THE FISCAL DECENTRALIZATION PROCESS IN THE
PHILIPPINES: LESSONS FROM EXPERIENCE

by

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The topography of the Philippines is by itself a strong reason for a decentralized form of government. It is composed of more than 7,100 islands. Pre-Spanish history says that the country was composed of villages called "barangay'. Each barangay was ruled by its own chieftain, spoke its own dialect, formulated its own laws based on tradition and needs. There were no alliances between barangay and very little notion of a country. "The people do not act in concert or obey any ruling body; each man takes care only of himself and of his slaves."\(^2\)

Centralization came with the invasion of the country by the Spaniards, the Americans, and the Japanese. A strong central government was needed to control numerous attempts to regain freedom. When independence was finally restored in 1946, reconstruction was directed by a strong government. But the innate desire for autonomy asserted itself through the years. A Local Autonomy Act was passed in 1959 (Republic Act 2264) to grant fiscal and regulatory powers to local governments. In 1967, a Decentralization Act (RA 5185) was enacted to increase the financial resources and powers of local governments. The 1973 Constitution of the Republic mandated that the state "shall guarantee and promote the autonomy of local governments to ensure their fullest development as self-reliant communities". These initiatives were stymied by the martial rule of the country for twenty years. Its end was brought about by the expressed action of the Filipinos against authoritarianism. Thus, the strengthening of democracy through people empowerment was on top of the agenda of the Aquino and Ramos governments. A Local Government Code was enacted in 1991 that institutionalized a systematic allocation of powers and responsibilities between the national and local governments. It would be fair to say that the political motive was a strong factor that influenced devolution. Decentralization was perceived to be an effective means of diffusing power from the center that would effectively prevent an authoritarian regime, such as the Marcos regime, from re-emerging in the future.\(^3\) Decentralization was a common response of many governments all over the world to the clamor for a greater voice in the way they are governed.\(^4\)

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1 Former Undersecretary, Department of Finance, Republic of the Philippines and President, Galing Pook Foundation.
2 Jose S. Arcila, An Introduction to Philippine History, Ateneo de Manila University Press, 2000, citing a letter written by Miguel Lopez de Lagaspi to the King of Spain in 1565.
3 S. Asanuma, R. Mahi and R. Simanjuntak, "Decentralization: The Philippines' Experience" A paper presented before the conference on Decentralization that was convened by Hitotsubashi University, January 2003.
4 William Dillinger and Marianne Fay, "From Centralized to Decentralized Governance" Finance and Development, International Monetary Fund, December 1999.
The efficiency factor in devolution began to surface during the Ramos administration. Market reforms were vigorously pursued by government. Trade, banking and industry were liberalized. A privatization program was pursued to relieve the central government of several functions where it has no comparative advantage. Devolution was compatible with these thrusts. Government recognized that it would be more efficient if communities were given the power and the responsibility to decide on goods and services that they need. President Ramos encouraged the processes of consultations, consensus building, and provision of adequate information to constituents.

**A Compartmentalized Approach to Devolution.** The Local Government Code provides the policy framework for devolution. It was formulated in segments however and devolution was not viewed as a coherent whole with each part complementing the others. Book I of the Code was formulated by the Senate and covered the principles of devolution and the responsibilities that were devolved to LGUs. Book II pertained to financing and budgeting and was crafted by the House of Representatives. The revenue structure was thus formulated independent of the expenditure functions.

The decision making process of expenditure assignment leaned heavily on the political side rather than efficiency considerations. The overriding consideration was to devolve expenditures that were closest to their beneficiaries. There was little discussion on the processes of developing the capability of LGUs to administer the devolved services. There was also no discussion on minimum standards.

The services that were devolved by the Code are the following:

**Villages (barangay)**

- Agricultural support services including collection of produce and buying stations
- Health center and day care center
- Solid waste collection
- Village justice system
- Roads and infrastructure funded by the village
- Information and reading center

**Municipalities**

- Agricultural extension and on-site research services
- Community-based forestry projects and management of communal forests
- Primary health care services and access to secondary and tertiary health services
- Public works and infrastructure projects funded out of local funds
- School building projects
- Social welfare services
- Information services
- Solid waste disposal system and environmental management system
- Municipal buildings, cultural centers, public parks and sports facilities
- Tourism facilities and promotion

**Provinces**

- Agricultural research extension and on-site research services
- Enforcement of forestry laws
- Hospital and tertiary health services
- Social welfare services
- Infrastructure funded from provincial funds
- Low-cost housing
- Telecommunication services for provinces and cities
- Low-cost housing projects for provinces and cities
- Investment support services, industrial research and development services for provinces
- Tourism promotion

Cities are expected to perform the services that have been assigned to municipalities and provinces.

The quantification of the devolved services was done on a macro-level. The Department of Budget and Management was tasked to estimate how much it cost the central government to deliver the services that were devolved. This amounted to P6.6 billion in 1993. The estimate provided a rough gauge of how should be the increase in the IRA.  

The exercise of matching expenditures and resources ended on the macro level and did not continue on a per LGU basis.

The revenue structure was also formulated separately from the expenditure assignment. There was no opportunity to match resources with needs. Thus, policymakers failed to see the inconsistency between the two. Since the jigsaw pieces were not fitted together, the role of grants as an equalizer was not appreciated. Consequently, the grant formula does not incorporate any equalization factor to address horizontal imbalances.

**The Financing of Devolution.** The inherent power of local governments to create their own sources of revenues is rooted in the Philippine Constitution. These are defined by the Local Government Code and are allocated among the different levels of local governments: provinces, cities, municipalities, and the barangay. The Code also reserves the imposition of major taxes to the central government such as customs duties, taxes on income, sales, and excises.

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5 A 40 percent IRA was equal to P27.96 billion that was considered sufficient to finance the aggregate costs of the devolved responsibilities.
The revenue-raising powers under the Code were essentially based on the Local Tax Code (1973) and the Real Property Tax Code (1974). These Codes used the following criteria in the assignment of taxing powers to LGUs:  

a. The tax base should be evenly distributed among local jurisdictions.

b. The tax base should not be mobile to avoid tax-induced movements of factors of production.

c. Local taxes should be revenue-productive and buoyant over time.

d. They should be easy to administer and to comply with.

The provincial government is given the power to impose levies on real properties, i.e. the basic real property tax at one percent (1%) of the assessed value of land and improvements. It can also impose additional levies on real property such as the Special Education Fund tax, the idle land tax, and special assessment. Before the Code, municipal governments had the power to impose the real property tax. The Code withdrew such power and mandated provincial governments to exercise it. Municipalities share 40 percent of the collection and 30 percent is allocated to the where the property is located. The municipal government has an assessor and a treasurer who administer and collect the tax under the supervision of the province. The assessor is appointed by the Local Chief Executive while the treasurer remains an appointee of the Department of Finance.

Congress retained the practice of using a fraction of the market values as the tax base. These percentages are differentiated relative to land use: 20 percent for residential and timberlands; 40 percent for agricultural lands, and 50 percent for commercial and industrial lands. Buildings are also taxed on a fraction of their market values and the ratios vary depending on whether buildings are residential, commercial or industrial. The Code gave the local legislative council the power to legislate the assessment values (i.e. taxable values). This power introduced a greater influence of politics on real property tax administration.

The province can also impose a tax on the transfer of real property tax ownership, a tax on admission to amusement places, and a tax on businesses enjoying franchises.

The local business tax remains to be the major revenue-source of municipalities. Congress adopted tax rates that varied depending on the type of business and gross receipts. Producers are taxed more heavily than wholesalers. Tax rates on "essential products" are reduced by 50 percent. The lawmakers held that differentiated rates promote vertical equity. For businesses that are not mentioned in the Code, the Code allows the imposition of a 2.0 percent rate.

Cities are given broader taxing powers because they can impose the provincial and municipal taxes. In addition, they can increase the tax rates by 50 percent.

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6 The studies were made by the then Joint Executive legislative Tax Commission (now the National tax research Center under the leadership of Dr. Angel Q. Yoingco.
7 The Department of Finance proposed the use of market values as the tax base.
The smallest level of local governments, the barangays were provided with nominal taxing powers. They are allowed to tax small retailers and collect fees and charges from cockfights, outdoor advertisements, and places of recreation.

Local governments are also given common revenue-raising powers. These are the collection of fees and user charges.

The 1991 Code prescribes limitations on the taxing powers of local governments by prescribing ceilings on tax rates, defining the tax bases and exemptions, and prescribing the procedures.

**Assistance, Equalization, Both, or None of the Above?** Internal revenue allotments (IRA) or grants have always been seen as a form of financial assistance from the central government. They used to be shared with local governments in accordance with several formulae. For example, five percent of the income tax was distributed to all local governments depending on population. Other taxes such as the franchise tax were distributed to local governments where the taxes were collected. The system proved horrendously complicated and grossly inequitable. In 1970, about 70 percent of grants to provinces were received by only five provinces. Forty-two percent of grants to municipal governments were received by only 10 out of 1,421 municipalities.\(^8\)

Presidential Decree 144 simplified the allotment significantly by consolidating the different schemes into one formula. Twenty percent of the internal revenue collections of the third preceding year (exclusive of those accruing to special funds) were earmarked for local governments. It was distributed based on a formula that used population, land area and equal shares. Local governments were also given shares from collections from petroleum taxes. However, grants were not disbursed in accordance with the formula and the central government prescribed ceilings on the amount of allotments they could receive. Instead of receiving 20 percent, LGUs received internal revenue allotments (IRA) within the range of 7 percent to 17 percent. Grants were distributed on an arbitrary basis resulting to a highly politicized system that reinforced greater control over local governments instead of enhancing local autonomy.\(^9\) The allotment system was also inequitable. On a per capita basis, more allotments were distributed to LGUs with greater fiscal capacities. It also failed to contribute to sound fiscal management because LGUs were never certain at any point in time of how much allotment they would receive.

The grant system under the Local Government Code essentially follows the framework under PD 144. A fraction of internal revenue collections has been earmarked for LGUs. The IRA was increased to 40 percent with the goal of matching the amount of devolved expenditures. The allocation of the IRA was altered to provide more resources to barangays in

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\(^9\) Studies on the grant system were made by A. Q. Yoingco, National Tax Research Center and Roy Bahl and Larry Schroeder "Intergovernmental Fiscal Relations" in Local Government Finance in the Third World, Praeger Publishers, 1983.
recognition of their role in developmental projects, the barangay being the lowest unit in touch with the daily lives of our people". The distribution is:

<table>
<thead>
<tr>
<th>LGU</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provinces</td>
<td>23 percent</td>
</tr>
<tr>
<td>Cities</td>
<td>23 percent</td>
</tr>
<tr>
<td>Municipalities</td>
<td>34 percent</td>
</tr>
<tr>
<td>Barangay</td>
<td>20 percent</td>
</tr>
</tbody>
</table>

The actual amount that each LGU will receive is determined in accordance with three criteria with the following weights:

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>51 percent</td>
</tr>
<tr>
<td>Land area</td>
<td>25 percent</td>
</tr>
<tr>
<td>Equal sharing</td>
<td>25 percent</td>
</tr>
</tbody>
</table>

The reduction in weight of the population factor (formerly 70 percent) was made to "decongest the urban centers and develop the countryside". The increased weight on equal sharing (formerly 10 percent) was intended to effect a more equitable sharing of the IRA. Apparently, Congress had a literal meaning of equity, i.e. giving each local government the same share regardless of its needs and resources.

Grants to LGUs are required by law to be automatically released within five days after the end of the quarter. They cannot be subject to any lien that may be imposed by the central government except when the national government experiences an unmanageable public sector deficit. The President in consultation with the leaders of Congress and the leagues of Local Chief Executives can reduce the amount by 10 percentage points.

The Road to Fiscal Freedom. It should not come as a total surprise that the Local Government Code does not have many positive effects on local government finance. Contrary to the goal of devolution, local governments have become more dependent on grants. The IRA accounts for about 64 percent of their total revenues compared to 39 percent before devolution.

Is it realistic to expect the devolution program result to fiscal freedom for local governments? It would not be fair to think so since the Local Government Code hardly altered policies on local finance. The framework that supports the fiscal provisions of the Code is of martial law vintage. The taxing powers that LGUs enjoy are those that they have been enjoying since 1973. The tax bases have remained the same. Additional powers such as the village tax on small retailers are nominal. The Code has also unintentionally weakened the fiscal capacity of LGUs through provisions that: 1) withdrew the power of municipal

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12 This prerogative was exercised by then President Ramos who ordered a reduction in total government spending, including grants to prevent a huge budgetary deficit due to the Asian crisis in 1997.
governments to impose the real property tax; 2) increased the level of exemption of residential buildings from the land tax; 3) provided local legislative assemblies with the power to approve assessed values.

The real property tax, which is expected to bring in the revenues to LGUs, is acknowledged as an expensive and a difficult tax to levy. "Valuation is an art, not a science, and there is much room for discretion and argument with respect to the determination of the tax base." Estimates show that many LGUs spend more to collect a peso of the tax. The Bureau of Internal Revenue with all its resources and power finds it difficult to collect the VAT and capital gains on the sale of real properties. The LGUs cannot therefore be totally faulted for their chronic problems on real property tax administration. However, they should not be totally exonerated for their failure to bring up assessed values to current levels and to collect delinquencies.

The grant system is also of martial law vintage. The differences in the pre and post devolution IRA structure are marginal: a) increase in the amount of IRA from 20 percent to 40 percent; b) changes in the weights on the factors of distribution; c) change in the relative shares of allocation among the levels of local governments; d) sharing of proceeds from the utilization of national wealth, e.g. mining taxes, royalties, forestry charges depending on rules formulated by the central government.

Arbitrariness and the lack of certainty in the IRA system have come in various forms. In 2000, availability of funds was made as a precondition for the release of IRA.

Since the flaws of the grant system have not been corrected, there should hardly be major differences that can be expected from the effects of the pre-and post-IRA schemes on LGU resources. Grants have been perennially counter-equalizing and LGUs with more revenues, higher taxable capacity, and more expenditure outlays receive more grants. On a regional level, grants tend to flow more heavily to more developed regions like Region 4, Region 3, and the National Capital region. Likewise, if the number of people that an LGU has to support is an indicator of need, regions that are more populous are not fully assisted by the allotment system. Heavily populated LGUs like Manila, Quezon City, and Caloocan City receive smaller allotment per capita. Is this a cause for disappointment? A grant system where a large portion is distributed on an equal sharing basis cannot be expected to be an

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15 Although it can be said that the central government with its failure to prosecute major tax evaders and to index specific taxes relative to inflation hardly provides an example in the exercise of political will.
16 Studies on the effects of the IRA since the sixties have come out with similar results. The system is inequitable and does not support fiscal stimulation. These studies include those made by the Joint Legislative-Executive tax Commissions, now the National Tax Research Center, Roy Bahl and Larry Schroeder "Intergovernmental Fiscal Relations" in Local Government Finance in the Third World, Praeger Publishers, 1983. Associates in Rural Development by M. Guevara et. al. "Internal revenue Allotment System of the Philippines: Trends, Patterns, and Effects, USAID, 1994.
equalizer. It has even introduced perverse incentives for LGUs to split themselves or to convert into cities to receive additional IRA.

The is no currently no governance factor that can nurture an efficient transfer system. Subsidies are given to LGUs based on political patronage. LGU officials are "saved" from bearing the costs of under-utilizing their taxing powers because the pork barrel system provides dole-outs. There are no clear rules and no transparency in how they are disbursed. Similar concerns are experienced with respect to subsidies from the Office of the President. What are the rules? How are they obtained?

**The Angels are in the Details.** One has to look at the process of devolution as well as the diversity of local governments to recognize its positive impact. Because it is a process, changes in the five D's of local autonomy: devolution, decentralization, deregulation, democratization, and development will take time. Because of the diversity in local governments, the relative success of the processes needs to be contextual.

Within a short period of twelve years, devolution has resulted into the following gains:

a. **More Resources for Local Governments.** LGUs have at their disposal additional resources from internal revenue collections. The Special Education Fund Tax was made local revenue and is budgeted and disbursed by Local School Boards. The expenditures of LGUs increased from an average of 1.6 percent of GNP in 1985-1991 to 3.1 percent of GNP in 1992-2001. The share of LGUs in total government expenditures net of debt service rose from an average of 11.0 percent in the pre-Code period to an average of 22.2 percent in the post-Code period.  

b. **Greater Autonomy in Decision-Making.** Local Revenue Codes are no longer required to be approved by the central government through the Department of Finance. Valuation of properties is done by city and provincial governments without the need of an imprimatur from the DOF. The budgets of municipalities and component cities are now reviewed by the provincial legislative assembly instead of the central government through the Department of Budget and Management.

c. **Development of Processes towards Accountability.** The provisions on referendum and recall create pressures for local government officials to be responsive to the demand and needs of their constituents. They also promote transparency and accountability. The Code defines the processes through which voters can propose or amend any ordinance. There are also provisions that enable voters to recall any local elective official for loss of confidence. The power of recall have been used by the electorate in several communities.

d. **Efficiency in Public Choice.** LGU expenditures on education, housing and community development rose by more than the costs of devolution and inflation. It can be

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thus argued that communities have raised the efficiency of governmental processes by reallocating expenditures to acquire a public goods basket of greater value to the community.\textsuperscript{19}

The recent work of Manasan noted significant growth in areas that were devolved to LGUs. Their expenditures on health increased from 0.08 percent of GNP in 1991 to 0.43 percent of GNP in 2001. LGU spending on education rose from 0.07 percent of GNP to 0.28 percent.\textsuperscript{20}

e. **Heightened Level of Public’s Consciousness on Local Governments.** There is vibrant and enthusiastic recognition of the importance of local governments in getting things done well, and this is growing. LGUs are used as the entry point and medium for implementing programs that reduce poverty, protect the environment, improve service delivery, and promote welfare of children and women. The Poverty Alleviation program of the UNDP ranks LGUs relative to an index that measures efforts of communities to improve the life of the poor. The Asian Institute of Management ranks cities in terms of their competitiveness, e.g. adequacy of infrastructure, transparency in dealing with the local bureaucracy. The UNICEF evaluates efforts of LGUs in making their communities child and women friendly. From being recipients of assistance, LGUs are considered equal partners in implementation. Development efforts are focused on collaborating with LGUs—a possible shift in priorities and strategies towards decentralized program management.

f. **Demonstrated Success on Excellence in Governance.** Every year, the “Galing Pook Foundation”\textsuperscript{21} reviews more than a thousand applications of LGUs that describe how they have achieved efficiency in service delivery and empowered communities to implement development programs. Ten programs are recognized annually and those that demonstrate continuing excellence in governance are also awarded. The programs demonstrate that many LGUs are able to manage their resources efficiently, explore innovative ways of doing things, and institute transparency and accountability in their day-to-day operations. Cases where LGUs build irrigation dams and school buildings at one-half the costs of central government are used as benchmarks in infrastructure projects. The following programs are some of those that are relatively well-known and define the standards and processes for leadership and management:

- Participatory Governance in Naga City\textsuperscript{22}
- Delivery of Health Services in Nueva Vizcaya
- Fiscal Management in San Fernando City and Quezon City

\textsuperscript{20} Manasan, op. cit.
\textsuperscript{21} The Program promoting excellence in local governance was initiated by Harvard University and has the support of the Ford Foundation. The program has been adopted in nine countries including the Philippines. The Philippine program is collaboratively managed by the Department of Local Governments, the Galing Pook Awards Foundation, multilateral institutions, and NGOs.
\textsuperscript{22} The Mayor of Naga City, Jesse Robredo was recipient of the Magsaysay Award for governance that is equivalent to the Nobel Prize in Asia.
They serve as models that are used in mainstreaming effective public service through replication in other communities.

h. Processes for empowerment, engaging the community, comparing services that are provided with taxes

Lessons from Experience.

1. For countries that have had decades of disenchantment with the inefficiencies of centrist governments, devolution is an attractive alternative. When powers and responsibilities are given to a level of government that is closest to the people, there is probability that efficiency, accountability and transparency would be enhanced. There is a good chance that publicly provided goods and services will be produced following the preferences of constituents. Governance can be more participatory thus empowering community members to take part in making informed choices.

2. Devolution is a systemic process. It needs to have a rational framework so that expenditures and revenue assignments can be made efficiently. To equalize the capacity of local governments to provide a certain level of public services or to equalize the actual performance of this level of service by local governments, a system of equalization transfers is needed.

3. The devolution process must grow into a coherent system. Incentives and disincentive in the political system must support a “hard budget constraint” on local decision makers, i.e. they should bear the costs and be fully accountable for the consequences of decisions that they make. Conflicting incentives, such as the pork barrel system or grants from the President’s Office that are distributed through political patronage are regressive and are inconsistent with devolution. The processes of empowering communities are equally challenging. They start from a paradigm shift towards partnership and collaboration. It requires opening the process to ensure that everyone affected will have an equal opportunity to influence decisions. Engagement is supported by giving communities access to information and building their capacities to use information in asking questions, in evaluating performance, and in suggesting alternatives and options.

4. Devolution needs a long transition period which requires a strong oversight institution to see through the process to the end. Mechanisms for monitoring, review and corrective changes of the policy in the interim needs to be institutionalized. National agencies

Bird, op. cit.
Bird, op. cit.
should prioritize helping build the capability of LGUs in administering devolved responsibilities.

5. Devolution can only be successful if ordinary citizens are empowered to take part in the decision making process. Empowerment starts from giving them access to information and providing them with opportunities to be meaningfully involved in planning, project implementation, and evaluation. A model on good urban governance that works well in the Philippines is the Naga City model.

Most of the processes in decision making in Naga City use this model including the process of budgeting tax funds. Every year, the mayor calls for an education summit where he presents the state of education in the city. He gives a summary of how children perform in test scores, the dropout rate, and other indicators. Summit participants are then divided into workshops where they set targets and benchmarks in terms of textbook to student ratio, average size of classes and improvement in test scores. They then develop a consensus on priority programs where their tax money should be spent. The consensus is generally used as the basis for budgeting the Special Education Fund tax. The budget is then posted on the government’s website. Projects to be bid out are posted on the government’s website including specifications, timelines, and costs. Every citizen in Naga has a Manual that lists all the services that he is entitled to, where and how they can be obtained and the time period within which the services should be delivered. There is a mechanism where comments, commendations, and complaints of citizens can be made, processed and acted upon.

6. There are many other local governments in the Philippines that have succeeded in developing and using the processes of participatory governance. Their efforts have fared well
despite inefficiencies of the devolution system in the Philippines. But there are also many other local governments that have remained under the shadow of traditional politics. There is great diversity in the quality of leadership in local governments. Therefore, the wisdom of maintaining a “one size fits all policy” comes into question. There will be inaccuracies and injustice in generalizing about what is true for 79 provinces, 115 cities, 1,499 municipalities, and 41,969 villages. It may be timely to consider giving more attention to designing “asymmetrical fiscal federalism”. Such an approach can focus on what may work rather than on fitting everyone into the same centrally determined box.  

One way of looking at this is the process of accreditation where LGUs who pass minimum standards in service and product delivery and specific attributes of governance can be given greater autonomy and be given more functions to administer such as the delivery of elementary education.

The very essence of devolution is providing a policy regime where creativity and innovation can flourish and where support is given to replicating cases of excellence in many other communities.

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25 Bird, op. cit