] However, when the mayor/governor is able to access funding for a local project that is also of some interest to the RDC, he may give priority to the project even if it is not in consonance with local priorities.

4.19 Fundamentally, Manila still remains the center of policy and most significant action even for the local level, affecting priorities and ultimately performance. For example, institutionally, the national government retains control over most investments and must grant a range of approvals even though initial decisions are taken at the local level. This exposes the LGUs to political pressures and more often than not to necessitating the intervention of congressional or senatorial leaders on their behalf, once again feeding into the patronage and machine politics that dominate.

4.20 **Local budgeting.** Four key characteristics of the local budget process tend to make the process highly non-transparent. The first refers to the formulation of the income targets/ estimates on which the annual budget is anchored. The determination of the revenue target is largely based on a crude assessment of past trends in local revenue generation. Many local treasurers report applying a 5 percent-10 percent upward or downward adjustment to the previous year's actual revenue. In LGUs where the Local Finance Committee is active, some negotiation between the treasurer and other members of the LFC on the revenue goal takes place. While local treasurers have an incentive to keep the revenue targets low, the other members of the LFC would like to work with a larger budget.[49] Thus, aggregate LGU data for 1997-2001 shows that in general the revenue estimates for own-source revenue are seldom met, with 5 percent-20 percent shortfalls in own-source revenues (Table 4.2).

**Table 4.2 Revenue (Shortfall) / Excess Over Target (per cent)**

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| **ALL LGUS** | | | | | |
| Real Property Tax | (14.50) | (19.06) | (8.69) | (12.46) | (13.17) |
| Local Business Tax | (4.86) | (13.93) | (2.49) | (6.86) | (10.39) |
| IRA | (1.03) | (8.80) | (2.41) | (6.18) | (14.43) |
| Operating and Misc. Rev | (12.94) | (14.55) | (16.90) | (8.60) | (13.55) |
| TOTAL INCOME | (5.06) | (12.71) | (5.02) | (8.39) | (13.83) |

4.21 Since 1998, the IRA estimate supplied by the DBM has also become unreliable. In 1998, the IRA estimate was 9 percent short of actual releases. This figure went down to 2 percent and 6 percent in 1999 and 2000, respectively, but shot up again to 15 percent in 2001 due to the increasing national budget deficit. Given LGUs' dependence on the IRA, this trend distorts the local budget process.

4.22 In practice, poor revenue estimates (particularly by the DBM with respect to the IRA) lead to cuts in allotments and, consequently, obligations, relative to appropriations. Many LGUs visited respond to revenue shortfalls by implementing across-the-board cuts. In addition, many LGUs also imposed a 10 percent-15 percent reserve on appropriations for the MOOE at the start of the year in anticipation of revenue shortfall. This practice not only puts a further squeeze on MOOE expenditures, it also makes it difficult to track how well actual expenditures reflect appropriations in the budget execution stage.

4.23 The second issue refers to the recent practice of granting additional personnel benefits out of "savings". This practice appears to have fostered such strategic behavior on the part of LGUs, whereby they manipulate budget execution figures so as to generate these so-called "savings."

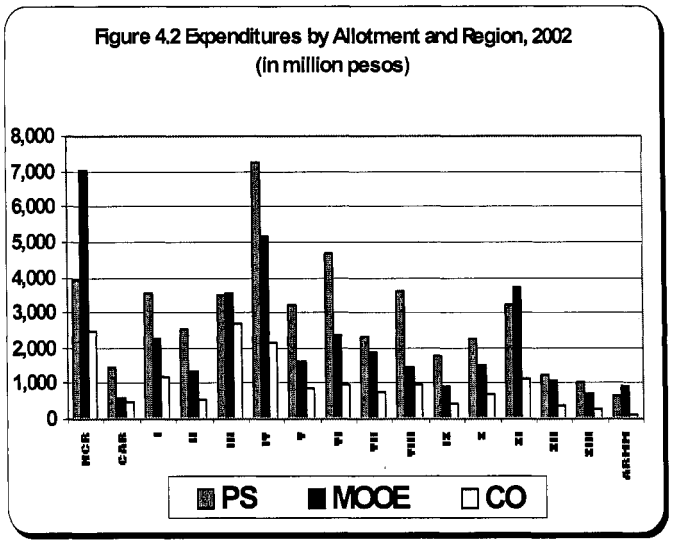
4.24 The third issue refers to the fact that in actual practice, after funds are set aside for the mandatory expenditures, budgeting at the local level is done largely in an incremental fashion. For all intents and purposes, the approach tends to assume that the existing funding level is appropriate. No consideration is given to program performance and cost-effectiveness in selecting budget allocation. The province of Bulacan, however, recently instituted a system whereby they regularly review actual

[49] While the BLGF provides local treasurers with their revenue targets, it appears that these numbers are seldom used by LGUs for budget purposes. Also, failure to meet the BLGF targets does not lead to any serious consequence for the treasurers.

program accomplishments vis-à-vis targets and budgets. This and similar experiences could be monitored for possible replication in other LGUs.

4.25 The fourth issue refers to the lack of effective community participation in the preparation and monitoring of the local budget. In many of the LGUs visited in this study, the public is typically not invited to the budget hearings conducted by the Sanggunian. Although budget hearings are officially open to all interested parties, information on their conduct is not widely disseminated. On the other hand, public monitoring of budget execution is not possible since the budget document and other expenditure statements are not circulated in many LGUs.[50]

4.26 **Controlling the wage bill.** The LGC resulted in the transfer to LGUs of 60 percent of the total pre-devolution number of personnel in key NGAs. Although LGU employment has been estimated at about 250,000 permanent and 95,000 temporary employees, absence of accurate data constrains an assessment of the size and structure of LGU complements, and impedes their effective management and development.




4.27 PS expenditures constitute the largest expenditure category for LGUs, squeezing out MOOE and CO in most regions (Figure 4.2). Section 325 of the LGC limits PS expenditures in each fiscal year to 45 percent of the total income in the preceding fiscal year for first to third class LGUs, and 55 percent for fourth to sixth class LGUs. In 2002, for instance, according to COA data, LGUs spent PhP144.5 billion in total. Of this, PhP71.10 billion or 49.2 percent was spent on PS, PhP49.3 billion (34.1 percent) on MOOE, and PhP24.1 billion (16.7 percent) on CO[51].

4.28 In reality, PS expenditures are higher than officially reported since it is common practice to charge the payments of temporary employees (e.g. consultants, contractuals and job-workers - especially in engineering departments) to MOOE or against development projects. Additionally, even for functions and positions whose PS costs are meant to be funded entirely from the national budget, LGUs commonly supplement national budget allocations with their own resources. Examples are LGU funding for police operations and maintenance, or for supplements to the police wage bill. There are instances of LGUs having to pay for the travel and other expenses of judges and other national government personnel. LGUs routinely pay for office expenses of DILG personnel located in their jurisdictions, while some LGUs appoint temporary employees who work in the DILG office. COA reports cite numerous LGUs for not observing the 45-55 percent cap on PS.

4.29 Some LGUs have successfully streamlined their staff and structures, with personal leadership of the local chief executive being key to such success. An example is the city of Cabanatuan (Nueva Ecija province). At the time of decentralization, it had a staff of 1,500. By 2000, the mayor had reduced the number of employees to 748 against 797 plantilla positions. This was achieved mainly due to the political will of the mayor, his adherence to transparent, rule-based and inclusive processes, and his ability to reward remaining employees over and above their formal compensation package.

[50] One laudable exception is Naga City which presents such information on its website.
[51] COA: Annual Financial Report on Local Governments, 2000.

4.30 The civil service compensation and classification system has accentuated rigidities due to its all-embracing character, and created fiscal burdens for LGUs. Devolution of personnel gave rise to salary differentials between devolved and other LGU staff. The centrally mandated pay and grading structures for permanent LGU positions have created significant fiscal burdens for LGUs. For example, LGUs feel that the continuance of the 'Magna Carta' for public health workers forces LGUs to realign their wage rates for other staff, and that it impinges upon their fiscal autonomy, encouraging them to find ways to circumvent them. And in some cases, the transfer of personnel has given rise to excess staff for the same position (e.g. each province maintains a provincial agriculturist, but also has absorbed personnel from the provincial agricultural office of the Department of Agriculture).

4.31 The pay and grading arrangements imply that in lower class LGUs, the salary of transferred (devolved) personnel may be higher than that of their mayors. In spite of the Salary Standardization Law mandating a uniform pay scale across levels of national government and LGUs, LGUs in a lower income class pay their employees less as compared to those in the national government because of a lack of resources. The NG does not have the capacity to enforce and monitor these schedules. Notwithstanding this, remuneration levels and structures vary widely across LGUs, depending upon the income and resources of LGUs. However, some LGUs, especially those in lower income classes, are constrained to pay higher salaries than they can afford to transfer personnel, and they also have to standardize their salary structures to harmonize salary levels of local personnel with those of transferred personnel.

4.32 LGUs have found ways around national restrictions on civil service pay by (a) supplementing low salaries with allowances and benefits, resources permitting, (b) ignoring or delaying payment of centrally mandated increases in salaries and allowances, (c) leaving devolved positions unfilled and (e) hiring "temporary consultants" to fill spots quickly. Grade inflation seems to be a common response to inadequate compensation levels. However, smaller LGUs face a problem in dealing with grade stagnation of employees: opportunities for upward mobility are far more restricted due to their more compact organizational structure.

**Local Government Procurement**

4.33 **Procurement process prior to RA 9184.** The LGC decentralized procurement to LGUs at a time when the legal and institutional framework for public procurement was unclear and non-transparent. Prior to the enactment of the LGC, infrastructure development and service delivery were functions of the national government, and procurement of goods, infrastructure projects and consulting services was undertaken at the national level. Procurement for purely local projects, such as the construction of rural roads and barangay schools, was likewise handled by national government agencies through their local offices with minimal participation from LGUs.

4.34 The LGC categorized procurement under a decentralized environment into infrastructure projects, goods and consulting services. This was a period when public procurement in the Philippines was governed by more than 60 laws, executive orders, presidential decrees and administrative orders, including issuances from government agencies applicable to respective departments. Furthermore, most EOs and IRRs were promulgated to fill the gaps caused by the absence of procurement legislation. This resulted in confusion and conflicting interpretation of laws and rules, increasing the likelihood of collusion, rigged bidding, delays and irregularities in the bid evaluation process.

4.35 Such devolution, while encouraging innovation, revealed serious flaws in LGU procurement. By virtue of the autonomy granted under the LGC, each LGU was authorized to adopt its own rules in the procurement of infrastructure projects. This led to the adoption of varying sets of rules among LGUs, resulting in confusion among both bidders and LGUs. For procurement of goods, the major deficiencies of the IRR included the lack of suitable procedures and criteria for bid evaluation, as well as for the determination of suppliers' qualification in terms of financial capacity, technical capability and experience for award of the contract. Common weaknesses in LGU procurement rules for infrastructure projects and goods related to the bidding process and the terms, conditions and

procedures for awarding the contract. The lack of a defined system of accountability was a common feature of LGU procurement rules. However, the flexibility granted by devolution also led to numerous cases where dynamic local chief executives adopted transparent processes and practices, including strengthened civil society oversight, which have increased the cost efficiency of procurement and reduced scope for graft and corruption (Box 4.1).

**Box 4.1: Innovations in Local Procurement**

In Abra province, a community group (CCAGG) first organized following the 'People Power' revolt of 1986 pursued 'audit' activities over public projects in the province ranging from inspection of construction standards for public works to investigating procurement practices. Its watchdog activities earned it a great deal of respect from the government and people to the point that the regional DPWH director ordered the inclusion of the CCAGG its bids and award committee and required a CCAGG monitoring report before payments are made for regional public works. But CCAGG's success also came at a high cost, in particular the life of one young lawyer who was assassinated and several harassment incidents. Yet, such examples are celebrated because they are rare and seem to require "crusading zeal" and a willingness to take extreme risk in a political environment that is permissive about civil and political violence.

4.36 Prevailing LGU procurement policies and practices disclosed numerous areas of concern, key among which were:

i) *Delays or lengthy processes characterized LGU procurement*, and bid activities were sometimes extended on a regular basis.

ii) *There was a disconnect between planning, budget formulation and procurement execution.* Procurement plans were developed for budget purposes, but their implementation was not monitored nor their potential benefit for facilitating timely and quality agency service delivery as an accountability mechanism for procurement. Moreover, changing priorities and budget cuts led to the abandonment of some plans.

iii) *Excessive local preference.* Some LGUs granted preference to contractors/suppliers whose businesses are located in their jurisdiction, sometimes to the point of excluding "non-local" bidders from contracts. This practice went against competitive practices which, as a general principle, should govern all procurement activities.

iv) *Negotiation of contract price.* Price negotiation was said to be a key entry point for possible corruption in the procurement process. While EO 40 prohibited price negotiation, most bidding documents did not allow the reduction of quantities along pre-agreed percentages. Hence, some parties negotiated with the lowest bidder to stay within the approved budget.

v) *Price monitoring* did not form part of a standard and efficient procurement function in LGUs.

vi) *Inadequate procurement record keeping system* in most LGUs hindered effective supervision and audit.

4.37 These weaknesses resulted in (a) inefficiency and delays at various stages of the procurement process; (b) higher cost of procurement for LGUs; (c) manipulation of the rules for benefiting favored bidders, and opportunities for graft and corruption; (d) a high possibility of contract default for want of qualifications; and (e) lack of a system of accountability in the rules for conditions where in cases of redress for anomalies committed, the pressure is shifted to the affected parties instead of to the LGU officials responsible. LGUs also tended to lack effective mechanisms to keep track of the progress of procurement. In most cases the concerned parties were not aware of delays and problems, leaving issues and problems unresolved.

4.38 The old procurement rules required that invitations to bid should be advertised two weeks in advance in at least one newspaper of local circulation. Rules on procurement of goods required copies of the invitation to be posted in at least three publicly accessible and conspicuous places. Some LGUs had not, however, been complying with these requirements - either by failing to advertise or post the

required invitations, doing so for only a very limited time or advertising/posting the notices in places where access by concerned or interested parties is limited. These practices discriminated among bidders and limit the competitiveness of the procurement process. Some LGUs with the technical capability and necessary equipment preferred to implement infrastructure projects by direct administration orders (referred to as force account), due to substantial savings from doing so. Other LGUs however continued to contract out works, seeing this as a more efficient means to execute infrastructure projects.

4.39 **The Government Procurement Reform Act (RA9184).** The legal framework for procurement has substantially improved with the passage of the Government Procurement Reform Act of 2003 (GPRA: RA 9184); the key issue is how soon and how well the implementing rules and regulations are implemented. The GPRA was enacted in December 2002 with the promulgation of the IRR in September 2003. The new law covers the public procurement of all LGUs and addresses fundamental issues which are expected to positively impact LGU procurement: (a) eliminating proliferation of laws on public procurement, which has facilitated inefficiency, rent-seeking and leakage of scarce public resources; (b) reorganizing and strengthening agency and LGU Bid and Award Committees and procurement units to ensure accountability in procurement processes and procedures and sustained system improvement for greater cost efficiency; the law prohibits the Local Chief Executive to be the Chairman of the bid assessment committee (BAC); (c) establishing one authoritative regulatory and oversight entity for all public procurement for the national government, LGUs and GOCCs; (d) minimizing anomalous procurement practices such as rigged bidding, fake advertising notices, misrepresentations in bid proposals, irregularities in bid evaluation, inspection and contract implementation, and weak warranty provisions for infrastructure projects; (e) ameliorating proficient procurement staff; (f) strengthening the system of rewards and punishments in the performance of the procurement function; and (g) establishing an appropriate complaints mechanism; (h) linking procurement planning with budget through annual procurement plans; (i) mandatory use of the Government Electronic Procurement System; (j) Standardizing procurement forms and manuals; (k) imposing penal and administrative sanctions against erring bidders, contractors and suppliers; (l) enhancing capacity of procurement staff; and (m) strengthening the involvement of civil society organizations in policy formulation and reform implementation.

4.40 The GPRA also addresses specific LGU procurement weaknesses, such as the lack of a common set of rules on procurement of infrastructure projects. Moreover, it simplifies pre-qualification procedures, strengthens the post-qualification process, reduces officials' discretion on bids and awards, establishes a Government Procurement Policy Board (GPPB) for oversight and regulation of government procurement, professionalizes the public procurement function, protects procurement officials from unjust legal suits arising from the performance of their duties, and imposes criminal and civil liabilities for those found guilty of collusion and other anomalies.

4.41 The implementation of RA 9184 is still in its infant stage, thus at present, administrative controls over procurement remain generally weak. Where transparency in LGU procurement is effective, as in Naga city where all unit prices of awarded bids are made publicly available in newspapers and on the internet, the credibility and accountability of the procurement process is immensely strengthened. However, there are still too many influences jeopardizing the efficiency and integrity of the procurement process including high rates of re-bidding, and price negotiations before award create concern about the process. Re-bidding sometimes results when the bidding is not in line with expectations, or the lowest bidder is not qualified. In respect of congressional initiatives and CDF, actual procurement practices in district-level projects tend to be non-transparent as some elected officials are reported to pre-determine the winning contractors. This jeopardizes the credibility of the process and compromises the integrity of BAC members. Furthermore, LGUs in general lack effective mechanisms to track their procurement activities and progress. In many cases concerned parties are not aware of delays and problems, leaving issues and problems unresolved for unreasonable lengths of time.

4.42 Several issues emerged with the implementation of RA 9184: (i) rapid dissemination of the IRR to all stakeholders including local governments, the private sector and civil society; (ii) implementation of electronic procurement as a transactional tool; (iii) preparation of a report on capacity, quality and size of contracts for works; (iv) training on harmonized bidding documents to all levels including national local governments; (v) introducing a system of value engineering analysis on a pilot basis to check that designs and cost estimates ensure best value for money; and capacity building of civil society organizations.

4.43 Members of the various LGU procurement committees generally lack experience, capability and background to deal with procurement issues. Members rely on their own interpretations and perceptions in administering the rules. Procurement Manuals have now been drafted and they will be issued in January 2005. These will guide BAC members in addressing issues likely to arise during procurement. The national training program that includes LGUs is now being implemented with the training of trainers in October and November 2004. The next training courses will involve massive capacity building for LGUs through the accredited State Universities and Colleges.

4.44 Another concern over local government procurement is Article XIII of the GPRA, which regulates bidding of provincial projects[52]. This article protects local bidders, stifling competition. Thus, preference for local contractors still dominates local government procurement, and the GPRA has not been able to address this issue.

**Financial Management and Controls**

4.45 LGU financial management rests with the Local Chief Executive (LCE). The LCE is assisted by three key financial officials: the Treasurer, the Budget Officer and the Accountant, who report directly to the LCE and are independent of each other. The Treasurer is appointed by the Bureau of Local Government Finance (BLGF) from among three nominees recommended by the LCE. The DILG, DOF and DBM exercise oversight of administrative and financial control over LGUs. Municipalities and cities carry out limited oversight of Barangay activities. Accounting and budgeting guidelines are issued by COA and DBM respectively. DBM has no powers to review LGU budgets except those of provinces and major cities. COA has the power to audit LGUs. The internal audit function is non-existent in most LGUs.

4.46 Financial management in LGUs is still mainly based on manual systems; staff are pre-occupied with transaction processing with very little time spent on financial advice to management, financial analysis and managerial accounting and reporting. There is no national leadership to motivate and upgrade the financial management profession as functions and responsibilities are dispersed in several agencies.

4.47 Financial management capacity in most LGUs is very weak. The BLGF, which is the principal oversight agency for LGU financial management, has played a somewhat passive role in discharging its responsibilities. There is no clear financial leadership role in an LGU: responsibilities are split among the three principal officials (treasurer, budget officer and accountant). Financial reporting is essentially regulatory in nature. Moreover, reports submitted to oversight agencies often carry different data and are not always reconciled. There are no updated Accounting, Treasury and Budget management manuals. Planning and monitoring as effective tools of internal control are not well used. The present budget system is looked upon more as an expenditure authorizing mechanism rather than a tool for management control. The absence of computerized accounting and information

[52] The article provides that "Within five years from the effectivity of this Act, a contractor who participates in the bidding of provincial priority programs and infrastructure projects, whose principal office is within the same province, and who submits the lowest bid among the provincial bidders which is higher than the lowest bid made by a contractor with principal office outside the said province, shall be granted privilege to match the bid made by the latter."

management, inadequate performance monitoring and lack of a cost accounting system[53] all contribute to delays in timely and accurate reporting of financial data.

4.48 COA's role in the financial management of LGUs now requires re-examination to make it more effective from the governance and accountability perspectives[54]. The COA audit focuses on disbursements of funds. Revenue audit is not a priority: in many LGUs, revenues have not been audited for the past three years; in some, not at all. While disbursements are critical because of the very nature of these accounts, major audit risks also arise from neglecting audit of LGU revenues or revenue accounts. Like disbursements, revenues involve cash that, by its very nature, is exposed to the risk of fraud or misappropriation. Further, accuracy and completeness of these revenues cannot be ensured absent a thorough audit. Subsequently, related reporting by LGUs containing information about revenues may increase the risk of misstatement. Although trial balance and related account schedules are obtained by the auditors from the auditee for financial audit purposes, it is estimated that about 80 per cent of the audit team's time is devoted to vouching and validating transactional documents such as Official Receipts (ORs), Purchase Orders (POs), and other relevant documents used by an LGU to support its operational transactions, to check compliance with the government and the COA rules and regulations. This is not fully aligned with COA's current thrust to focus on financial audit, which started in 2002.

4.49 Internal audit is a key weakness in LGU financial management, and its absence is one of the factors weakening LGU governance. Most LGUs do not have internal auditors. The Office of the President, in its Administrative Order (AO) No. 70, dated April 14, 2003, mandated all government offices, including LGUs, to create/organize an Internal Audit Service (IAS). The IAS is envisaged as an integral part of the office, without intruding into COA's constitutional authority and mandate. In practice, many LGUs pay lip service to this provision by tasking their accountants to be the internal auditors as well.

4.50 Inconsistent execution of financial audit is also an issue in many LGUs. The execution of the financial audit, based on the planned audit work program, differs when compared to the actual work performed by the LGS auditors. Although an annual work program is prepared during the planning activity in the regional level, the detailed procedures executed when compared with the planned and prepared audit work program would differ, not meeting therefore the objectives of the planned audit work. For instance, the work program for a financial audit on the expense accounts would include a reasonableness test of certain expenditures through analytical review. The timing of LGU audit is also neither adequate nor properly scheduled.

4.51 A New Local Government Accounting System (NLGAS) was introduced starting January 2002. Its implementation still needs to be carefully managed, with COA and other oversight agencies needing to provide sustained, adequate and timely implementation and technical support to LGUs. The NLGAS is a simplified set of accounting concepts designed to ensure correctness, completeness and timely recording of financial transactions, and production of accurate and relevant financial reports. The objective of the NLGAS is to make the government accounting system comprehensible, conform to generally accepted accounting principles and generate reports useful for management decision-making. NLGAS manuals have been issued by COA. Extensive NLGAS training has been conducted for financial management personnel including from LGUs. Orientation for executives was also held. All the accounting reports received by the COA for the year ending 2002 were prepared in accordance with the new guidelines.

4.52 The introduction of the NLGAS has provided a unique opportunity to improve accounting procedures, manuals and training of LGU accounting staff. However, the large volume of staff and LGUs that need to be trained and supervised make this a formidable task. COA has developed

[53] The NLGAS and NGAS account for purchases of tangible assets like equipment, vehicles, construction of buildings, etc. COA has prescribed the pertinent accounting policies.

[54] See "Strengthening of Accountability in Poor Local Government Units: Audit Components" (World Bank).

software for the computerized implementation of the NGAS. To save on cost and respond to the need of the government, COA has developed three different software applications programs, each one representing a complete accounting system, which will be distributed free to all LGUs and national government agencies. Currently COA charges a fee for customization, implementation and training. As COA owns the source code, it can easily introduce modifications to respond to changes in information requirements without having to call on service providers. An important feature of the computerized NGAS is the adoption of Responsibility Accounting wherein responsibility centers or cost centers are to be established for each agency to effectively control and monitor costs. A Users Guide and Training Manuals have been likewise prepared by the COA. Once the software is launched, training will be conducted in all NG agencies and LGUs Upon installation of the computerized system, teams with competent technical expertise (consisting of programmers, system analysts, and auditors) will be on hand for timely trouble-shooting and technical support. The LGUs may select the most suitable software program depending on its needs and human and financial capability. The "simplified" software program reportedly requires only one computer. The COA computerized accounting system is geared more towards national government reporting and is not oriented to serve LGU reporting.

4.53 Another problem is that the budget management process is not used as a management tool for efficient and effective resource management. There is very little financial analysis and performance monitoring in financial management (discussed earlier).

4.54 The internal control environment is weak in LGUs: financial management skills are low, leadership is lacking and there is weak oversight by national government agencies. Internal control over cash and property management needs major improvement to safeguard LGU assets and strengthen accountability over LGU resources. Although there are numerous reports of good practice, weak implementation of prescribed internal control practices is extensively reported in COA's Annual Audit Reports (Box 4.2). Administrative Order No. 278 of 1992 required all national and local agencies to establish an Internal Audit Unit (IAU). But this was never fully implemented – reportedly due to lack of qualified personnel and the cap on personal services expenditures. Successive COA Annual Audit Reports have exposed serious internal control lapses, including: (a) lack of compliance with laws, rules and regulations; (b) weak control over fixed assets and lack of recording and inventory of fixed assets (non-reconciliation of property records with the controlling account causing differences running to millions of pesos in an LGU, material enough to warrant qualified/adverse opinions); (c) weak control over cash management due to retention of collected revenue in cash by treasurers in contravention of regulations requiring deposits at authorized banks; (d) weak control over accounts payable as officials commit 50 percent of estimated revenues (this practice has resulted in accumulation of accounts payable when revenues fall short of estimates); (e) a weak human resource base in financial management, particularly in rural LGUs where it is difficult to find qualified and experienced accountants - there is also no systematic training of LGU financial officials; and (f) audit findings are not always implemented. Physical inventory, needed to verify the existence and condition of property, plant and equipment and inventories, is rarely undertaken effectively.

4.55 The rapid turnover of LGU elected and appointed officials is a principal cause of the above state of affairs. LGU mayors and councilors are elected for three years. Although training of elected officials is carried out by DILG, it is not certain whether all elected officials attend such training. With every change of LGU political leadership, new administrative and financial staff are appointed replacing key experienced staff. In addition, some LGU leaders and officials disregard laws, rules and regulations in pursuit of their political or personal interests.

4.56 The NLGAS when fully implemented may be able to address many of these internal control weaknesses.[55] Key problems such as the reconciliation of the subsidiary records with the controlling

[55] It should be noted that manual systems are currently in place. Where these are being circumvented, it would appear that a computerized system could be equally susceptible to such circumvention.

account, updating of property records and the reconciliation of the bank account could be solved with the installation of the computerized NLGAS. The system is designed such that for controlling accounts with subsidiary records, accounting entries in the controlling account will not be accepted if no recording is done in the subsidiary records.

**Box 4.2: Weaknesses in the Internal Control Environment**

Laxity in enforcing basic financial discipline in LGUs is evidenced by numerous COA reports which have highlighted the need for more disciplined financial management:

- *Overall position:* In 2000, only 250 of the 1689 LGUs audited were given clean audit reports by COA. Accumulation of contingent assets such as claims for disallowed payments increased by 6.16 percent from PhP1.598 million in 1997 to PhP1.697 million in 2000. It can be argued that this increase is attributable to the leniency of local managers in enforcing remedial measures against erring officials, some of whom have already left government service due to retirement or expiration of terms. Unliquidated cash advances to local officials: In 2000, COA reported that an amount of PhP2.3 billion was outstanding, an increase of 10.59 percent from the previous year. Cash advances are to be given only for specific purpose, and they must be liquidated as soon as the purpose for which it has been given is fulfilled. Cash overdrafts amounted to PhP1.28 billion in 2000, an increase of 8.9 percent from the previous year.
- *City finances:* In 1999, the Ombudsman filed criminal and administrative charges against a city mayor for procuring asphalt at a price of PhP27.6 million. It was overpriced by PhP18.3 million. This led to the preventive suspension of the mayor. The Philippine Center for Investigative Journalism (PCIJ) also documents how the procurement process is being manipulated in some LGUs. In Makati city, the prices paid to suppliers were 55-482 percent higher than the market prices. For example, a TV was purchased for PhP43,077 (market price PhP19,900), a computer for PhP68,755 (market price PhP27,000) and toner ink for PhP6,500 (market price PhP1,116). Items bought for Makati were overpriced by an average of 519 percent. More blatant is the example of paper copiers purchased for PhP89,000, whereas they were available in the market at PhP11,000. The office of the vice mayor of the city estimated the actual cost of one road project to be PhP3 million, whereas it was billed at PhP14 million.
- *Barangay finances* also reveal severe internal control issues. In one case, a total of PhP486,000 collected by a barangay captain was deposited to his current account with a bank. Provisional receipts were issued instead of official receipts for the amount of PhP490,940.50 that was collected. Collections were recorded in the cash book, but were not deposited in the barangay account. Out of PhP349,940.50 collections, PhP341,527.90 was disbursed without an approved budget and covering disbursement vouchers or payrolls. The audit discovered that the balance was with the barangay treasurer instead of in the barangay bank account.

4.57 The booking of receivables from Real Property Tax under the NGAS is likely to have a major impact on LGU financial management. Previously the RPT was not recorded in the books of accounts. Only the treasurer knew the total collectibles from the RPT. However, with the NGAS in place, the LCE can now easily monitor the treasurer's collection efficiency/performance by reviewing the financial reports rendered by the accountant. The NGAS also enables the LGU to make provision for bad accounts in case of failure of the property owner to pay the tax due. LGUs record real property tax receivables only in the financial reports submitted to COA for audit, but these audited financial reports are not used for financial management purposes (e.g. to determine the efficiency of collection of real property tax). Revenue from RPTs is still recognized by LGUs on a cash basis in preparing their statement of income and expenses (submitted to the BLGF which evaluates the collection efficiency of RPT). Collection efficiency is measured in terms of increase over the previous year's collection rather than as a per cent of what is collectible.

4.58 The 2002 revamping of COA's organizational and functional structure will help ensure improved external audit. In 2002, COA revamped its organizational and functional structure. A Regional Director who earlier supervised the audit of all government sectors in a region (comprising 400 to 500 government agencies) now handles only a few clusters of a sector thereby strengthening audit quality in the agencies under supervision. Instead of a provincial auditor, teams are now auditing

LGUs, under the direct audit supervision of the cluster director. The reduction in the span of supervision of directors has resulted in closer supervision over audit teams, commonality in the interpretation of laws, rules and regulations and improved audit reporting.

4.59 The BLGF plans to pilot the introduction of 14 performance indicators to monitor LGU financial performance. These initiatives, if implemented and observed by LGUs, could strengthen financial discipline in LGUs.

**Recommendations**

4.60 **Expenditure management**. NEDA's current efforts to strengthen the local planning process deserve support. There is a need to reorient the RDCs so that they become an effective venue for integrating national and local plans. In this regard, regional offices of national government agencies would do well to reflect LGU priorities in their planning submissions before forwarding the regional sectoral plans to their central offices. It is important to develop horizontal and vertical alignment of plans. This means that lower LGU plans would input to higher level plans while the latter would serve as a framework for the formulation of the former. NEDA has begun an exercise to strengthen the linkage between national, regional and provincial planning – this initiative requires sustained support.

4.61 The transparency of the budget process could be enhanced by improving the estimates of LGU income, the predictability of IRA transfers and the public availability of LGU budget documents. The BLGF could play a leadership role in providing technical assistance in this area. At the same time, the predictability of the IRA should be enhanced. Finally, publication of LGU budget documents and financial statements in conspicuous places in the municipal/city hall premises could promote NGO/public monitoring of LGU budgets, accounts and projects.

4.62 It may now be time to scrap the compensation and position classification system for a new system with greater flexibility to LGUs in exchange for heightened accountability. The problems of the compensation system are well-documented and are not repeated here. Some rationalization of this system is required such that regional labor market differences might be better incorporated into staffing and compensation levels. It may also be desirable to review and minimize or explicitly monetize, as the case may be, salary supplements and non-wage benefits. A review of the compensation system should be accompanied by a study to recommend basic reform of the position classification system. It seems appropriate now to consider granting flexibility in classification and compensation issues to certain classes of LGUs in exchange for greater transparency and accountability.

4.63 Provinces and cities need functioning personnel management and information systems to address information gaps which currently prevent effective management of their wage bill and human resources. It is essential that the human resource agenda for LGUs focus on putting in place a functioning human resource management and information system at the national and LGU levels, which can facilitate the management of: (i) compensation, classification, personnel and positions; (ii) streamlining, restructuring and reorganization where feasible (e.g. in pilot sectors or departments); (iii) actions to mitigate the effects of redundancy (voluntary departure, early retirement), and (iv) capacity building in LGUs.

4.64 **Procurement.** It will be important to sustain the systems improvements and capacity-building needed to support LGU procurement reforms to increase competition and transparency: this will have a significant impact on improving bidding efficiency, reducing cost and strengthening governance. Specific measures to strengthen LGU procurement could include the following:

i) *Deleting Article XIII of the GPRA* which provides for preferential treatment of local bidders for bidding of provincial projects. The deletion will make the procurement process more competitive, fairer and more transparent.

ii) *Actions aimed at strengthening transparency and accountability* could facilitate oversight of LGU procurement, and enable civil society to play its watchdog role more effectively. These actions could include, for example, (a) the publication of the unit cost or unit price in infrastructure, construction and goods in newspapers and local bulletin boards, (b) promulgation of a manual on procurement procedures to serve as a guide to members of local committees, (c) seminars and workshops to educate LGUs, (d) replicating the strategies and experience of Procurement Watch in promoting transparency and accountability, and in preparing LGU procurement plans. The impact of civil society groups' participation in procurement activities is only recently being felt. Their participation has led to greater transparency in procurement.

iii) *Aggressive action by the national government* to professionalize the procurement function and strengthen LGU-level procurement capacity, and also provide quality assurance for LGU procurement. The Government Procurement Policy Board could prepare an implementation plan to monitor compliance of the GPRA and the IRR by LGUs.

iv) *Greater inter-LGU cooperation in procurement.* This could include publishing/sharing information on prices of procured items and blacklisting of contractors/ suppliers, innovations in procurement procedures, capacity building, and disseminating information on government procurement reforms and implementation of IRRs.

v) *Long-term support for institutional strengthening.* Key initiatives focus on: (i) strengthening the Government Procurement Policy Board to improve its regulatory and oversight role, including for local procurement; (ii) establishing an appropriate protest and complaints mechanism for national and local procurement; (iii) professionalizing the procurement function, including training programs (for members of procurement committees, procurement officers and COA auditors on procurement audit); and (iv) training and awareness building among NGOs, private sector and civil society.

vi) *Restoring COA independence vis-à-vis LGUs.* RA 9184 and its IRR stipulate the role of COA in the procurement process: the COA representative has been made an observer in the bids and awards committee proceedings. It is not clear why this provision was felt necessary. In actual practice, this compromises COA's ex-post independent external audit function. Under normal circumstances, there should be no need for an external auditor to 'observe' the procurement committee deliberations. Uncharitable critics could assert that the very inclusion of this provision reveals how the political economy of procurement works in practice: pressure could be brought on the lone COA representative to 'concur' to the deliberations and COA would then not be able to object to the transaction come audit time. It is desirable that the government reviews this provision and restores COA's independence vis-à-vis LGUs.

4.65 **Financial management.** Strengthening financial management in local governments is a tremendous challenge, and its success will depend on the extent to which COA and other oversight agencies can provide implementation support, and development partners can provide implementation assistance for progressive chief executives. The financial management strengthening strategy could build on government and donor-funded initiatives and develop a program to (a) strengthen the BLGF by empowering it to be the main driver of local government financial management reform; (b) initiate a set of actions aimed at strengthening the internal control environment ; and (c) build financial management capacity in LGUs in the long term. The BLGF should work closely with COA in designing the revised accounting, budget and treasury manuals and proposing a longer term financial management improvement program. These steps could be expedited by utilizing grant resources available with the COA, DOF and DBM.

4.66 Establishing credible internal audit systems is essential for strengthening LGU financial management and controls. The current signing practice by chief accounting officers at LGUs should be converted to a formal internal auditing. COA should play a role in establishing and assisting the internal auditing. At last, views and opinions from LGU officials should be treated seriously and the

national government should listen to the feedbacks from LGU officials in financial management, especially in using NLGAS.

4.67 It would be desirable for the oversight agencies (DBM, DOF, DILG and COA) to estimate the total cost to install and customize the NLGAS, and treat this item of expenditure as a compulsory outlay in the budget. This can release LGUs from the financial burden of paying for the entire installation, customization and training expenditures.

4.68 More effective training of treasurers, accountants, procurement personnel, procurement committee members, and financial management personnel is needed to sensitize them to the new procurement and financial management regimes.

## 5. MEASURING AND MANAGING PERFORMANCE

5.1 Measuring and managing LGU performance assume special importance in the context of the issues examined in this report:

- LGUs seeking to access additional financing from the private sector and national government agencies need to be able to demonstrate that their performance can be assessed in an accountable and transparent manner, incorporating feedback from service users and leading to measurable change in performance; and
- Several amendments to the LGC have been proposed in recent years. Some of these propose greater fiscal autonomy for LGUs. Stronger local autonomy necessitates a performance management[56] system that can influence LGU behavior in improving service delivery through more accountable, efficient and equitable utilization of resources.

5.2 National authorities are still in search of a meaningful performance index for comparing the relative progress of types and classes of LGUs. Systems to address these questions are as diverse and numerous as LGUs themselves. However, it remains very difficult to compare performance across LGUs, especially over time. Since this report explicitly focuses on a short-term action agenda, it does not compare performance across LGUs or touch upon many key issues relating to performance management, except to outline the Philippine experience in broad terms. In addition, many LGUs are still reluctant to share their performance data, making comparisons difficult. This report restricts itself to an annex of 'snapshots' of well-performing LGUs, mainly in the areas examined in previous chapters, to draw some lessons if possible. An assessment of LGU performance that goes beyond the anecdotal will be separately undertaken.

### Performance Measurement and Management: The Philippine Experience

5.3 In the Philippines the development of performance management has progressed on a dual track. National government agencies (NGAs) and development partners have expressed interest in nationally standardized tools that could be used to assess LGU performance and provide incentives to high-performing units and capacity-building support to others. The result is that a wide array of such tools is in use in the Philippines today. Some of the assessment tools are strictly focused on measuring financial flows—either revenue generation or expenditures. Others are used to assess the performance of LGUs against specific sets of normative criteria, which also allows for inter-LGU comparisons. Within this group some are focused on rule compliance, while others use various indicators to measure development outcomes. Some tools, especially a few put to use by LGUs themselves, concentrate on enabling local managers to more completely understand their internal performance. A subset of these has been integrated with financial management data to measure costs and manage ongoing performance.

5.4 The DILG's Local Productivity and Performance Measurement System (LPPMS) is a major national government initiative. It was introduced in the 1980s as a monitoring mechanism for DILG to assess LGU service delivery capacities and limitations. With the advent of the 1991 LGC which devolved substantial powers and functions to the LGUs, the need to rationalize the system became apparent. Instead of a monitoring mechanism for the DILG, the LPPMS was enhanced to become not just a tool for general supervision by the DILG but also as a management tool for the LGUs to evaluate their own performance.

[56] Performance management is defined as the regular assessment and improvement of the results (outcomes) and efficiency of services or programs.

**Box 5.1: Local Government Performance Management: Lessons of Experience**

The local government performance management systems (PMS) of five countries were reviewed to identify common themes or lessons. All the systems reviewed emphasized building strong links between measurement of the past, management of the present, and planning for the future. Key lessons learnt include:

(i) ***Incremental change in responsibility and accountability patterns has been found to be more effective and sustainable*** in inducing individuals to change performance behavior than large systemic shifts.

(ii) ***Successful interventions focused on rating performance of specific functions of local administrations,*** rather than emphasizing an overall comparative ranking of the administrative units themselves.

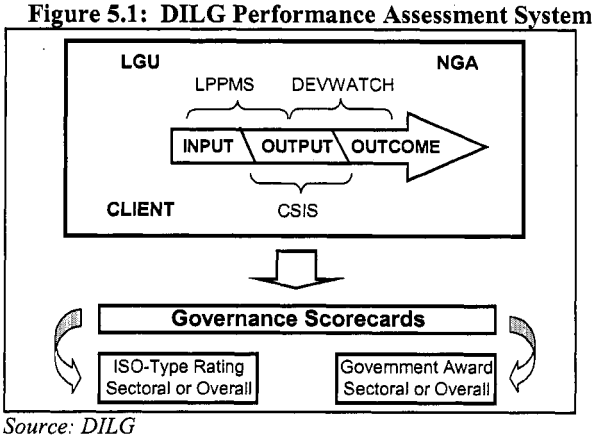
(iii) ***A quality PMS must be results-oriented.*** A good system will be limited to a few critical indicators, but with sufficient detail at appropriate levels so that staff can be held accountable for assessing their levels of accomplishment and making decisions on what changes are needed to improve performance. Local leaders deal daily with competing demands from diverse constituents. Therefore, to be useful as a mechanism for benchmarking, a PMS should provide information that measures quality/satisfaction and quantity/equity, together with unit costs. The system must be designed and operated with a high degree of accuracy, consistency and integrity while ensuring that both cost and complexity of survey operation are appropriate to locally prevailing conditions.

(iv) ***Even the best PMS are severely limited in their ability to influence change: indicator data are merely the 'tip of the iceberg'.*** PMS data do not explain why performance outcomes have been achieved and the information provided by formal assessment systems is always being supplemented by informal intelligence gathering carried out by political leaders. A PMS must always be recognized as a tool that can be most useful in sustaining improved development outcomes when it is used to regularly measure change over time. Given the limitations of data, quality of data collection and analysis, and potential politicization of the survey process, using such numbers as a means to compare the performance LGUs at any given point in time should be done with caution. It is more useful to monitor trends over time and to allow LGUs to assess their improvement over time.

5.5 The LPPMS provides LGUs with one tool to assess their strengths and weaknesses in the performance of their new roles and increased responsibilities brought about by devolution. As such it makes use of indicators mostly derived from the LGC (e.g. presence of LGU-owned administration building, percentage compliance with prescribed number of mandatory offices, presence of LGU-initiated health programs) to measure the performance and productivity of LGUs. The system was implemented nationwide during the 1990's. However, partly as a result of trying to meet these dual objectives, and partly due to resource limitations (particularly in information technology), the system was acknowledged as being in need of a further overhaul.

5.6 The DILG embarked on a revamp of the system during 2000, with funding assistance from CIDA. In order to overcome several weaknesses and to enhance the utility of the system to a variety of stakeholders the system will be upgraded to integrate three components (figure 5.1):

**Figure 5.1: DILG Performance Assessment System**




*Source: DILG*

- The original LPPMS self-assessment tool for LGUs, which is intended to provide information to national government on the overall state of decentralization and to provide information to LGUs which can feed into local planning and budgeting processes.
- A Citizens Satisfaction Index System (CSIS), initially known as the devolution score card, which aims to monitor the extent of implementation of devolution especially among the so-

called devolved agencies (agriculture, health, social services, and environment and natural resources), and allows the public to provide feedback on the quality of basic services delivered in the area. Potential users of CSIS are civil society organizations and private sector groups.

- The Local Development Watch (DevWatch) aims to go beyond the development of indicators and assess the state of development/underdevelopment of LGUs brought about by decentralization. Indicators of the DevWatch project include measures of society, economy, and environment and monitor progress in sustainable development at the provincial, city, and municipal levels. It has been successfully pilot-tested in several LGUs, and has the advantage of being Internet-based, which can serve as a model for eventually extending the use of information technology for capturing, collating, analyzing and disseminating data in the enhanced system.

5.7 Separately from the Local Government Performance Measurement System (LGPMS) other national government agencies maintain databases of local government information, related to the mandate of the agency. For example the Bureau of Local Government Finance has been assisted by USAID to develop an online database of 126 separate financial characteristics of LGUs. When completed, the entire database will be made available in internet-compatible format. Discussions are underway to possibly link the BLGF database with the LPPMS to allow the integration of financial with development and service delivery data, to strengthen the linkage between measuring outputs and allocating inputs. Other agencies such as the DBM, COA and the CSC maintain information that could be usefully linked to provide a comprehensive performance management system.

5.8 In the private sector, the Local Government Unit Guarantee Corporation (LGUGC) has developed a comprehensive set of indicators to assess creditworthiness and credit risk of LGUs. The system consists of in-depth assessments of an LGU's capacity to repay debt, its overall socioeconomic development profile, recent operational performance and financial condition. LGUGC has availed of technical assistance from USAID and AUSAID to test the reliability of their rating system against international standards. Both assessments confirmed that the system consistently produced quality results. The credit screening process has been used to assess the top 500 LGUs based on total income. The system can be applied to all LGUs in the country with minimal additional cost.

**Issues**

5.9 A dichotomy exists between systems designed to appraise LGUs in comparison with each other and/or against standardized norms and those designed to support internal LGU performance management efforts. Over the past twelve years, local governance in the Philippines has been characterized by continuous change resulting from adaptive innovations emanating from both local government and non-government sectors. The evolution from a dominant relationship between national and local government to a complex web of relationships not just between LGUs and the center, but among themselves and between LGUs and non-government sectors, has opened the potential for new solutions that were not feasible prior to the passage of the LGC.

5.10 There currently exist over 30 different performance measurement systems that have been introduced, primarily by international agencies, for various purposes in the Philippines. (This does not count the many systems that are in use by individual LGUs.) Little effort has been made in using these different sources of information on local government functioning to form a coherent understanding of the complexity of decentralized service delivery and the role of national government agencies.

5.11 Most Philippine PMS tools are used as a retrospective assessment tool disconnected from management support necessary to improve performance. While most appraisal systems designed by international organizations are based on norms or standards of development, few of the ones introduced to the Philippines have been coupled with capacity building programs that assist an LGU to directly incorporate the assessment information into ongoing management practice. One example is

the Province of Bulacan, which has initiated a province-wide effort through which each department has identified key result areas, performance indicators, baseline conditions and annual achievement targets running to 2007.

5.12 There are exceptions to this: a number of systems in use in various LGUs are explicitly prospective in nature. One, the City Development Strategy, was introduced by the World Bank to assist cities to design medium-term performance strategies. This has been adapted, to a greater or lesser extent in about 20 cities. The City of San Fernando, La Union, has taken this model and expanded upon it so that now all 24 barangays in the city have undergone a similar performance-based strategy design process. The City of Cebu uses a process analysis tool introduced in the early 1990s by DBM. All departments of the City are strongly encouraged by the Mayor to use the tool, known as SPRING, to identify performance impeding process imperfections and to establish benchmarks to assess whether process modifications have been effective.

**Recommendations**

5.13 There is a clear need to establish a national performance assessment system for broad comparative purposes, beginning perhaps with the LGUGC credit screening system. A national system capable of providing comparable performance assessment of LGUs, and applicable to all LGUs above the Barangay level, would be desirable. The LGUCG credit screening system could be considered for scaling-up to cover all LGUs, since it has been successfully tested against international rating standards and is independently operated. The design phase of the LGPMS system could take into account the need to distinguish between indicators of locally provided services and those for national mandates. The role of the Leagues in collating and managing regional information could be further explored.

**Box 5.2: Institutionalizing Performance Management Systems**

Experience to date indicates that encouraging LCEs to institutionalize performance management systems (PMS) is perhaps the most difficult aspect of the entire process. Typically, political disinterest in documenting performance weaknesses is cited as one barrier. However, several LGU systems have continued not only to be used, but to be substantially enhanced by the staff of the LGU long after external assistance was withdrawn. These examples suggest that (a) the most effective mechanism for improving performance is to tie an organizational PMS to individual work planning that enables staff to be an integral part of the target setting process and (b) mechanisms for regular client feedback must be an integral part of the overall design.

The involvement of national government agencies and development partners in collecting and managing data on local performance raises perceptions that such information could be used to apply sanctions or provide financial incentives based on relative performance, thus skewing LGU interest in institutionalizing PMS. The Leagues, supported by independent contractors, could play an important role in promoting performance management methodologies; managing provincial, city-level and municipal databases; and in using the information to identify development and capacity-building needs. The Leagues are well-placed to facilitate resource pooling, for example, in response to such identified needs and to undertake comparative analysis across LGUs within their jurisdiction. The League of Cities has already indicated its willingness to support the system of Good Urban Governance.

5.14 It is desirable that organizational performance systems be ultimately integrated with personnel evaluation systems. Some moves have been initiated by the CSC to create a new methodology that assists staff to map work processes and set targets collaboratively with their managers so that both understand how to objectively measure performance. This initiative could be appraised and considered for support by donor partners if needed.

5.15 Implementing performance-based budgeting systems that effectively integrate budget and performance information and provide meaningful guidance for day-to-day operations has not been

attempted. The difficulties are real but can be overcome if appropriate tools are introduced voluntarily and supported proactively by both national agencies and development partners. A major challenge is upgrading IT capacity and linking that to financial and human resource management systems to support performance improvement. In the late 1990s, the USAID GOLD project created an integrated financial management information system (FMIS) that brought together the functions and information generated by the LGU offices of Budget, Treasury and Accounting. This system continues to be used in Bulacan and Negros Oriental provinces, where the system has been upgraded to include the recent revisions in the National Government Accounting System. Bulacan has also undertaken major IT projects to enhance human resource management as well as procurement, tax collection and other management functions.

5.16 It may be useful to emphasize the spread of generic tools, such as the CSC Public Service Excellence Program, that can be adapted by LGUs to initiate the construction of locally relevant PMS. The Consortium of Centers for Local Governance and the network of DILG/LGA-linked Institutes of Local Government Administration (ILGAs) represent regionally-based support entities with significant experience in supporting local governance processes. Providing technical and financial assistance for such 'demand-driven' capacity-building could be an excellent means for enabling LGUs to recognize the fundamentally facilitating role played by DILG. Ultimately, benchmarking with other LGUs should shift away from awarding Best Practice awards for individual projects towards assessment of the functioning of whole systems. The Province of Bohol has shown that such standards are not beyond the reach of middle-grade LGUs.

# 6. CONCLUSION

## Next Steps

6.1 This report on the Philippines decentralization experience has focused on two themes: (i) LGU access to resources for development, and (ii) cross-cutting processes which ensure accountability for resource use. The intention is to enable the administration to focus on a short to medium term agenda, involving relatively few agencies. The key actions do not involve legislation, nor do they require complex inter-departmental coordination and consultations. Many of the actions can be taken by LGUs themselves, without national government intervention.

6.2 At both the national government and LGUs levels, several sets of immediate actions could potentially strengthen the management of decentralization over the longer term:

- An institutionalized and representative forum for discussing decentralization issues and options[57] now seems necessary. Such a body – perhaps convened periodically -- could provide a forum for stakeholders to debate and reach political consensus on decentralization-related issues. The DILG could appropriately take the lead on this.
- Support for expanding and deepening the capacity-building role of national government oversight agencies is crucial to the quality of LGU performance, and to the implementation of this report's recommendations.
- The national government should encourage LGUs to increase their OSRs though improved revenue collection systems and appropriate policies. These actions include encouraging LGUs to broaden their tax base, undertake periodic reassessments (e.g. of RPT), tighten revenue collection measures. Closer coordination on revenue collection between LGUs and the BIR should be encouraged. The national government should also fulfill its obligations to returning the local land use fees to the LGUs (under the current system, all mines explorers pay the land use fees to the national government which rarely returns the local share to LGUs).
- LGUs need to efficiently manage their expenditures and strengthen the linkages between planning, budgeting, and investment programming[58].
- It is now time to establish a clear and acceptable set of LGU performance assessment indicators, if necessary by providing incentives to LGUs to scale up good practice.
- The DILG plans to merge two of its bureaus. It would be desirable to complete this merger – a step in the right direction - at the earliest and provide a clear mandate and adequate resources to the merged entity. Strengthening DILG policy and technical assistance capability is important for LGU success. So are DILG efforts to strengthen its coordination with the DOF.

6.3 **Partnerships.** Partnering with Philippine institutions in the conduct of this study has provided an opportunity to maximize its relevance. This will be continued. Consultative workshops were held to sharpen the focus of this study, identify the most relevant issues, and 'ground-truth' the recommendations. Participants included representatives from the national government, LGUs, Congress, academia, civil society organizations and donor partners. It is essential that this partnership be continued as the national and local governments continue to seek ways to strengthen decentralization and ensure that it delivers on its promise. The Philippines' development partners stand ready to support this process.

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[57] Somewhat like the now-dormant Decentralization Review Council, with elected representatives from national and local levels, as well as other experts.

[58] The ADB is providing technical assistance to strengthen local planning and expenditure management.

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