
I. Introduction

The objective of the Approach Paper is to detail a practical operational strategy for the Bank in supporting intergovernmental fiscal reforms in the Philippines in the medium-term. Given the expansive scope of the issues in decentralization, the Approach Paper prioritizes the key issue areas that the Bank should focus on based on, among other things, its competitive advantages, the current policy environment and political economy for reform, and the initiatives of other development partners. The Approach Paper builds on a review and synthesis of lessons from the past studies (including on-going and recent ESW), an analysis of key institutional and policy bottlenecks, and the engagement of various stakeholders to outline a proposed program of activities for engaging national and local government to pursue decentralization reforms.

The Approach Paper identifies four broad sets of binding constraints that weaken the capacity of local governments to provide basic devolved services and to drive local economic growth. The binding constraints are:

- **High level of fragmentation in sub-national government**, which results in weak economies of scale in public administration and service provision.
- **Weak political and institutional environment for local accountability**, specifically: a) a lack of clarity in the division of responsibilities between national government agencies and local governments for service delivery in devolved sectors; b) weak systems for monitoring and evaluating local service delivery; c) weak social and electoral accountability for local government performance; and d) the proliferation of procedural requirements and unfunded mandates from oversight agencies and nationally-enacted laws and policies.
- **Inefficiencies and inequities in local resource bases**, specifically: a) a mismatch between local government fiscal capacities and local service delivery responsibilities; b) weak local fiscal autonomy from local tax bases; c) inequities in the assignment of taxing powers across levels of local government; and d) limited options for local government infrastructure investment financing.
- **Weak capacity for public administration and service provision in sub-national government**, specifically: a) weak local government capacity for core functions of planning, budgeting, financial management, and revenue mobilization; and b) weak local government capacity for capital investment planning and debt management.

Recognizing the need to focus the Bank’s efforts on a discrete set of strategic activities, the Approach Paper seeks to prioritize policy reform initiatives and programs that are focused on strengthening accountability mechanisms and institutionalizing systems for public monitoring and evaluation of local governments. It also recognizes the importance of political economy issues and proposes avoiding heavy investments in structural reforms that require national legislation unless the new administration demonstrates a strong political commitment to such reforms and the political and economic environment presents opportunities for legislative revisions. Finally, the Approach Paper recognizes that the Bank’s strategy should ultimately consider the priorities of the new administration in local governance and decentralization and focus on common areas of interest.
In line with these principles, the Approach Paper puts forth five strategic areas that are grouped into two broad thrusts. Three strategic areas are focused on strengthening the institutional environment for local service delivery and local economic growth for all local governments, namely: a) to engage the national government on incentive systems for local government performance; b) to engage provinces to optimize their role as inter-local government coordinators; and c) to undertake sector reviews of devolution of local services. Two strategic areas are focused on strengthening the capacity of major cities and metropolitan areas to serve as engines of economic growth, namely: d) to engage major cities and metropolitan areas to support critical infrastructure investments; and e) to engage the national government on facilitating local government access to private credit.

The Approach Paper is organized as follows:

- Section II provides a brief background on the key motivations for decentralization reforms in the Philippines.
- Section III identifies and discusses the various binding constraints in the current intergovernmental fiscal arrangements.
- Section IV provides a summary table of the binding constraints.
- Section V proposes a strategy for the Bank for supporting decentralization reforms in the Philippines.
- Section VI identifies the resources needed to implement the proposed strategy.
II. Background – Motivations for Decentralization Reforms

The passage of the Local Government Code (LGC) of 1991 represents a turning point in the history of Philippine governance by providing local governments with extensive autonomy and resources and by formally decentralizing local public administration and service delivery responsibility in various sectors to local government units (LGUs). It also entrusts local political leaders, duly elected through a democratic process, with the responsibility of guiding the development process in their respective localities.

With the enactment of the LGC, the statutory responsibility for providing and financing the following services was devolved to LGUs:

- land use planning
- agricultural extension and research
- community-based forestry
- solid waste disposal system
- environmental management
- pollution control
- primary health care
- social welfare services
- hospital care
- local public buildings and structures
- local public parks
- local services and enterprises (e.g., public markets, public markets, slaughterhouses, etc.)
- local infrastructure facilities (e.g., local roads and bridges, school buildings, health facilities, housing, communal irrigation, water supply, drainage, sewerage, flood control, etc.)
- environmental management
- pollution control
- local infrastructure facilities (e.g., local roads and bridges, school buildings, health facilities, housing, communal irrigation, water supply, drainage, sewerage, flood control, etc.)
- primary health care
- social welfare services

Along with the devolution of basic local services, the Code provides LGUs with enhanced access to fiscal transfers through the Internal Revenue Allotment (IRA), expanded powers of taxation, and the power to create indebtedness and to avail of credit facilities. The increased fiscal capacities of LGUs, mainly as a result of the IRA and the assignment of specific local taxes, have enabled local governments to increase their share of expenditures relative to the country’s Gross National Product (GNP) from 1.9 percent in 1991 to 3 percent in 2007. Own-source revenues generated by LGUs have increased at a slower rate, from 0.8 percent of GNP in 1991 to 1.1 percent in 2007.

Despite this strong shift towards devolution, LGUs have not fully realized their collective potential as envisioned by those who crafted and helped to enact the law. There remain major opportunities to pursue decentralization reforms that will unlock the potential of local governments in terms of delivering basic services and serving as engines of economic growth and development.

Evidence of Weak Outcomes from Local Service Delivery

Hard evidence on LGUs’ service delivery performance is scarce given the inaccessibility of data disaggregated to the local level. The available evidence suggests that the impact of devolution on service delivery has been uneven, at best. Table 1 presents a simple Human Development Index (HDI) transition matrix which indicates whether provinces, grouped by their HDI scores in 1990, progressed, regressed, or stagnated over the following 10 years. Of the 74 provinces analyzed, only eight (in bold) managed to improve their scores enough to move up to the next higher cohort while three provinces (italicized) actually registered lower HDI scores.

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1 Socio-economic data in the Philippines is typically disaggregated to the regional level, which corresponds to the administrative deconcentration of national government agencies rather than the jurisdictional decentralization of local governments.
Furthermore, a recent study found that the growth in provincial income in the years since decentralization has had weak impacts on poverty reduction.\(^2\) Econometric analysis of provincial data from 1988 to 2000 indicated a significant and positive relationship between the rate of mean income growth and the rate of poverty reduction at the provincial level. The estimate of the growth elasticity of poverty reduction is approximately 1.3, which pales in comparison to estimates from other developing countries such as China (2.9), Indonesia (3.0), and Thailand (3.5).\(^3\) The historically low level of economic growth of the Philippines compared to its peers in East Asia, coupled with its low growth elasticity of poverty reduction at the sub-national level, are important factors behind the country’s slow rate of poverty reduction.

**Evidence of Weak Outcomes in Economic Development**

With the passage of the Code, there were high expectations that LGUs would invest heavily in local infrastructure given the well-accepted notion that adequate infrastructure is critical for economic growth. However, evidence has shown that the growth in local infrastructure has been weak since the onset of decentralization. Past studies have asserted that while overall LGU expenditures have doubled as a share of GNP since decentralization (from 1.6 percent in 1985-91 to 3.3 percent in 1992-2003), the LGU infrastructure expenditure share has largely remained unchanged.\(^4\) Furthermore, LGU infrastructure investments as a share of total LGU capital outlays have actually contracted (from 59.6 percent in 1985-91 to 34.6 percent in 1992-2003).

Unsurprisingly, evidence suggests that LGUs have also not succeeded in fully maximizing their growth potential and have not fulfilled one of the key motivations behind the push for devolution in the late 1980s, which was to change the Manila-centric pattern of growth by empowering other regional centers of economic activities. In fact, a recent study has found that decentralization has not led to a more diversified pattern of growth across regions.\(^5\) Economic growth in the country since the enactment of the Code has continued to be driven by the National Capital Region (Metro Manila). The share of Gross Domestic Product (GDP) contributed by NCR actually increased from 32.8 percent in 1991 to 37.3 percent in 2007, while the shares of Visayas and Mindanao decreased over the same period, from 16.0 percent and 17.7 percent, respectively, to 15.7 percent and 17.0 percent.

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\(^3\) Estimates were made by Cline (2004). Furthermore, Ravallion (2001) estimated an average growth elasticity of 2.5 for 47 developing countries.


III. Binding Constraints in the Current Intergovernmental Fiscal Arrangements

The weak outcomes at the sub-national level are rooted in a set of binding constraints in the current framework and implementation of decentralization in the Philippines. These constraints have negatively affected the incentives and capacities of LGUs to fulfill their primary roles as basic service providers and, in the cases of larger and more urban jurisdictions, as engines of economic growth. These binding constraints are: 1) a high level of fragmentation in sub-national government and a corresponding weak institutional environment for effective inter-LGU coordination; 2) weak political and institutional environment for LGU accountability; 3) inequities and other distortions in the LGUs’ resource bases; and 4) weak technical capacity among LGUs. These are discussed in turn in this section.

High level of fragmentation in sub-national government

All in all, the high level of fragmentation in sub-national government in the Philippines contributes to inefficient local public administration and service delivery due to weak economies of scale and the poor institutional and policy environment for inter-jurisdictional coordination. These fundamentally limit the ability of many LGUs to provide basic services efficiently and adversely affect the capacity of major cities and metropolitan areas to function as engines of economic growth.

The historical roots of local governments in the Philippines, along with the archipelagic geography of the country, have translated into a hyper-division of jurisdictional boundaries, resulting in a local government system comprised of a large number of small jurisdictions at each level of sub-national government (approximately 80 provinces, 120 cities, 1,500 municipalities, and 42,000 barangays) relative to population (approximately 90 million). This severe fragmentation reduces the efficiency of basic service delivery, particularly as each LGU at every level demands a basic organizational structure with inherent overhead costs, and complicates inter-LGU coordination/cooperation. This problem is particularly acute in devolved sectors where the high level of fragmentation among LGUs results in the increased costs of decentralization due to inter-jurisdictional spillovers and loss of scale economies in service provision. The devolved services where the coordination at the geographic level extending beyond municipal/city boundaries is crucial include the development and maintenance of road networks, health referral systems, environmental management, and the provision of public utilities, such as water and electricity.

Figure 1 shows a statistically significant, inverse relationship between the population size of municipalities and the share of expenditures allocated for General Public Services. This suggests that because of lack of scale, smaller LGUs are forced to spend a larger share of LGU expenditures on overhead administration costs – rather than direct service delivery – compared to relatively larger LGUs.

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6 In 2007, the average city population was 265,000 while the average for cities outside Metro Manila was 194,000. The average municipal population was 38,000.

7 This finding is consistent with the classic Decentralization Theorem (Oates, Wallace. 1972. Fiscal Federalism. NY: Harcourt Brace Jovanovich.)

8 The relationship is statistically significant at the 0.01 level with an R² of 0.09. General Public Services expenditures include general administration expenditures that cannot be attributed to other sectors/departments of the LGU.
In terms of political effects, the hyper-division of LGUs tends to reinforce the entrenchment of dynastic clans that control political and economic affairs for each small jurisdiction. The small size of the jurisdiction to be “captured” means that it is relatively costless, both politically and financially, for a local clan to establish and sustain dominance over the territory and turn it into their political bailiwick with high entry barriers for new entrants into the local political scene. The severe fragmentation has also made it easier to perpetuate a patron-client political culture at the local level, wherein local chief executives concentrate on publicly-provided private goods (e.g., free medicines and emergency hospital treatment, subsidies for burial costs, scholarships) rather than local public goods (e.g., public health and day care services, improved and well-maintained roads, school buildings, and public infrastructure, etc.).

The proliferation of rival political clans in neighboring jurisdictions also weakens incentives for inter-LGU cooperation and coordination in service delivery and investments. The existing system of LGU finance (particularly the automatic IRA transfer and the proliferation of congressional allocations that bypass higher levels of local government) reinforces the individualism of LGUs and creates further disincentives for cooperation. Unsurprisingly, Regional Development Councils, which are organized by the National Economic Development Authority (NEDA) at the regional level and include the membership of all the LGUs in the region, have been found to be largely ineffective in serving their mandated role as coordinating bodies for national and local government strategies and investments at the regional level.

**Weak political and institutional environment for LGU accountability**

Presently, the mechanisms for holding local chief executives accountable for performance are weak and frequently ineffective. This is driven by several major factors, including the confusing and overlapping assignment of service delivery functions across levels of government, weak social and electoral accountability, and the national government’s extensive procedural requirements and unfunded mandates to LGUs. All in all, the weak systems for LGU accountability result in weak demand-side

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9 The larger the jurisdiction to be controlled, the greater the need for local political elite to form an alliance/coalition with others, including, in some cases, with their political rivals, thus forcing them to engage in more cooperative political behavior.
pressure for LGUs to function more efficiently as public service providers and as engines of economic
growth.

Unclear division of responsibilities for devolved functions – While a large set of basic services has been
statutorily devolved to the local governments in the Philippines, the reality is that there is a multi-
tracked system of service delivery in practically every sector. Inequities in LGU resource bases (as
discussed in the next sub-section) limit the fiscal capacity of local governments to provide all the
services that were decentralized to them by the LGC. Concurrently, national government agencies
(NGAs) leverage on loopholes in the Code to “fill in the gaps,” such that the NGAs continue to play major
roles in the direct delivery and finance of local services. Importantly, legislators and the President utilize
discretionary funds to directly finance local projects, which are often not coordinated with the LGUs
where the projects are located.

The complex division of responsibilities for the delivery and finance of local services between central
and sub-national governments that is prevalent in the Philippines is consistent with the emerging
literature on ‘partial decentralization’ (in contrast to full decentralization where local governments have
full autonomy over both service provision and finance).\(^{11}\) The experience of ‘partial decentralization’ in
other countries is that the diluted lines of accountability for local services result in a governance trap.\(^ {12}\)
As locally elected officials blame poor services on inappropriate design and insufficient funding from the
national government, citizens continue to perceive the national government as responsible for public
services and hold them accountable when things go wrong. As a result, the national government
continues to justify its central role in local service provision and continues to retain budget and service
delivery responsibilities. Local politicians, on the other hand, face strong incentives to take advantage of
the situation to capture the political process for patronage and clientelism.\(^ {13}\) All in all, the expected
benefits of decentralization due to greater local accountability and better preference-matching are
severely compromised.

A recent WB study on local service delivery in the Philippines illustrates the problem of ‘partial
decentralization’ in the local roads sector. The LGC assigns to provinces, cities, and municipalities the
primary responsibility for the planning, construction, improvement, and maintenance of local roads that
were administratively transferred to them, i.e., provincial roads, city roads, and municipal roads,
respectively. However, while the LGC assigns to barangays the responsibility for maintaining barangay
roads (i.e., farm-to-market roads that connect local communities to the urban/semi-urban centers of
cities and municipalities) it is unclear about who is primarily responsible for barangay road planning,
construction, and improvement. Case study data on local road expenditures for two cities and three
municipalities located in two provinces indicates that the national government, through the Department
of Public Works and Highways (DPWH), retains a strong role in barangay road provision.\(^ {14}\) The share of
local road and bridge investments financed and implemented through DPWH in 2004-07 exceeded 90
percent for the barangay road networks in three of the five case study cities/municipalities and
exceeded 60 percent in another (see Table 2). In contrast, the vast majority of expenditures on city and


municipal roads in the case study LGUs were undertaken by the city and municipal governments themselves.

Table 2: Road Expenditures by Funding Source in Case Study LGUs, 2004-07
(Real 1985 Pesos, in PhP thousands)

<table>
<thead>
<tr>
<th>Road Class / Case Study LGU</th>
<th>Total Expenditures</th>
<th>Expenditures per km.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% LGU</td>
<td>% NGA</td>
</tr>
<tr>
<td>City/Muni Roads</td>
<td></td>
<td></td>
</tr>
<tr>
<td>City A</td>
<td>87%</td>
<td>13%</td>
</tr>
<tr>
<td>City B</td>
<td>98%</td>
<td>2%</td>
</tr>
<tr>
<td>Municipality A1</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Municipality A2</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Municipality B</td>
<td>87%</td>
<td>13%</td>
</tr>
<tr>
<td>Barangay Roads</td>
<td></td>
<td></td>
</tr>
<tr>
<td>City A</td>
<td>0%</td>
<td>100%</td>
</tr>
<tr>
<td>City B</td>
<td>84%</td>
<td>16%</td>
</tr>
<tr>
<td>Municipality A1</td>
<td>2%</td>
<td>98%</td>
</tr>
<tr>
<td>Municipality A2</td>
<td>39%</td>
<td>61%</td>
</tr>
<tr>
<td>Municipality B</td>
<td>4%</td>
<td>96%</td>
</tr>
</tbody>
</table>

In each of the LGUs where DPWH undertook the majority of barangay road expenditures, the mayors of the LGUs essentially said that although the barangay roads are integral infrastructure in their jurisdictions, the LGUs did not have the primary responsibility for financing barangay roads and they simply did not have the resources to invest substantially in these roads. The local communities, through their barangay officials, were then compelled to request for support from their local congressmen to finance barangay roads projects through the latter’s discretionary allocations. As a result, what ends up getting funded are numerous small-scale roads projects that are not integrated within a cohesive local road plan. In fact, DPWH investments in local roads were often not coordinated with the LGUs and were typically determined based on political calculations of the congressmen. Furthermore, because of the sheer extensiveness of the barangay road networks (particularly in municipalities, wherein the municipal road networks are commonly less than one-tenth the length of the barangay road networks), the expenditures on barangay roads on a per kilometer basis are significantly less than the expenditures on city and municipality roads, suggesting poor quality and limited sustainability of the constructed roads.

As a consequence of the convoluted division of responsibilities for the local road sector in the Philippines, local road conditions continue to be poor, even as local officials are able to avoid accountability for outcomes in this sector, which is typically cited by citizens as one of the most important local public goods. The weak institutional environment for local accountability, coupled with stark inefficiencies and inequities in LGU resource bases, create strong incentives for local officials to rely on lobbying for resources directly from national government and legislators, rather than to mobilize resources from local tax bases.

National legislators and, to a certain extent, even the president continue to use discretionary funds (e.g., Priority Development Assistance Funds, which are allocated to congressmen and senators) to finance local roads projects to curry favor with local voters, thus perpetuating a culture of transactional and clientelist politics. While the local roads sector presents one facet of ‘partial decentralization’ in the Philippines, other devolved sectors such as health, agriculture, water supply, and environmental management are also afflicted by unclear divisions of responsibility for service delivery between the

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15 Only 7 percent of barangay roads were reported to be paved as of 2000, up from 2 percent in 1981, compared to 34 percent for municipal roads and 77 percent for city roads.
central and local government. However, the specific issues in each sector are unique and the lessons from the local roads sector may not apply directly to these other sectors.

For example, one option for solving this mismatch of resources and responsibilities in the roads sector would be to formally assign the responsibilities of managing the barangay road networks to cities and municipalities, which are relatively better funded vis-à-vis their service delivery responsibilities compared to the impoverished barangays. In the health sector, in contrast, the overwhelming issue is the weak fiscal capacity of the provinces to maintain, operate, and improve the hospital systems that were devolved to them without corresponding adjustments to their resource bases. Here it would not make sense to transfer these provincial hospitals to, say, the highly-urbanized cities in the provinces simply because the latter have comparatively greater fiscal capacities. Addressing the problem of partial decentralization therefore demands a sector-by-sector approach, rather than a uniform, “one size fits all” approach.

**Weak social and electoral accountability –** The LGC instituted mechanisms to institutionalize citizen participation in the LGU planning and budgeting processes, primarily through special bodies such as the local development council and the local health and school boards. However, the functionality of these special bodies varies significantly across LGUs and the voice of non-government stakeholders in local governance is generally very weak.\(^\text{16}\) No systematic information on LGU performance is available to allow voters to assess their local governments’ performance and use elections to reward good performers and punish laggards. Not surprisingly, perhaps, recent research has suggested that local elections have been ineffective instruments for holding local chief executives accountable for their performance in service delivery.

Table 3 below summarizes the outcome of the 2001 election of provincial governors vs. the change in the HDI scores of their provinces over the preceding six year period (equivalent to two full electoral terms). The re-election rates of the governors who presided over significant increases in HDI scores (i.e., over 10 percent) were not necessarily higher compared to those who presided over negligible changes in HDI scores (i.e., no change or decrease).

<table>
<thead>
<tr>
<th>Change in HDI Score</th>
<th>Re-elected</th>
<th>Defeated</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 20%</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>10 – 20%</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>0 – 10%</td>
<td>24</td>
<td>9</td>
</tr>
<tr>
<td>0% (no change)</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>&lt; 0%</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total (n=56)</strong></td>
<td><strong>36</strong></td>
<td><strong>20</strong></td>
</tr>
</tbody>
</table>

Furthermore, a more recent study that utilized 2004 and 2007 gubernatorial elections data suggests that performance, as measured using a model-based Good Governance Index, is not strongly associated with election results.\(^\text{17}\) Good performance did not appear to be sufficient for a gubernatorial candidate to win while bad performance still seemed to have been rewarded in the 2007 elections.

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Weak systems for monitoring and evaluating local service delivery — A review of past measures to assess the quality of local governance revealed that dozens of measures, using both quantitative and qualitative methods, have been developed since 1992. However, practically all these indicator systems were greatly limited by at least one of the following factors: 1) measures were piloted in a small sub-set of LGUs but were never scaled up to the national level (e.g., Governance Quality Index, Governance for Local Development Index); 2) measures were carried out periodically but were limited to a single level of local government (e.g., Cities Competitiveness Ranking); and 3) measures were implemented nationwide on a one-shot basis and have not been repeated (e.g., Filipino Report Card on Pro-poor Services).

With regard to sector-specific performance and socio-economic indicators, these are typically reported at the regional level and are not disaggregated to the LGU level (e.g., Family Income and Expenditure Survey). The one system that has been instituted on a national-scale at the local government level is the Local Government Performance Management System (LGPMS) of the Department of the Interior and Local Government (DILG), which is a web-based system comprised of numerous indicators to help LGUs assess their capabilities and performance in the delivery of essential services. However, LGPMS is severely constrained by the fact that it is a self-administered tool, wherein the data entered is generated by the LGU itself, and access to its database is strictly restricted to the LGUs and DILG, which prevents the public from accessing and scrutinizing the data.

All in all, in spite of numerous piecemeal efforts, the Philippines still does not have a reliable and comprehensive system for measuring local governance and service delivery. The absence of nationwide systems for monitoring and evaluating local services has prevented cross-LGU comparisons of performance and compromised one of the expected benefits of decentralization, which is the competition among local governments to stimulate greater responsiveness to the needs of constituents.

Onerous procedural requirements and unfunded mandates from the center — LGUs are subjected to a multitude of mandates and requirements from NGAs and national laws, most of which are focused on dictating LGU inputs/expenditure requirements, which typically do not take into consideration the fiscal capacities of LGUs to carry out these mandates, and LGU processes, which are generally not harmonized nor coordinated among the respective oversight NGAs. Unfunded mandates to LGUs include the Salary Standardization Law, additional benefits for health workers under the Magna Carta for Health Workers, and waste disposal facilities under the Solid Waste Management Act. LGUs commonly struggle to comply with these laws, with many smaller and poorer LGUs deciding to simply ignore them under the threat of legal penalties.

Different oversight agencies are responsible for providing planning guidelines for different levels of LGUs (e.g., DILG oversees barangay, municipal, and city planning processes while NEDA oversees provincial

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19 To illustrate, in the course of pre-testing the survey instrument for local service delivery survey in the Province of Isabela, the survey team had to discard a question regarding household perceptions of the quality of the public services in their own municipality compared to those in neighboring municipalities because most respondents were unable to offer any informed view of the question.

Multiple planning requirements abound at the local level, encompassing both cross-sectoral plans (e.g., LGU comprehensive development plan, comprehensive land use plan, local development investment plan, executive-legislative agenda) and sector-specific plans (e.g., gender and development plan, local poverty reduction action plan, local agricultural productivity and development plan, solid waste management plan, coastal resource management plan). These planning requirements generate significant compliance costs for LGUs, although their impact in substantially improving the quality of resource management by the LGUs is dubious. Furthermore, the NGAs themselves have shown very weak capacity to monitor and enforce LGUs’ compliance with these requirements.

Inequities and inefficiencies in LGU resource bases

Establishing appropriate levels of funding across levels of government in a decentralized system is a tricky matter. This, however, is critical to designing a well-functioning inter-governmental system for effective governance. The current inter-governmental fiscal arrangement in the Philippines is sub-optimal in many ways, which severely compromises the ability of LGUs, particularly the small, rural municipalities and provinces that represent the majority of LGUs, to adequately provide the local basic services assigned to them by the LGC. Furthermore, the limited options for LGU infrastructure investment have especially constrained the ability of major cities and metropolitan areas to invest heavily in critical infrastructure that can drive economic growth.

Weak LGU fiscal autonomy from local tax bases – While the LGC devolves considerable responsibilities to local governments for service delivery, the taxing powers assigned to LGUs are vastly insufficient to carry out these duties. Table 4 below details the shares of LGUs in general government expenditures (net of debt service) and general government revenues. While the share of local government expenditures out of general government expenditures more than doubled from 11.4 percent in 1985 to 25.4 percent in 2003, the share of local government revenues only increased from 5.9 percent of general government revenues to 8.0 percent. The fiscal autonomy of local governments in the Philippines has actually deteriorated, as local revenues funded more than half of local expenditures in 1985 compared to less than one-third in 2003.

<table>
<thead>
<tr>
<th>Year</th>
<th>% Share in General Gov. Exp.</th>
<th>% Share in General Gov. Rev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>11.4</td>
<td>5.9</td>
</tr>
<tr>
<td>1991</td>
<td>12.6</td>
<td>4.6</td>
</tr>
<tr>
<td>1995</td>
<td>21.8</td>
<td>5.9</td>
</tr>
<tr>
<td>2001</td>
<td>25.7</td>
<td>7.7</td>
</tr>
<tr>
<td>2003</td>
<td>25.4</td>
<td>8.0</td>
</tr>
</tbody>
</table>

Table 5 summarizes the various taxes that are assigned to LGUs in the LGC. Cities have the widest range of taxing tools available while provinces and municipalities either have no access to certain tax measures or are required to share the proceeds with sub-levels of LGUs, which dampens their incentives to invest in improving tax collection capability. In addition to local taxes, LGUs are allowed to levy user fees and charges on businesses and occupations. Several key tax bases are reserved for the national government, including the personal and corporate income tax, custom duties, the value added tax, and excise taxes on alcoholic beverages, tobacco products, and petroleum products.

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Table 5: Summary of LGU Tax Assignments

<table>
<thead>
<tr>
<th>Local Tax</th>
<th>Cities</th>
<th>Provinces</th>
<th>Municipalities</th>
<th>Barangays</th>
</tr>
</thead>
<tbody>
<tr>
<td>On Real Property Transfers</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Business of Printing and Publication</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Franchises</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Sand, Gravel, and other Quarry Resources</td>
<td>X</td>
<td>X</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>On Amusement Places</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Professionals</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Delivery Vans and Trucks</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Real Property</td>
<td>X</td>
<td>X</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>On Idle Lands</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Businesses</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>On Community Tax</td>
<td>X</td>
<td>X</td>
<td></td>
<td>*</td>
</tr>
</tbody>
</table>

* Shares in the proceeds of the higher level LGU that collects the tax.

While local tax assignment is generally consistent with the traditional criteria of appropriateness – economic efficiency, equity, and administrative feasibility – the majority of the productive tax bases are restricted to the national government. Among the local tax bases, only the real property tax and business tax bases provide substantial local revenues, although these tax bases are commonly very small for many rural LGUs. The LGC also limits the power of LGUs to set tax rates by specifying floors and ceilings on the tax rates that can be imposed and, in some cases, fixed rates on local taxes. Furthermore, the LGC allows LGUs to adjust tax rates only once every 5 years and by no more than 10 percent.

Inequities in local tax assignment – While the mismatch between expenditure responsibilities and revenue powers is evident across LGUs, variations in tax assignments across the levels of LGUs result in more severe fiscal gaps for some LGUs. Specifically, cities are generally allowed to set higher tax rates compared to provinces and municipalities. The broader range of taxes and higher rates available to cities coupled with the requirement for provinces and municipalities to share real property tax collections, typically a primary source of local revenues, result in wide disparities in local revenue mobilization between cities, on one hand, and municipalities and provinces, on the other. The vertical fiscal imbalance is further exacerbated for provinces given their lack of access to business taxes, which only cities and municipalities can collect. This is illustrated in Table 6, which shows the shifts in the shares of own-source revenues among the three levels of LGUs since the institution of the LGC in 1991.

Table 6: Distribution of Own-source Revenues of LGUs by Level of Government, 1985-2003 (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>All LGUs</th>
<th>Provinces</th>
<th>Municipalities</th>
<th>Cities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>100.0</td>
<td>18.4</td>
<td>38.9</td>
<td>42.7</td>
</tr>
<tr>
<td>1995</td>
<td>100.0</td>
<td>14.8</td>
<td>31.7</td>
<td>53.5</td>
</tr>
<tr>
<td>2001</td>
<td>100.0</td>
<td>11.9</td>
<td>23.3</td>
<td>64.8</td>
</tr>
<tr>
<td>2003</td>
<td>100.0</td>
<td>10.1</td>
<td>22.1</td>
<td>67.9</td>
</tr>
</tbody>
</table>

Among the three main levels of LGUs, provinces are short-changed in the local tax assignments of the LGC. Provinces are not allowed to levy business taxes, which, along with real property taxes, are the most productive of LGU own-source revenues. Secondly, the maximum allowable real property tax levy for provinces is just 1 percent compared to 2 percent for cities. Furthermore, the lower tax ceiling for provinces is exacerbated by the fact that the assessed values of real property in provinces, which are predominantly based on rural areas, are typically much lower per unit of measure compared to cities.

which are relatively more urban. Finally, due to the fact that provinces do not have access to revenue-productive business taxes, the buoyancy of own-source revenues of provinces pale in comparison to cities and municipalities (see Table 7).

<table>
<thead>
<tr>
<th>Table 7: Buoyancy of Own-source Revenues of LGUs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provinces</td>
</tr>
<tr>
<td>Municipalities</td>
</tr>
<tr>
<td>Cities</td>
</tr>
</tbody>
</table>

Weak effects of IRA on equalizing fiscal capacities – The current IRA formula\(^{26}\) does a poor job of compensating for the varying levels of fiscal capacities of LGUs, often worsening the horizontal imbalance among LGUs of the same level. Figure 2 shows the average IRA transfers for the three types of LGUs classified according to the amounts of own-source revenues they generate. The data shows that on average the IRA distribution to the provinces is highly regressive, allowing those provinces with the highest own-source revenues to receive three times more IRA than those with the least own-source revenues. The distribution, however, is somewhat less regressive for municipalities and progressive for cities.

The pattern of horizontal imbalance is also evident when we look at expenditure data for specific LGUs. Table 8 compares the overall health expenditures over a five-year period of two provinces: one that inherited a tertiary hospital from DOH after devolution in 1991 (province B) and another that did not (province A). While province A’s health expenditures per capita were generally in line with national averages, province B’s expenditures were more than twice the average as a result of higher operating costs and investment needs of the tertiary hospital. Province B has been forced to allocate much larger shares of both the total spending and the IRA to health.

\(^{26}\) The LGC mandates that 40 percent of national internal revenues based on the collections of the third fiscal year preceding the current fiscal year shall be allotted to LGUs. The IRA is first subdivided among the different levels of LGUs using the following distribution: provinces (23 percent), cities (23 percent), municipalities (34 percent), and barangays (20 percent). The shares for each level of LGU are then allocated horizontal for provinces, cities and municipalities based on the following formula: population (50 percent), land area (25 percent), and equal sharing (25 percent). For barangays, the horizontal sharing is based on: population (60 percent) and equal sharing (40 percent). The IRA is by nature an unconditional block grant that is automatically released to the LGUs five days after the end of each quarter.
Table 8: Cumulative Health Expenditures in Case Study Provinces, 2003-07
(Real 1985 Pesos, in PhP thousands)

<table>
<thead>
<tr>
<th>Province A</th>
<th>Province B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Expenditures</td>
<td>95,934</td>
</tr>
<tr>
<td>-Personal services</td>
<td>77,310</td>
</tr>
<tr>
<td>-MOOE</td>
<td>16,250</td>
</tr>
<tr>
<td>-Capital Outlay</td>
<td>2,373</td>
</tr>
<tr>
<td>Annual Exp. Per Capita</td>
<td>16</td>
</tr>
<tr>
<td>-Personal services</td>
<td>13</td>
</tr>
<tr>
<td>-MOOE</td>
<td>3</td>
</tr>
<tr>
<td>-Capital Outlay</td>
<td>0</td>
</tr>
<tr>
<td>Estimated Average National Annual per Capita Expenditure on Health</td>
<td></td>
</tr>
<tr>
<td>Health expenditure/Total Expenditure</td>
<td>20.1%</td>
</tr>
<tr>
<td>Health expenditure/IRA</td>
<td>21.2%</td>
</tr>
</tbody>
</table>

Table 10 below further demonstrates the indifference of the IRA with regard to the actual expenditure burdens of the two case study provinces in the road sector. Province A, even though it has a smaller land area and population, has a provincial road network that is three times longer than Province B. As a result, the average IRA per kilometer of Province B over 2003-07 was more than three times that of Province A (PhP 466 per km. vs. PhP 1,479 per km.). Similar disparities are evident in the comparison of the two case study cities, wherein City A’s relatively longer road network resulted in an average IRA per kilometer that was less than one-fifth that of City B (PhP 1,597 per km. vs. PhP 8,698 per km.).

Vertical inequities in IRA formula – Studies have suggested that the statutory formula for distributing the IRA across the different levels of LGUs is inconsistent with the distribution of expenditure responsibilities among the different levels. The following table compares an estimate of the distribution of the costs of devolved functions immediately after devolution in 1991 with the IRA allocation formula and suggests that cities are the clear beneficiary of the IRA allocation formula. The access to increased IRA transfers is the primary reason why since devolution, there has been a push among municipalities to convert to cities.

Table 9 – IRA Distribution vs. Estimated Share of Devolved Functions

<table>
<thead>
<tr>
<th></th>
<th>% IRA Share</th>
<th>% Share of Devolved Functions post-LGC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provinces</td>
<td>23%</td>
<td>46%</td>
</tr>
<tr>
<td>Cities</td>
<td>23%</td>
<td>7%</td>
</tr>
<tr>
<td>Municipalities</td>
<td>34%</td>
<td>46%</td>
</tr>
<tr>
<td>Barangays</td>
<td>20%</td>
<td>Negligible</td>
</tr>
</tbody>
</table>

This issue is patently illustrated with the way the IRA distribution relates to the relative needs for public spending in the roads sector. Table 9 below summarizes the distribution of IRA and road expenditures on a per km basis in a sample of seven LGUs in two provinces. In this sample, both provinces receive far

29 The number of cities has more than doubled from 60 cities in 1991 to 138 cities at the end of 2009.
less IRA allocations per kilometer than their component cities and municipalities, which have substantially less spending needs as indicated by their far shorter road lengths.

Table 10: Relative Resource Availability and Spending in LGU Road Sector for Case Study LGUs, 2003-07
(Real 1985 Pesos, thousands)

<table>
<thead>
<tr>
<th>Road Class</th>
<th>IRA</th>
<th>Total LGU Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Per Km</td>
</tr>
<tr>
<td><strong>Provincial Roads</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Province A</td>
<td>452,743</td>
<td>466</td>
</tr>
<tr>
<td>Province B</td>
<td>633,076</td>
<td>1,479</td>
</tr>
<tr>
<td><strong>City/Muni Roads</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>City A</td>
<td>106,369</td>
<td>1,597</td>
</tr>
<tr>
<td>City B</td>
<td>173,954</td>
<td>8,698</td>
</tr>
<tr>
<td>Municipality A1</td>
<td>24,284</td>
<td>3,624</td>
</tr>
<tr>
<td>Municipality A2</td>
<td>14,553</td>
<td>2,347</td>
</tr>
<tr>
<td>Municipality B</td>
<td>58,853</td>
<td>4,946</td>
</tr>
</tbody>
</table>

Disincentive effects of IRA on local revenue mobilization – The large IRA transfers from the center have a disincentive effect on local tax efforts, as evidenced by the continued high dependency of most LGUs on IRA and limited increase in the generation of own-source revenues over the last 18 years. Based on panel data for provinces and cities in 1995-2000, regression analysis of per capita local tax revenue on per capita IRA allocation confirms the disincentive effect of the IRA on local tax effort.\(^{30}\) The findings suggest that LGUs that receive a larger IRA – whether in absolute terms or relative to their expenditure responsibilities – tend to be lax in their tax effort.

Lack of transparency in allocation of non-IRA transfers – LGUs also benefit from ad hoc grants from national government agencies and legislative funds to support various local services. A study conducted to analyze the quantity and composition of non-IRA transfers to LGUs in 2003 estimated that the aggregate total for these transfers was equivalent to over 20 percent of the total IRA transfer for that year.\(^{31}\) The largest component of this total, comprising 61 percent, was funded by legislative discretionary funds (termed as Priority Development Assistance Funds [PDAF]), which were mainly used to finance local infrastructure, such as roads and barangay facilities. Unlike the formula-based IRA distribution, these non-IRA transfers are distributed to LGUs through a wide variety of mechanisms, ranging from ad hoc grants from legislators to matching grants from national government agencies and donors. There is generally less transparency in the non-IRA funding systems, which has adverse effects on LGU planning and budgeting, and less information available for these miscellaneous transfers.

As discussed earlier, several case study LGUs in a recent WB study on local service delivery in the Philippines indicated a continued heavy dependence on national government transfers for local road investments. In these cases, national funding for local roads mainly was sourced from discretionary funds; the regular budget of national agencies, such as DPWH, the Department of Agriculture (DA), and the Department of Agrarian Reform (DAR);\(^{32}\) and the Motor Vehicle Users’ Charge. Regardless of project source (e.g., DPWH budget or PDAF) and form (e.g., lump sum item or a specific project), the road

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\(^{30}\) Manasan, Rosario G. 2007.


\(^{32}\) The regular budgets of DPWH, DA, DAR, and the Department of Education (DepEd) frequently include budgetary reallocations for specific local projects, which are termed as “insertions,” resulting from the lobbying of congressmen during budget negotiations. Congressmen will claim credit for these local projects even though these were not funded from their PDAF allocations.
expenditures were identified by local congressmen but implemented by a national government agency, such as the DPWH.

DPWH has been the main instrument of the national government in the provision of roads and it commonly undertakes road projects both funded out of its own regular budget and financed by other entities, such as legislators, DA, and DAR. To illustrate the complexity of funding sources for DPWH-implemented projects, the agency’s project implementation reports for the two case study provinces indicated over a dozen different funding sources for capital investment projects undertaken in the provinces from 2004 to 2007.33

**Limited options for LGU infrastructure financing** – The LGC statutorily provides LGUs with considerable flexibility to utilize credit financing, including bank credit, bonds, and build-operate-transfer (BOT) arrangements. There has been a 27-fold increase in borrowing since the LGC was passed, however most of this growth occurred in the 1990s and the overall level of debt service has remained low at around 2-3 percent of total local revenue.34 Proceeds from LGU loans comprised less than 4 percent of income during 1992-2002 and declined to approximately 2 percent during 2003-07. While data from the two major sources of LGU credit (the Land Bank of the Philippines [LBP] and the Development Bank of the Philippines [DBP]) suggests that the majority of LGUs (approximately 60-70 percent) maintain outstanding debt with these government financial institutions, the frequency of borrowing remains low, with less than 8 percent of LGUs undertaking loans in 2007.35

A critical factor behind the relatively low levels of LGU borrowing is the restrictions set by the Bangko Sentral (BSP) that prevent private financial institutions (PFIs) from serving as depository banks of LGUs and using IRA as collateral for LGU loans.36 As a result, private banks play a very limited role in extending financing to LGUs since the access to LGU deposits (and, importantly, the bank-client relationships) has been limited to government financial institutions (GFIs), mainly LBP and DBP. In 1996, the national government adopted the LGU Financing Framework, which was a policy calling for a segmented approach to capital financing wherein lower-income LGUs would have access to subsidized loans and grants from the Municipal Development Fund (MDFO), those in the middle tier could access credit from government financial institutions (GFIs), while upper-tier LGUs could access private commercial finance.

Very little progress has been made in increasing the access of upper-tier, creditworthy LGUs to private capital, which has been a severe limiting factor for infrastructure development in major cities and metropolitan areas.37 The GFIs have thus far been very successful in lobbying the national government in continuing to protect their oligopoly on the LGU credit market. The LGU Guarantee Corporation was created specifically to guarantee municipal bond issues of LGUs financed from private sources, but the rate of bond issues has not accelerated given increased layers of cost on bond issuances. There has been some progress with the involvement of the private sector in infrastructure investments, mostly

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33 These include DPWH funding, congressional funding (upper and lower house), the Office of the President, and various special infrastructure funds that flow to DPWH from other agencies and donors (DepEd, DAR, DA, Special Local Road Fund, Various Infrastructure Local Projects fund, School Buildings Program, Division of City Schools fund, Water System to Waterless Municipalities fund, Social Expenditure Management Program, PWLP, etc.)
34 Based on Department of Finance, Bureau of Local Government of Finance data.
36 BSP issues waivers to these restrictions on a case-by-case basis to facilitate loan transactions between PFIs and LGUs. However, these are exceptional cases and the process for approving waiver requests from PFIs is very long.
through management contracts, but few efforts to use build-operate-transfer arrangements given the very weak institutional and technical environment to support such transactions in the Philippines.

**Weak technical capacity among LGUs**

The weak overall technical capacity of LGUs, particularly in fiscal functions, coupled with complicated and onerous requirements of national oversight agencies, results in minimal transparency in planning and budget preparation, which provides local chief executives a very high level of discretion in allocating local resources. This is a major constraint that limits the ability of LGUs to provide basic services that respond to the specific needs of the local population. Furthermore, even the largest and most advanced city governments in the Philippines have been found to have very poor capacity for capital investment planning and debt management, which is a critical constraint to facilitating increased infrastructure investment in these potential growth engines of the country.

**Broad weakness in LGU capacity for fiscal functions** – Philippine local governments, particularly the numerous smaller LGUs in rural areas, continue to have weak technical capacity to deliver basic services, particularly in terms of institutional capacity for planning, budgeting, and financial management. This weakness is broadly manifested in LGUs in the following ways:

- Many of the planning mechanisms and processes statutorily required by the LGC are not functioning in many local governments – for example, a study estimated that only 30 to 50 percent of LGUs have local development councils in place.
- Furthermore, project prioritization is usually a highly discretionary process influenced very heavily by the local chief executives (i.e., governors and mayors), which is not based on assessment of local development needs and is conducted with little reference to costs and benefits.
- Financial management capacity is weak, with most LGUs still reliant on manual systems wherein the budget and accounting staff are focused on transaction processing with minimal effort on financial advice to management, financial analysis, and managerial accounting and reporting.
- The internal control environment for cash and asset management is weak among LGUs due to weak financial management skills, poor leadership, and weak oversight by NGAs. The internal audit function is non-existent in the vast majority of LGUs.
- The Commission on Audit (COA), which is the supreme auditing institution for government entities in the Philippines, conducts financial audits of all LGUs. However, while COA’s Annual Audit Reports provide an audit opinion on LGU financial statements and highlights issues in local accounting and financial management, these findings are frequently not addressed by the LGUs given the weak environment for holding local officials accountable for correcting these problems.
- LGUs generally have weak capacity in all major tax administration functions – registration, collection, compliance – because of unqualified human resources, inadequate automation of core tasks, and lack of training.

The weak technical capacity among sub-national governments is exacerbated by the proliferation of local planning and budgeting requirements (as discussed in an earlier sub-section). Multiple national oversight agencies issue process-heavy guidelines for LGU planning, budgeting, and expenditure management, which have not been fully harmonized with each other and have created fragmented systems with high compliance costs for the LGUs. Unsurprisingly, evidence suggests that the

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preparation of LGU plans is very uneven and that most LGUs only prepare annual investment plans, which are statutorily required by the LGC in order to enable LGUs to appropriate a 20 percent allocation of the IRA under a special fund (Local Development Fund).\textsuperscript{39}

Weak investment planning and debt management capacity for major cities – A recent credit rating pilot for eight first-tier Philippine cities revealed weak technical capacity for planning and implementing critical infrastructure investments.\textsuperscript{40} Generally, the cities had no stated financial policies and no investment policy outlining medium-term priorities. Multi-year development plans, which were prepared in accordance to DILG requirements, were not backed by investment cost estimates or operating expenditure implications. Furthermore, debt management skills are basic, at best, with none of the cities having stated debt policies. Borrowings (if any) are done on an ad-hoc basis, with the financing decision resting solely on the mayor rather than being driven by long-term financial plans.

The findings suggest that even if major cities that have potential as engines of economic growth are able to access expanded options for infrastructure financing from the private sector, their current capacity to plan and implement complex capital investments is limited. While having increased demand-side pressure for strategic long-term investments in key urban areas is a critical pre-requisite, the weak technical capacity demonstrated by even the most advanced Philippine cities represents an important binding constraint.


\textsuperscript{40} The credit rating analysis and financial management assessments were conducted by Standard and Poors. The pilot cities were Quezon City, Marikina, Taguig, Mandaluyong, Malabon, Naga, Tacloban, and Iligan.
### IV. Summary Table of Binding Constraints in the Current Intergovernmental Fiscal Arrangements

<table>
<thead>
<tr>
<th>BINDING CONSTRAINTS</th>
<th>Fundamental issues affecting LGUs as basic service providers</th>
<th>Fundamental issues affecting LGUs as engines of economic growth (focusing on major cities and metropolitan areas)</th>
</tr>
</thead>
<tbody>
<tr>
<td>High level of fragmentation in sub-national government</td>
<td>• Weak economies of scale in public administration and service provision and weak institutional and policy environment for inter-jurisdictional coordination</td>
<td></td>
</tr>
<tr>
<td>Weak political and institutional environment for local accountability</td>
<td>• Lack of clarity in the division of responsibilities between line agencies and LGUs for service delivery in devolved sectors, which is rooted in a diverse range of issues in each devolved sector</td>
<td>• Weak social and electoral accountability for LGU performance</td>
</tr>
<tr>
<td></td>
<td>• Weak systems for monitoring and evaluating local service delivery</td>
<td>• Proliferation of procedural requirements and unfunded mandates for LGUs from oversight agencies and national laws and policies</td>
</tr>
<tr>
<td>Inefficiencies and inequities in LGU resource bases</td>
<td>• Mismatch between LGU fiscal capacities and local service delivery responsibilities due to: 1) vertical (across the levels of LGUs) and horizontal (among LGUs within the same level) imbalances in the IRA formula; 2) weak LGU fiscal autonomy from local tax bases; and 3) inequities in the assignment of taxing powers across levels of LGUs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Lack of transparency and inefficiencies in the allocation of non-IRA transfers from the national government for devolved services</td>
<td>• Limited options for LGUs infrastructure investment financing due to: 1) exclusion of PFIs from the LGU credit market; and 2) weak institutional environment for public-private partnerships</td>
</tr>
<tr>
<td>Weak technical capacity for public administration and service provision in sub-national government</td>
<td>• Weak LGU capacity for planning, budgeting, financial management, and local revenue mobilization, which is exacerbated by onerous procedural requirements from oversight agencies</td>
<td>• Weak LGU capacity for capital investment planning and debt management</td>
</tr>
</tbody>
</table>
V. Proposed World Bank Strategy for Supporting Decentralization Reforms

The binding constraints in the intergovernmental fiscal system of the Philippines represent a very diverse and daunting set of challenges. The reform measures required to directly address these issues range from revisions of the Local Government Code (e.g., to address structural flaws in the IRA and local tax assignments) to policy reforms led by oversight and sectoral national government agencies to institutional reforms to create stronger demand-side pressure for local accountability. As a development partner that has worked closely with government on local government finance (dating back to Municipal Development Projects in the 1980s and up to the present as co-chair of the Philippine Development Forum, Working Group on Decentralization and Local Government [PDF-WG]), the Bank maintains strong partnerships with the key stakeholders (including DILG, the Department of Finance and its special offices [Municipal Development Fund Office and Bureau of Local Government Finance], NEDA, the Department of Budget and Management, GFIs, and the various leagues of LGUs) which are critical to pushing reforms in this area.

Historically though, the Bank has not utilized a comprehensive approach to supporting the government in supporting reforms to the intergovernmental fiscal system. While the Bank has been involved in numerous activities in this area (including loans for municipal finance [e.g., LOGOFIND, SSLDIP], technical assistance [e.g., City Development Strategies], and partnerships [e.g., PDF-WG, under which various ESW activities have been undertaken]), these have not been planned and implemented in an integrated manner. This approach paper represents an effort to put forth a comprehensive strategy to support decentralization reforms in the Philippines over the balance of the CAS period.

Broad principles for defining the Bank’s strategy for supporting decentralization reform

The sheer magnitude of the binding constraints requires the Bank to focus on a discrete set of strategic activities in order to maximize its resources, leverage on its competitive advantages vis-à-vis other development partners, and build on recent and on-going activities in this area. The following principles are proposed for identifying the strategic priorities of the Bank:

- Taking into account the condition of ‘partial decentralization’ in the delivery of statutorily devolved services in the Philippines, the Bank should build on lessons from recent literature on the topic, which finds strong evidence that in contexts where decentralization has not led to citizens being able to hold local governments accountable for budgetary allocations and their outcomes, reforms that are primarily focused on: a) channeling greater funds to local governments, without taking into account the weak incentives of local officials to efficiently allocate resources; and b) supply-driven capacity-building activities, without taking into account the weak incentives of local officials to strengthen technocratic capacities of the local government; are unlikely to result in effective results. This suggests the need to prioritize policy reform initiatives and programs that are focused on strengthening accountability mechanisms and institutionalizing systems for public monitoring and evaluation of LGU performance.

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• The strategy should objectively take into account the political feasibility of fundamental reforms required to address the binding constraints. A very practical implication of this is that the Bank should avoid investing heavily in supporting structural reforms to the LGC (e.g., for reforms to the IRA and local tax assignments) unless the new administration demonstrates a strong political commitment to such reforms and the political/economic environment presents opportunities for legislative revisions. To illustrate, under the banner of the PDF-WG, ADB and JICA recently supported extensive technical assistance to DILG in identifying alternative options for the IRA formula and a set of revisions to the local tax provisions of the LGC. However, these technical reforms were, in reality, not backed by the full political support of DILG, other national oversight agencies, and the leagues of LGUs, and did not take into account the political environment in the legislature for structural reforms to the LGC. Hence, these efforts did not progress in the legislative process.

• The strategy should support activities where the Bank’s scarce resource can be leveraged for wide-ranging impact while recognizing the great heterogeneity among LGUs. This suggests prioritizing activities that:
  o Have broad potential for addressing binding constraints that both: 1) compromise the ability of LGUs to efficiently provide basic services; and 2) limit the capacity of cities and metropolitan areas to function as engines of economic growth. As per the Summary Table of the binding constraints in the previous section, this suggests focusing on policy reforms and programs that mitigate the high level of fragmentation among LGUs and that strengthen systems for local accountability.
  o Leverage on reforms that are focused on a specific sub-set of LGUs that can produce a broader impact on improved basic service delivery and economic growth. This suggests exploring the potential of provinces (of which there are only approximately 80) as inter-LGU coordinators and providers of incentives for improved LGU performance as well as focusing on capacitating the few critical cities and metropolitan areas that can have potential to serve as regional growth poles and drive national economic growth.
  o Build on existing Bank engagements, including lending (current and pipeline activities), AAA and technical assistance, and partnerships.

• Finally, the strategy should ultimately consider the priorities of the new administration in local government reforms and focus on common areas of interest. This suggests that the Bank immediately engage key policymakers of the new administration after the elections to take stock of their short and long-term priorities and identify specific policy reforms and programs consistent with the Bank’s strategy that Bank may support.

The implications of these principles are that the Bank should avoid investing heavily in certain areas in the near term. These include:

• The Bank should avoid investing heavily in structural reforms to address inefficiencies and inequities in LGU resource basis unless the new administration demonstrates a willingness to invest political capital and the political/economic environment presents opportunities for legislative revisions of the LGC to reform the IRA and local tax assignments. However, support for reforms on the margin that do not require legislative reforms, such as introducing conditional sectoral and/or cross-sectoral block grants, would have a greater potential for success.

42 The political history of decentralization in the Philippines and the current political economy challenges to reform are reviewed in a forthcoming paper from EASPR (“The Political Economy of Decentralization in the Philippines”).
The Bank should avoid investing heavily in supply-driven capacity-building activities, particularly at the municipal level where there are approximately 1,500 LGUs, given the weak incentives for local officials to seriously invest in strengthening local technocratic capacity and the uneven results from many of the government’s past capacity-building initiatives at the local level. It is likely to be more cost efficient for the Bank to focus on strengthening the capacities for provinces, major cities, and metropolitan areas given the relatively more manageable number of these LGUs and certain presumptions of greater incentives for governors and big city mayors to strengthen local technocratic capacity (as discussed below).

**Proposed strategy for supporting decentralization reforms**

The proposed strategy includes five strategic areas that are grouped into two thrusts, with one set of strategic areas that seek to improve the institutional environment for local service delivery and local economic growth for all LGUs and another set of strategic areas more narrowly focused on strengthening the capacity of major cities and metropolitan areas to serve as engines of economic growth.

**Strategic areas for strengthening the institutional environment for local service delivery and local economic growth**

1. **Engage GOP on incentive systems for LGU governance and performance** – This strategic area seeks to mitigate the weak political and institutional environment for local accountability by introducing incentives for LGU performance as well as instituting systems for the monitoring and evaluation of LGU performance. The Bank was in the midst of preparing a pilot project with DOF that was stalled in 2008 due to the onset of the financial crisis and the lack of consensus among the LGU oversight agencies (i.e., DOF/MDFO, DILG, DBM, and NEDA). With the arrival of a new administration in July 2010, there is an opportunity to revive the policy dialogue with the GOP.

   This strategic area seeks to assist the Philippine government in institutionalizing an incentive system for LGUs that includes the following features: a) the provision of financial incentives to LGUs (e.g., in the form of additional block grants on top of the IRA) in exchange for improved performance (e.g., in cross-sectoral functions, such as planning, budgeting, and financial management; and in delivery of basic services); b) the institution of an objective and transparent system for public monitoring and evaluation of LGU performance (e.g., by making the existing self-assessed Local Government Performance Management System of DILG publicly available and introducing the independent measurement and validation of the indicators); and c) the provision of resources for capacity development to facilitate improved LGU performance.

   The parameters of LGU “performance” was originally defined as performance of cross-cutting functions, such as local revenue mobilization, planning, budgeting, and financial management, and this may be re-cast to explicitly link to the provision of devolved services. While the system technically supports stronger top-down accountability for LGU performance, the design of the system should also begin to stimulate bottom-up accountability by: a) requiring the public disclosure of the LGU performance measures, which should allow for cross-LGU comparisons; and b) requiring transparent fiscal reporting by the LGUs, which should complement existing efforts of the national government to streamline financial planning and reporting.
requirements. These interventions could be linked to efforts to institutionalize bottom-up, participatory planning at the local level and a form of ex post accountability (e.g., reporting on investment outputs).

Furthermore, the Bank’s existing activities to institutionalize participatory planning and project implementation at the community-level through community-driven development activities are important mechanisms for strengthening demand for local government accountability and governance. These activities strongly complement the more supply-driven approach of performance incentives for LGUs. The planned National Program Support for Community-Driven Development is envisioned to create a platform for convergence of various CDD activities of the national government across sectors.

The key activity for the CAS period under this strategic priority is:

- Lending/TA to support performance-based incentive system for LGUs
- Additional Financing for KALAHI-CIDDS and preparation of NPS for CDD, which should leverage a more direct engagement with LGUs in implementing community-driven development activities that institutionalize participatory planning and governance

The possible activities for FY11/12 under the Programmatic AAA on Local Governance and Decentralization are:

- Re-engagement with the LGU oversight agencies on performance-based incentive systems, including a review of the appropriate institutional arrangements (the original counterpart was MDFO) and of the overall objectives and framework for such a system, and possible high-level policy dialogue (e.g., with GET)
- Engagement with other key stakeholders, such as the leagues of LGUs, national legislators, and civil society groups to promote the concept for performance-based incentive systems for LGUs

2. Engage provinces to optimize their role as inter-LGU coordinators – This strategic area seeks to mitigate the issue of hyper-fragmentation among LGUs and the resulting loss of economies of scale in local public administration and service provision. Although a first-best solution would be to amalgamate neighboring LGUs into larger jurisdictions in order to reduce the sheer number of LGUs, such a structural reform is unlikely to be politically viable. However, there are other more practical, though not systemic, approaches to promoting better coordination among LGUs. For example, findings from field case studies indicate that while political and financial incentives are very weak for municipal mayors to coordinate horizontally amongst themselves, development-oriented and resourceful provincial governors have shown the ability to utilize the political and financial capital of their offices to initiate and support inter-LGU initiatives (such as South Cotabato’s common solid waste management facilities) and to align municipal priorities with provincial objectives and strategies using incentives (such as Bohol and Albay’s counterparting schemes, and Cebu’s performance incentive program).

43 The Joint Memorandum Circular No. 1 of 2007 is an inter-agency policy of NEDA, DBM, DILG, and DOF that seeks to synchronize and harmonize local planning, budgeting, and expenditure management requirements of LGUs.

44 The weak incentives for horizontal coordination among city mayors are evident in the continuing struggle to coordinate metropolitan-wide services in Metro Manila, which is comprised of 16 distinct cities plus one municipality. The Metro Manila Development Authority (MMDA) was established for the purpose of coordinating inter-jurisdictional policies and services across the 17 LGUs but it has had limited success, partly due to the fact that the Chairman of MMDA is a cabinet-level appointee of the President rather than an elected official.
While this strategic area seeks to build on inherent political incentives of governors to strengthen alliances with their constituent mayors, the reality is that the strength of such incentives varies widely from province to province depending on the political context. Hence, the activities under this area may selectively engage provinces that demonstrate a willingness to assume a more prominent role to fill-in the ‘missing middle’ as inter-LGU coordinators and providers of incentives for improved delivery of services at the municipal level.

The activities under this strategic area would focus mainly on providing technical assistance to provinces, most probably linked to existing lending operations. These activities complement, and may build from lessons to be learned from, the coordinated area-based approach to be piloted under SO 3.2 in FY11.

The key activities for the CAS period under this strategic priority are:

- TA to support provincial alliance-building with component municipalities, particularly those that lead to investments for common-use facilities such as solid waste management facilities (which can be financed through the DBP Regional Infrastructure for Growth lending operation)
- Policy advice (e.g., policy notes) and TA to support the design and piloting of province-led performance incentive systems (building on lessons from the Cebu province and other similar cases)
- Partnership with various development partners (CIDA, EC) in strengthening the institutional and policy environment for inter-LGU coordination, which is being coordinated through the PDF-WG’s recently convened a sub-technical Working Group on “Inter-Local Cooperation”

The possible activities for FY11/12 are:

- Policy note on province-led performance incentive systems (reviewing Cebu province case), potentially under a Programmatic AAA on Decentralization
- TA for the 2010 Newly Elected Officials orientation of DILG, which will be supported by the DIALOG TF and includes an alliance-building workshop component that DILG plans to implement in all provinces (this activity may serve as the basis for identifying potential provinces that will receive additional support for provincial alliance-building)

3. **Sector review of devolution of local services** – This strategic area seeks to mitigate the weak political and institutional environment for local accountability by clarifying the responsibilities between line agencies and LGUs for devolved sectors, recognizing the diverse range of issues across the different sectors that have been created by loopholes in the LGC that allow the national government to maintain involvement in statutorily devolved sectors. A recent WB study on local service delivery, which utilized LGU case studies to analyze expenditure patterns and service delivery in the local health and roads sectors, highlighted weak outputs and outcomes that emerged from the unclear lines of accountability for service delivery and financing in these devolved sectors. Preliminary assessments of other devolved, sectors such as agriculture, environmental management, and water supply, also suggest that the partial decentralization of these sectors is among the major constraints to effective and efficient service delivery.
This strategic area seeks to deepen the Bank’s understanding of devolution issues in each devolved sector, leading to the identification of opportunity areas for the various sector teams to push forward reforms in local service delivery through on-going engagements (lending, TA). Furthermore, the activities under this area will, in the long-term, provide key inputs to any future reforms to address inefficiencies and inequities in LGU resource bases given that a clear assessment of LGU expenditure needs based on minimum service levels will necessarily serve as the basis for the redesign of the IRA and LGU tax assignments.

The key activity for the CAS period under this strategic priority is:

- ESW to develop policy notes for each devolved sector to: a) review the de facto allocation of responsibilities between line agencies and LGUs for local service delivery; and b) propose sectoral reforms to clarify the overlapping arrangements, including possible options for introducing transparent and objective sectoral transfer mechanisms to replace the current regime of ad hoc and opaquely distributed sectoral transfers.

The possible activities for FY11/12 are:

- Phase 2 of the Local Service Delivery Study, focusing on the agriculture and environmental management sectors, potentially under a Programmatic AAA on Decentralization.
- “Action plan for further devolution” is a proposed PDF-WG activity in the pipeline for the DIALOG TF that can be potentially re-conceptualized to support this strategic area.

**Strategic areas for strengthening the capacity of major cities and metropolitan areas to serve as engines of economic growth**

4. **Engage major cities and metropolitan areas to support critical infrastructure investments** – This strategic area seeks to address the weak technical capacity of LGUs for infrastructure investments. In the recently concluded Phase 1 of a TA on pilot credit ratings, which was conducted for eight first-tier cities, the assessment revealed chronic weakness in capital investment planning and debt management, even in well-resourced and relatively well-managed cities such as Quezon City, Marikina, and Taguig. Even if these cities are able to access expanded options for debt financing, their capacity to plan and implement complex capital investments is limited.

This strategic area seeks to provide technical assistance to major cities and metropolitan areas to strengthen their capital investment planning and debt management in order to support critical infrastructure investments. This area will also support reforms to improve the institutional and policy environment for inter-LGU coordination in a metropolitan area setting. Several unique conditions of this sub-set of LGUs suggest that capacity-building activities are more likely to be effective, including: a) greater fiscal autonomy for independent/highly urbanized cities to finance devolved basic services; b) naturally greater bottom-up demand for local accountability given lower transaction costs in densely populated urban areas for both business groups and disadvantaged groups to organize to demand better services; c) higher order incentives for city mayors to perform (as a result of competitiveness surveys, yardstick competition, international recognition); and d) greater national media attention and civil society/academe presence.
That said, to avoid the risk of implementing purely supply-driven capacity-building activities, the activities under this strategy should be targeted to major cities and metropolitan areas that have strong potential as engines of economic growth and have demonstrated the initiative to assume this higher order role.

The key activities for the CAS period under this strategic priority are:

- Targeted TA to address capital investment planning and debt management weaknesses of the major cities and metropolitan areas (e.g., through the planned Enhanced City Development Strategy activity)
- Urban/Infra projects in the pipeline (e.g., Metro Manila Urban Renewal project, urban transport projects)
- Active partnership with various development partners (CIDA, EC) in strengthening the institutional and policy environment for inter-LGU coordination, which is being coordinated through the PDF-WG’s recently convened a sub-technical Working Group on “Inter-Local Cooperation”

The possible activity for FY11/12 is:

- Phase 2 of the TA on pilot credit ratings for cities (Urban Hub/PPIAF), which will include:
  a) pilot credit ratings and financial management assessments for four additional first-tier cities, and b) TA to the original eight cities from Phase 1 to strengthen their credit-worthiness, including their capacity for investment planning and debt management

5. **Engage GOP on facilitating LGU access to private credit** – This strategic area seeks to mitigate one of the specific areas of inefficiencies and inequities in LGU resource bases by expanding the options for LGUs infrastructure investment financing. The current policy environment, which restricts PFIs from serving as depository banks of LGUs, has effectively created a duopoly for LBP and DBP and has essentially eliminated competition in the sub-national credit market (with MDFO fading into the background with the close of LOGOFIND). Although there have been several cases of PFIs lending to LGUs in recent years (through direct loans, bond issuances, and syndication arrangements with the GFIs), these have been minor exceptions. LGUs, particularly the first-tier cities such as Quezon City and Marikina, have continued to complain about the limited options available for them to finance critical infrastructure investments, which suggest that there is pent-up demand, at least among the larger and more progressive cities, for expanded access to private credit.

This strategic area seeks to engage DOF and BSP on key policy reforms (such as the depository bank restrictions and limitations on IRA intercept/collateral arrangements) that will facilitate the access of LGUs to private credit. This area will also explore policy options for creating a more conducive environment for public-private partnerships at the sub-national level. Importantly, the feasibility of these reforms is contingent on the willingness of the new administration to invest political capital to overcome the entrenched interests of the GFIs to protect one of their main business lines. However, unlike binding constraints with the fiscal transfer system and local tax assignments, the reforms for LGU capital finance are policy-based and do not require legislative revisions to the LGC. This is also an area of collaboration with IFC.

The key activities for the CAS period under this strategic priority are:
- Policy advice and TA to support revisions in GOP policies for LGU capital finance that will open the sub-national credit market to PFIs, perhaps gradually and on a selective basis through a phased and segmented approach
- Policy advice and ESW to review and strengthen the policy and institutional environment to stimulate public-private partnerships at the sub-national level
- Pilot risk-based lending to first-tier LGUs through Sub-national Finance Facility (WB/IFC)
- Pilot mechanisms that mitigate LGU credit risks for PFI lending (e.g., guarantees, syndication arrangements with GFIs)

The possible activities for FY11/12 are:
- “Action Plan for maximizing LGU corporate powers” is a proposed PDF-WG activity in the pipeline for the DIALOG TF, which could potentially be re-conceptualized to support this strategic area
- On-going Sub-national Finance Facility (WB/IFC)
VI. **Resources Required to Implement Proposed Strategy**

- Senior Specialist to lead overall decentralization reform agenda, including coordinating activities across sectors, leading the engagement with government and other partners, and mobilizing internal Bank resources to support analytical and operational activities.
- BB to support Programmatic AAA on Decentralization in FY11 and follow-up activities in FY12.