SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT

A. Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **The Local Government Code.** The Local Government Code (LGC) was passed into law in 1991 and markedly increased the level of local autonomy of local government units (LGUs). The legislation included high impact provisions that: i) transferred responsibility for the delivery of a large number of basic services to local government units, ii) initiated revenue sharing between the national and local governments, iii) encouraged LGUs to explore alternative sources of revenue, and iv) laid the foundation for active citizen engagement in local governance. Subsequently, financial transfers to LGUs were increased with 40% of internally generated taxes allocated to LGUs through the Internal Revenue Allotment (IRA). While potentially significant own-source revenues were assigned to LGUs, over time, most have remained largely dependent on financial transfers from the IRA.

2. **Context.** These decentralization reforms provided the legal basis for improved service delivery. However, the implementation of reforms at the grassroots level is influenced by the country’s political economy, which is characterized by strong political ties between the national and local governments and the tendency of the national government to use the intergovernmental fiscal system for patronage purposes and to ensure national unity. Several parts of the country, including Mindanao, are affected by violent conflicts involving communist insurgencies and armed conflicts between families and clans, which are mainly about the control of land and natural resources. When processed through these filters, the quality and quantity of local service delivery typically suffer. However, a more efficient intergovernmental fiscal relations system may actually help diffuse regional tensions by providing LGUs with adequate financial resources and the ability to match service delivery to local preferences and needs. It is this potential that guided the first review of the LGC in nearly 22 years. The recently completed study, which was supported by ADB, covered the Act’s fiscal provisions including revenue assignments and LGU revenue raising powers, functional expenditure assignments, intergovernmental transfers, LGU borrowing, creation of LGUs, inter-local alliances and cooperation, and local fiscal administration.

3. **Expenditure assignments and service delivery mandates.** The significant devolution of service delivery responsibilities to LGUs implemented under the LGC is largely unfinished. In comparison with neighboring countries such as Indonesia, the Philippines have not progressed in terms of the clarification of roles and responsibilities across tiers of government. The lack of clarity in the assignment of service delivery responsibilities between the national government and the LGUs leads to serious problems, including claims that unfunded mandates for LGUs are multiplying (i.e., service delivery obligations by national departments that need to be financed by LGU sources of revenue). To address this deficiency, the government has proposed differentiating between fully devolved functions and delegated functions. Delegated functions represent those the national government is responsible for and which are best supported through transfers from the national budget. In addition, the government has proposed amendments to the LGC that prohibit subsidies to out-posted staff of the national government.

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1. This assessment focuses on the decentralization and local governance aspects of public sector management.
2. This included expenditures in the health, agriculture, social welfare, and environmental sectors, among others.
3. Transfers from the IRA represent on average 66% of total local government revenues.
5. These subsidies were estimated to represent 0.5% to 2.0% of LGU budgets in 2012.
4. **Intergovernmental fiscal transfers.** Broad trends in intergovernmental financing over the past few years have seen relative increases in total resources available to LGUs. The IRA, which is set at 40% of the actual national government tax collections three years prior to the current year, has steadily increased to about 18% of the total national government expenditure. Nonetheless, there is almost uniform agreement that the IRA does not provide sufficient resources to LGUs. In particular, the IRA has been criticized for two main problems: (i) it fails to equalize revenue across LGUs at the expense of poorer LGUs relative to wealthy urban areas, and (ii) it serves as a disincentive to local revenue generation. While reform of the IRA is politically contentious, there is fairly broad agreement that the allocation should account for disparities in revenue generation or potential relative to expenditure needs. In other words, stakeholders have accepted that equalization should be an explicit objective.

5. **Local own-source revenues and tax administration.** Local own-source revenue collection, sourced primarily from real property tax and local business taxes, represents approximately 33% of total LGU revenues but remains low relative to GDP. The LGC expanded the ability of LGUs to create tax and non-tax instruments but at the same time limited the ability of LGUs to set tax rates. Other issues, such as the ability to set differentiated tax rates by business type, led to arbitrage and tax evasion, and limited local economic development. LGUs did not fully maximize their taxing powers due to conflicting incentives. The recent review of the LGC provided two high-impact, widely supported recommendations. First, to strengthen the administration and collection of real property taxes, the government proposed transferring administrative oversight of tax increases to the Department of Finance, while devolving decisions over rates and assessments to the local level. Second, the government proposed strengthening the technical capacity of assessors and real estate professionals involved in administering property taxes. Estimates indicate that the collection of real property taxes for all provinces, on average, could increase by 97% (P9.6 billion) while the collection of real property taxes for all cities could increase by 138% (P40.8 billion). In addition, the government proposed streamlining the business tax to a flat 1.5% of gross receipts. This change could provide an additional P36 billion in taxes for cities and P5 billion for municipalities.

6. **Lack of access to development credit financing.** LGUs need to increase access to debt capital financing to support large, multi-year expenditures such as infrastructure. Although LGU borrowing powers are granted under the LGC, the LGUs face a number of indirect restrictions. For example, a prohibition on opening depositary accounts in non-government financial institutions leads to monopoly pricing. Funding raised through credit financing or bonds must be used only for “self-liquidating, income-generating” projects. In addition, a number of administrative hurdles have been established including a requirement that LGUs must secure a no-objection from the monetary board before borrowing from a bank. Proposed remedies must address the dual objective of facilitating access to debt capital while at the same time mitigating the associated risks. Parallel administrative reforms will need to specify under what conditions LGUs can access debt capital, and how credit worthiness will be assessed and monitored.

7. **Weak public financial management systems.** Historically, public financial management (PFM) had been plagued by a number of critical deficiencies including mismatches and overlaps between government and LGU funding priorities, poor revenue and expenditure forecasting at the LGUs, a lack of transparency regarding the quality of LGU expenditures, and a lack of technical capacity (e.g., local budget officers and treasurers). However, the government has implemented a number of initiatives to address these deficiencies. The 2012 General Appropriations Act enacted the Full Disclosure Policy, which

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obligates LGUs to disclose a wide variety of financial information. The bottom-up budgeting project was launched in 2013 and uniform planning documents and methodologies were completed in 2016 to better harmonize budget planning and execution. Cash-flow forecasting has been strengthened and work has begun to professionalize public financial management within the LGUs. The government is also taking important steps to improve transparency and accountability in local government management. To assure wide-scale implementation of this policy, the government has embarked on a plan to provide the public with electronic access to LGU disclosures. At the same time, the government has supported efforts to make LGU budgets performance sensitive and to increase the role of civil society in performance monitoring. The Performance Challenge Fund, which was established in 2012, is a recent milestone in the development of incentives for good local governance in the system of transfers. The fund provides financial support on a competitive basis to LGU infrastructure projects that have met a series of good governance conditions —described by the “Seal of Good Housekeeping”— which aim to improve LGU financial management.

While these reforms have yielded measurable results, more needs to be done. The recommendations arising from the review of the LGC can serve as a basis for much needed amendments to the Act. The process of unifying budget documents and methodologies should be formalized across the national and local governments, and the bottom-up budgeting process could be expanded. Specific guidelines are required to harmonize budget and investment priorities at the national level with those of the LGUs. In addition, the government will need to continue to build its system for electronic disclosures to provide civil society with the tools to monitor and evaluate the effectiveness of local budgeting, and the responsiveness of local policy makers. Efforts must be redoubled to provide effective civil society with more sensitive feedback mechanisms and the capacity of local officials to implement these reforms must be raised. In particular, efforts to ensure women benefit from the reforms and participate in the process should be prioritized.

2. Government’s Sector Strategy

The Philippine Development Plan, 2011–2016 (PDP) identifies three primary objectives: (i) promoting inclusive growth and generating employment, (ii) improving governance and human development standards, and (iii) achieving macroeconomic and fiscal sustainability. Under this plan, the government’s decentralization reform efforts have focused on developing broad-based capacity at all levels, particularly in PFM, including planning, budgeting, budget execution, procurement, accounting, reporting, and internal and external audit. In particular, the key medium-term policy issues and reforms that are being pursued by the government and supported under the second Local Government Finance and Fiscal Decentralization Reform Program (LGF-FDR) include: organizing regular consultation forums through a Coordination Committee on Decentralization; defining functional revenue and expenditure assignments more clearly; improving resource planning, budgeting and expenditure management in key service delivery areas (e.g., health, education, and public infrastructure); increasing the effectiveness of performance measurement systems; increasing local government access to credit financing.

7 The disclosure mandate covers (i) annual budget reports; (ii) statements of receipts and expenditures; (iii) Priority Development Assistance Fund (PDAF) utilization; (iv) quarterly reports of the special education fund; (v) expenditures on social development, economic development, and environmental management under the IRA; (vi) annual gender and development accomplishment reports; and (vii) key procurement documents.

8 The Seal of Good Housekeeping will be awarded to LGUs with (i) proven comprehensive development plans and implementation agendas; (ii) sound fiscal management systems, and up-to-date financial reporting; and (iii) compliance with the Anti-Red Tape Law, and full disclosure of local budgets.

including nontraditional financing sources (e.g., bonds); increasing LGU taxing powers, and; generating other local sources of revenue (e.g., from economic enterprises). To provide continuity past the end of the PDP, LGUs will continue with the reform agenda through the LGU PFM reform roadmap, which was adopted in 2015 as part of second LGFFDR program. The roadmap provides for a number of initiatives, including the establishment of an open and transparent LGU PFM system which is stable and sustainable, capable of efficient and effective service delivery, and which rests on the highest level of accountability to stakeholders.

3. **ADB Sector Experience and Assistance Program**

10. ADB provided program loans and technical assistance (TA) to support the government's decentralization efforts. To begin, technical assistance supported reforms to intergovernmental fiscal relations, enhanced local resource mobilization, strengthened expenditure management, and LGU performance measurement. Achievements included a reduction in the release time for LGU shares in national wealth, recommended improvements in the use of the special education fund, and refinements in the architecture of the local governance performance management system.\(^\text{10}\) Building on these reforms, the first programmatic approach to further strengthened and enhanced the government's fiscal decentralization agenda.\(^\text{11}\) Subprogram 1 covered 2006–2007 and provided a comprehensive policy framework that broadened policy reforms in five areas covering: i) intergovernmental fiscal transfers; ii) fiscal management, planning, and public expenditure management; iii) LGU performance measurement systems and links to service delivery; iv) LGU access to credit; and v) LGU own-source revenues. Subprogram 2 covered 2008–2009 and continued work in the same target areas and finalized a number of key actions begun in subprogram 1. A subsequent Program Validation Report rated the program successful, although the report noted that more time and overt actions may be needed to bring about the progress envisaged in the program's outcome and impact statements.\(^\text{12}\)

11. To institutionalize these reforms, ADB provided additional technical assistance to enable participating LGUs to use improved land management and administration systems, including property valuation and taxation innovations, to generate increased local government revenues.\(^\text{13}\) A second TA was processed to help LGU's develop local own-source revenues and credit financing, close gaps in planning and performance measurement, and to formalize the Coordination Committee on Decentralization.\(^\text{14}\) These accomplishments set the stage for the second programmatic approach which was designed to provide LGUs with more resources and to improve their capacity to plan and budget for the general welfare of their citizens in a transparent and accountable manner.\(^\text{15}\) The key output areas are: (i) creating a conducive fiscal framework for inclusive growth, (ii) developing an adequate and equitable resource framework for fiscal sustainability, (iii) strengthening public financial management to assist efficient LGU service delivery, and (iv) fostering good local governance, transparency, and accountability.

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11 ADB. 2007. Report and Recommendations of the President to the Board of Directors on a Proposed Program Loan and Technical Assistance Grant Republic of the Philippines: Local Government Financing and Budget Reform Program Cluster. Manila.


PROBLEM TREE FOR PUBLIC SECTOR MANAGEMENT (Decentralization and Local Governance)

Large Regional Poverty Disparities

Non-Inclusive Growth

Inefficient Delivery of Services by Local Government

Inefficient Public Financial Management and Miss-aligned National–Local Development Goals

Local Government Systems are Inefficient and Lack Transparency

Weak Local Government Accountability to Constituents

Inadequate and Inequitable Distribution of Financial Resources to Local Government Units (LGUs)

Unproductive and Unstable Own-Source Revenue System for LGUs

Inefficient System of Inter-governmental Fiscal Transfers

Inefficient System of Inter-governmental Fiscal Transfers

Taxation:
- Institutional deficiencies (low productivity of tax instruments)
- Multiplicity of local government taxes and fees creates uncertainty
- Inefficient revenue-expenditure matching
- Uneven distribution of tax bases among LGUs
- Limitations to the cohabitation of tax bases

Access to debt capital markets:
- Obsolete LGU financing framework
- Complex institutional processes for LGU loan approval
- Lack of access to private sector borrowing
- Weak LGU bond market
- Slow implementation of Public–Private Partnerships

- Lack of a medium-term roadmap for local financial management reforms
- Uncoordinated planning, investment programming, and expenditure management
- National and local development priorities are not aligned
- Weak fiscal management capacity for revenue planning
- Absence of a multi-year budget process
- Absence of performance-based grant systems

- Lack of transparency over LGU budgets and expenditures inhibits effective monitoring
- Complex and inefficient systems for LGU performance measurement
- Low capacity of elected officials and administrative staff in LGUs
- Absence of inter-local alliances for service delivery
- Limited local participation
- Lack of institutions for solving functional assignment conflicts

- Informal revenue allotment (IRA) fails to adequately estimate expenditure needs
- IRA is not distributed according to fiscal capacity of LGUs
- Vertical distribution of IRA shares does not reflect expenditure needs
- Underdeveloped system of conditional transfers and unclear and outdated assignments of service delivery responsibilities by LGUs
- Absence of performance based transfer systems