A. Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **Legal and regulatory framework for decentralization.** Central-local relations in the Philippines are governed primarily by the Local Government Code (LGC) of 1991, which sets forth the rights, obligations and basic functions of various orders of local government. At the time of its passage, the LGC represented a major shift towards a model of decentralized local governance in the Philippines, with provisions to assign a significant share of functions to local government units (LGUs), establish a mandate for own-source revenue generation at the local level, increase the transfer of funds from national government to LGUs, and establish a framework for local participation and active citizen engagement in local governance. The goal of this ambitious reform was to reduce the distance between government and citizens and increase the quality and quantity of public services delivered by LGUs.

2. **Implementation challenges and policy shifts towards greater decentralization.** While the promulgation of the LGC in 1991 set forth a strong basis for decentralized local governance in the Philippines, implementation challenges and political economy factors have dampened its impact. A legacy of national administrations which have prioritized the National Capital Region over others has contributed to major disparities and imbalances. Persistent armed conflict in several parts of the country between communist and insurgent forces and the national government resulted in the prioritization of national unity and security over regional autonomy. However, there is a growing perception that security might be aided by a form of decentralized governance which creates space for the geographic, ethnic, and cultural diversity in the Philippines. This shift is reflected in the current administration’s policy focus on greater decentralization. Expediting the transfer of power and responsibility towards the regions and away from the national government was a signature policy for Philippine President Rodrigo Duterte when he was elected in 2016. The President himself is a vocal advocate of a major constitutional amendment to move the Philippines to a federal rather than unitary state. Regardless of political decisions on which form of governance is suitable, the current legal and regulatory framework is inconsistent with the evolving vision of increased local autonomy and decentralized service delivery.

3. **Comprehensive review of LGC.** Recognizing the need for an updated framework for decentralization, the Government of the Philippines initiated a comprehensive review of the LGC 1991 in 2015, supported by ADB. This review revealed a number of dimensions of the local governance framework that stand to be strengthened, a summary of which is presented below.

4. **Functional responsibilities and expenditure assignments.** The process of transferring service delivery responsibilities to LGUs has been initiated, but much remains to be done. A lack of clarity in the legal and regulatory framework on the assignment of exclusive and shared roles and responsibilities by various order of government has led to confusion, inefficient duplication of tasks, and service delivery gaps. LGU expenditures currently comprise approximately 18% of total government spending, which is low relative to other more decentralized peers in the region.\(^2\) Where functional responsibility has been transferred to local governments, the related budget does not always follow suit, resulting in common complaints of unfunded mandates by the LGUs. Likewise, central government agencies have resisted attempts to transfer personnel to LGUs.

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1. This assessment focuses on the decentralization and local governance aspects of public sector management.
2. For example, the share of local government expenditures in Indonesia is approximately 25%.
alongside their growing service delivery responsibilities, resulting in manpower shortages and capacity gaps.

5. **Intergovernmental fiscal transfers.** The Internal Revenue Allotment (IRA) remains the primary source of resources for local governments, comprising some two-thirds of total local government revenues. As national revenues have grown, so too has the IRA allocation to LGUs. From 2014 to 2016, the IRA allocation grew by 25% in nominal terms, and from 2.8% of gross domestic product (GDP) to 3% of GDP.\(^3\) The current IRA approach is subject to a number of criticisms. While the allocation rules are relatively simple and straightforward, they fail to achieve any significant horizontal equalization objectives. Thus, despite having the highest own-source revenue generation potential, relatively wealthy, densely populated urban areas continue to receive a high share of the IRA relative to those poorer, less economically dynamic LGUs. The IRA is also perceived as creating a disincentive for own-source revenue generation, where local governments can enjoy the “pleasure” of spending without suffering the “pain” of raising taxes. A recent ruling by the Supreme Court of the Philippines is likely to exacerbate this issue. By law, the IRA is set at 40% of the actual national government revenue collection. In the past, this has been interpreted by central government as meaning 40% of tax revenues. This view was challenged by LGUs, which interpreted the law as mandating 40% share of all government revenues (tax and non-tax) – a view which was recently upheld by the Supreme Court. It remains undecided whether this finding will be applied going forward, or retroactively applied; however, if the latter case prevails, central government would be in the position of owing LGUs some ₱1.5 trillion.

6. **Local own source revenues and tax administration.** The picture for local own source revenues (LSR) is mixed. As a share of GDP, LSR have held steady at approximately 1% since 2012. However, over the same period, the share of LSR relative to total LGU revenues has declined from 31% in 2012 to 29% in 2016. The LGC sets forth a mandate for LGUs to introduce new revenue instruments, but at the same time limits their ability to set tax rates. As a result, there is a proliferation of non-tax revenue collection instruments including fees, fines and user charges. Fully 30% of LSR come from non-tax revenues (footnote 3). These fragmented non-tax revenue instruments come at higher administrative cost and create barriers for the private sector which inhibit local economic development. A major barrier to LSR generation lies in the political factors which affect locally collected real property tax. LGUs currently have control over both valuation of real property at the local level, as well as rate setting (within a specified range) and collection of associated taxes. However, due to political factors, the assessed schedule of market values (SMV) in most LGUs is decades out of date. A 2013 study by the World Bank found that in most LGUs the SMV substantially lags true market values with assessed values ranging from 200% to 7,474% below true values, representing significant revenues which are forgone.\(^4\) To combat this and other shortcomings in local revenue administration, government has drafted a new valuation reform act under the Comprehensive Tax Reform Program. This act will recentralize approval of the SMV under the Department of Finance, bringing assessed taxable values up to date while reducing the effects of political factors at the local level, and address other shortcomings in property tax administration.

7. **Local government financing and investment conditions.** As in many countries, access to capital markets and other financing sources are constrained for local government in the

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Philippines. While the LGC grants LGUs borrowing powers in principle, there are a number of barriers. Local governments are prohibited from opening accounts in non-government financial institutions, leading to monopoly pricing on credit. Administrative barriers, such as the requirement for a no objection letter from the monetary board, also discourage borrowing. The Philippines is highly exposed to earthquakes, typhoons, floods and other natural disasters; local governments are poorly prepared to bear the financial risks associated with these shocks, and most have difficulty mounting a timely and effective response to such emergencies. LGUs are similarly constrained in encouraging private sector participation in the infrastructure market. An uncertain legal and regulatory framework, and poorly developed technical support mechanisms make it difficult for LGUs to attract private sector infrastructure investment. The proliferation of non-tax revenue instruments and a complex and lengthy process for the issuance of local licenses and permits results in a high cost business environment and stymies local economic development.

8. **Public financial management.** Local public financial management (PFM) has improved in recent years, but many issues remain to be addressed. There is significant variation in the form and content of local public finance reporting, weakening vertical linkages between planning and budgeting at municipal, provincial and regional levels. Transparency and public disclosures have improved since the introduction of a “Full Disclosure” policy in 2012, but variations across LGUs make it difficult to reliably compare performance, or for central government to obtain a comprehensive picture of local spending. There is a significant body of rulings, issuances and guidelines from central agencies to support good financial management at local levels; however, the lack of organization and sheer volume of these documents constrain their usefulness. Inefficiencies in budget and cash management practices affect budget execution, leading to consistent underspending and unanticipated surpluses, which have doubled as a share of GDP between 2012 and 2016.\(^5\) Government has begun to address these issues with a more systematic approach to capacity building. Standardized manuals on core public finance functions like budgeting, planning and cash management have been developed and circulated to LGUs. Government has begun to professionalize local public finance functions with the introduction of the Standardized Examination and Assessment for Local Treasurers.

2. **Government’s Sector Strategy**

9. The Philippine Development Plan (PDP) 2017–2022 sets forth a medium-term plan aligned with the long-term development objectives outlined in *Ambisyon Natin 2040*. The PDP focuses on promoting inclusive growth, regaining trust in public institutions and developing a competitive knowledge economy with high growth potential. In line with these priorities, the government has embarked on a major overhaul of central-local government relations in the Philippines. As discussed above, the most extreme reform proposal targets a constitutional amendment to introduce a federal system of decentralized local self-government; however, this aim is unlikely to be realized in the near future. More immediate efforts include a comprehensive review of the 1991 LGC, and the drafting of 21 amendments which have been proposed to update and strengthen the autonomy and accountability of local governments. These proposed amendments are under a broadly consultative process with key government and non-government stakeholders. Key reform areas include: (i) clarifying expenditure assignments and differentiating between fully devolved and shared responsibilities; (ii) empowering inter-governmental alliances and organizations to support more efficient service delivery; (iii) institutionalizing the principles of good PFM in the LGC; (iv) improving vertical linkages between planning and investment;

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(v) reducing administrative and financial barriers to local investment and economic development; and (vi) strengthening local revenue mobilization provisions. The government has also been steadily introducing a series of tools and mechanisms to strengthen local governance, especially over PFM. Most notably, government has developed a “Policy, Operational and IT Roadmap for Enhancing and Integrating LGU Fiscal Reporting Systems”. A key feature of this roadmap is the operationalization of the LGU Integrated Financial Tools (LIFT) platform, designed to integrate and harmonize the various LGU planning and fiscal reporting systems. Government is also working towards professionalization of core public finance functions at the local level, including local treasurers, local budget officers, and local planning officers. On the revenue side, government is in the midst of a Comprehensive Tax Reform Program, which aims to strengthen local revenue administration. The valuation reform act (para 6) is a central pillar of this reform and is expected to have a major impact on local revenues. The Department of Finance estimates an additional ₱25 billion could have been collected in 2016 with an updated SMV.\(^6\) The government is also addressing constraints to LGU financing and disaster risk preparedness through reforms to the public-private partnership framework which enable private sector participation in local infrastructure markets, and the proposed Philippines City Disaster Insurance Pool which will help mitigate the financial risks of natural disasters.

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

10. ADB has a longstanding partnership with the Philippine government on strengthening central-local relations. ADB’s engagement includes program loans, project loans and technical assistance to support government’s decentralization efforts. In 2007, a programmatic policy-based loan and TA grant for the Local Government Financing and Budget Reform Program helped the government improve the speed of resource transfers to LGUs, enhanced the framework for LGU performance management, and improved specific purpose fund governance.\(^7\) The cluster also provided a comprehensive reform framework covering a number of key fiscal management dimensions, including intergovernmental fiscal transfers, expenditure management, revenue mobilization and fiscal and service delivery performance. This successful collaboration laid the foundations for a second programmatic approach, the first subprogram of which was approved by the ADB’s board of directors in 2014.\(^8\) The Local Government Finance and Fiscal Decentralization Program included key outputs such as creating a conducive fiscal framework for inclusive growth, developing an adequate and equitable resource framework for fiscal sustainability, strengthening local PFM to support service delivery, and fostering good local governance. Technical assistance provided alongside this program has supported a range of activities, most notably the comprehensive review and amendment drafting for the 1991 LGC. ADB has since been engaged in preparing a new sector development program to support local governance reform with a target approval date of Q2 2019. Technical assistance provided in line with this program has supported development and implementation of the LGU Fiscal Reporting Systems Reform Roadmap, development of an e-compendium of LGU fiscal rulings and guidance, operationalization of the Standardized Examination and Assessment for Local Treasurers, and other related activities. ADB is simultaneously preparing a Real Property Tax and Administration Project to support domestic revenue mobilization and implementation of the proposed valuation reform act.

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\(^6\) Government of the Philippines, Department of Finance. 2018. *Presentation of Property Valuation and Tax Reform.*

\(^7\) 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.

\(^8\) ADB. 2014. *Report and Recommendations of the President to the Board of Directors on a Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to the Republic of the Philippines: Local Government Finance and Fiscal Decentralization Reform Program.* Manila.
PROBLEM TREE

CORE PROBLEM: Weak local governance and inefficient delivery of services

Legal and policy framework does not support decentralized local governance

- Unclear and overlapping responsibilities result in cost and confusion
- Lack of clarity on functional and expenditure assignments

Poor planning and investment, coordination, and poor budget execution

- Own-source revenue constrained, downwards accountability weakened
- Political factors influence real property valuation by LGUs
- Absence of meritocratic appointment of local PFM officials

Low levels of local economic growth and private investment

- Weak capacity and professionalization of local bureaucracy
- Weak linkages between LGU planning, budgeting, and cash management
- Various and fragmented systems for PFM reporting

Low private sector participation at local levels

- Inadequate financing options and poor disaster risk preparedness
- Complex issuance process for local permits, proliferation of non-tax fees
- Lack of financing and debt framework for LGU performance

LGU = local government unit, PFM = public financial management.