

# Fiscal Design and Subnational Governance: Autonomy and Equity Considerations

---

*Rosario G. Manasan, Senior Research Fellow*  
*7 September 2017*



Philippine Institute for Development Studies  
*Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas*

# Overview of presentation

---

- Context
- Why reform the fiscal decentralization framework
- Direction of reform
- Cost and risks in shifting to federal form of government
- Conclusion

# Federalism is a hot topic ...

---

- ❑ Adoption of federal form of government – one of President Duterte’s campaign promises and he reiterated this thrust in his 1<sup>st</sup> SONA in 2016
- ❑ Strong support for federalism among members of super majority at the House
  - Shift to federal form of government – part and parcel of proposed constitutional amendment/ revision
- ❑ PDP-Laban
  - actively involved in advocacy and design of “federalism model” for the Philippines

# Federalism discourse in the public arena

---

- Federalism oftentimes framed as representing the “countryside’s revolt against imperial Manila”
  - Short way of saying, government is too centralized despite decentralization under Local Government Code
  - another aspect of this narrative relates to the persistence of wide regional disparities in per capita household income, regional shares in GDP, and poverty incidence

Regions	DA		BFAR		DENR		DPWH <sup>a/</sup>		DTI		DSWD		DILG		PNP		DOH		DepEd	
	PhPM	% distn	PhPM	% distn	PhPM	% distn	PhPM	% distn	PhPM	% distn	PhPM	% distn	PhPM	% distn	PhPM	% distn	PhPM	% distn	PhPM	% distn
CO++	4,528	16.4	2964.4	53.9	2,379	19.9	15,911	18.9	261	13.9	5,843	47.7	969	9.0	70,948	94.8	17,176	17.0	20,483	5.5
NCR				0.0	54	0.5	18,105	21.5	6	0.3	748	6.1	156	1.4	779	1.0	3,169	3.1	30,835	8.3
CAR	1,114	4.0	34.8	0.6	546	4.6	746	0.9	81	4.3	197	1.6	640	5.9	141	0.2	2,609	2.6	7,787	2.1
RI	2,023	7.3	152.3	2.8	302	2.5	2,205	2.6	90	4.8	355	2.9	444	4.1	179	0.2	5,576	5.5	20,893	5.6
II	2,195	8.0	148.3	2.7	501	4.2	1,762	2.1	106	5.7	274	2.2	317	2.9	152	0.2	3,745	3.7	13,207	3.5
III	2,243	8.1	174.3	3.2	550	4.6	4,610	5.5	140	7.5	514	4.2	383	3.5	291	0.4	7,463	7.4	31,326	8.4
IVA	1,754	6.4	170.9	3.1	864	7.2	5,752	6.8	160	8.6	560	4.6	469	4.3	283	0.4	7,441	7.4	39,600	10.6
IVB	1,311	4.8	189.4	3.4	731	6.1	1,469	1.7	86	4.6	294	2.4	557	5.2	121	0.2	4,062	4.0	20,040	5.4
V	1,440	5.2	218.9	4.0	521	4.4	2,711	3.2	135	7.2	417	3.4	1,142	10.6	216	0.3	6,717	6.6	24,425	6.5
VI	1,543	5.6	191.4	3.5	521	4.4	2,359	2.8	92	4.9	523	4.3	829	7.7	287	0.4	7,623	7.5	30,375	8.1
VII	1,164	4.2	294.5	5.4	586	4.9	3,817	4.5	90	4.8	451	3.7	706	6.5	245	0.3	7,440	7.4	28,525	7.6
VIII	1,337	4.8	250.8	4.6	631	5.3	3,886	4.6	101	5.4	366	3.0	1,159	10.7	185	0.2	5,121	5.1	23,808	6.4
IX	1,230	4.5	160.0	2.9	895	7.5	7,300	8.7	71	3.8	428	3.5	539	5.0	181	0.2	5,291	5.2	17,839	4.8
X	1,441	5.2	127.1	2.3	694	5.8	4,032	4.8	93	4.9	423	3.4	662	6.1	178	0.2	5,405	5.3	16,942	4.5
XI	1,426	5.2	130.3	2.4	484	4.1	4,029	4.8	99	5.3	347	2.8	680	6.3	176	0.2	5,011	5.0	16,471	4.4
XII	1,773	6.4	122.8	2.2	949	7.9	3,485	4.1	123	6.6	284	2.3	364	3.4	163	0.2	4,140	4.1	17,122	4.6
XIII	1,064	3.9	166.8	3.0	728	6.1	2,003	2.4	141	7.5	235	1.9	794	7.3	134	0.2	3,121	3.1	13,521	3.6
Phil	27,588	100.0	5,497	100.0	11,934	100.0	84,183	100.0	1,876	100.0	12,259	100.0	10,811	100.0	74,841	100.0	101,109	100.0	373,200	100.0

<sup>a/</sup> refers only to "various local infrastructure" and "local infrastructure"

**Big portion of the GAA budget is allocated to the Central Offices (COs) of various departments. This does not necessarily mean that the these amounts actually gets spent in the NCR where COs are physically located. However, it means COs do exercise wide degree of discretion in allocating these to the regions during budget execution**

**Per Capita HH income, in current prices (in pesos)**

Region	1985	1994	1997	2003	2006	2009	2012	2015
NCR	11,575	37,070	61,211	65,625	81,336	91,792	96,891	110,792
CAR	6,880	15,457	25,544	36,240	46,788	55,167	66,453	69,814
RI	6,005	14,233	23,019	29,925	34,658	46,530	53,736	59,704
II	5,582	15,296	19,846	31,008	35,414	47,123	49,953	61,731
III	7,642	18,481	28,119	37,590	46,296	53,227	62,348	73,230
IVA	6,900	21,875	32,651	44,876	50,393	61,555	71,952	81,075
IVB	5,059	13,076	19,216	26,625	27,421	35,452	46,583	60,857
V	4,210	11,227	16,591	26,071	30,450	35,763	39,536	45,877
VI	5,132	13,418	19,411	27,273	31,815	40,450	52,811	55,881
VII	4,332	12,254	19,549	28,341	33,601	43,902	49,061	58,621
VIII	3,719	10,740	15,650	24,220	30,108	38,765	40,713	49,682
IX	4,653	10,401	18,623	20,792	27,687	34,947	39,390	47,344
X	5,266	12,254	20,030	26,173	32,905	39,405	45,757	54,468
XI	5,700	14,713	20,239	27,492	32,676	41,188	48,840	64,072
XII	4,966	12,802	18,072	26,612	27,239	37,454	40,154	48,001
XIII	4,518	11,122	15,880	20,672	27,088	34,383	43,513	50,654
ARMM		9,661	14,611	17,722	18,106	23,996	25,244	26,437
Phil	<b>6,294</b>	<b>17,564</b>	<b>27,303</b>	<b>35,597</b>	<b>42,372</b>	<b>51,489</b>	<b>58,583</b>	<b>67,622</b>
Coefficient of variation	0.327	0.433	0.478	0.368	0.393	0.337	0.315	0.301

- Per capita household income in NCR continues to be the highest in 1985-2015 but disparity in other regions' income relative to NCR's has narrowed

# Federalism discourse in the public arena

---

- More critical perspectives have started to emerge
  - If federalism is the answer, what is the question? – UPSE
  - “Autonomy is of primary importance, federalism is just secondary” – Governor X
  - Imperial Manila vs dynastic countryside – ADMU-SoG
  - Is federalism poverty-reducing or poverty-inducing?
  - What is budgetary cost of shift to federal form of government?

# If federalism is the answer, what is the question?

---

- ❑ Proponents (e.g., PDP Laban) say:
  - “Federalism is the practical solution to age-old problems of poverty, inequality and instability
  - ... it provides a system where national unity is maintained while protecting the diversity of our society”
  
- ❑ Economic literature suggests that potential benefits can be secured by adopting a federal form of government



# Potential benefits of shift to federal form of government

---

1. Increased efficiency → increased societal welfare to the extent that ...
  - Federal system brings government closer to the people, thereby allowing lower level governments to respond to local needs and preferences of their constituents
  - The jurisdiction of the level of government paying for the delivery of a given public service coincides with the geographic area where benefits of said public service are confined
    - Otherwise, government will tend to under-provide services which have positive benefit spillovers to other jurisdictions

# Potential benefits of shift to federal form of government

---

2. Increased efficiency and welfare also results to the extent that ...
  - Federal system promotes interjurisdictional competition assuming that the population have the ability to “vote with their feet” to get the “public services-tax package” they prefer
    - Thus, dampening rent-seeking tendency of local politicians

# Potential benefits of shift to federal form of government

---

3. Federal system enhances local accountability to the extent that ...
  - Lower level governments have some degree of revenue autonomy (i.e., if they raise a significant amount of revenues from local taxes and user charges)
  - Also, results from enhanced citizen participation in local governance
4. Federal system key to addressing ethnocultural conflict as it accommodates regional diversity – religious, linguistic, ethnic, or cultural

# Potential benefits of shift to federal form of government

---

- ❑ The first 3 of these potential gains - largely a function of the extent of decentralization
  - Said gains may be secured with greater fiscal decentralization with or without shift to the federal form of government
  
- ❑ Countries with federal form of government are not necessarily decentralized to the same degree and some of them may be less than decentralized than those with unitary form of government
  - Germany (federal) more centralized than Canada (federal)
  - Malaysia (federal) more centralized than Philippines (unitary)

# Potential benefits of shift to federal form of government

---

- ❑ With regards to the 4<sup>th</sup> potential benefit, adoption of federal form of government does not necessarily prevent break-up of conflict-ridden states (e.g., Pakistan → present Pakistan and Bangladesh)

# Distinction between multi-tiered unitary & federal form of government

---

- ❑ **Multi-tiered unitary form of government** – local government units exercise only the powers that the central govt (CG) chooses to delegate to them
  - CG can **unilaterally withdraw powers** delegated to subnational units
- ❑ **Federal form of government** – powers are shared by at least two levels of government (i.e., federal government and constituent units), each having some degree of autonomy in the exercise of certain powers, and each of which “deal directly with the citizenry in the exercise of their powers” [self-rule]
  - **Division of powers and allocation of resources** between federal government (FG) and constituent units (state/ regional/ provincial govts) are **written/ guaranteed in constitution**
  - Neither level of government can **unilaterally** alter the powers of the other

# Distinction between unitary & federal form of government

---

- ❑ Precisely because division of powers and resources between FG and state governments (SGs) are written in constitution, design of federal form of government should be subject of careful study
  - Otherwise, bad design gets enshrined in the constitution, making it more difficult to correct mistakes

# Distinction between unitary & federal form of government

---

- ❑ If the objective is to promote subnational autonomy and secure potential benefits from more decentralized governance, principles that guide design of fiscal aspects of federal form of government are just as relevant for decentralized unitary form of government
- ❑ These principles are aimed at ensuring that the FG and SGs face the right incentives for an efficient and equitable delivery of public services.



# Overview of presentation

---

- Context
- Why reform the fiscal decentralization framework – what are the potential gains?
- ✓ **Direction of reform**
- Costs and risks in shifting to federal form of government
- Conclusion

# Design should be informed by lessons learned from Philippine decentralization experience

---

- ❑ Deficiencies in the design of intergovernmental relations (or national- subnational relations) under the LGC – fiscal aspects
  - Expenditure assignment – lack of clarity
    - Overlapping and, at times, unclear assignment of functions across various levels of government
      - ✓ introducing concept of shared powers might address issue
    - Unfunded mandates → Relevant services either not delivered at all or not delivered in sufficient quantities
  - Tax assignment – low level of revenue autonomy, particularly for provinces

# Design should be informed by lessons learned from Philippine decentralization experience

---

- ❑ Deficiencies in the design of intergovernmental relations under the LGC – fiscal aspects
  - Intergovernmental transfers
    - Vertical fiscal imbalance; Inadequate equalization
    - Too much reliance on block grants to achieve different grant objectives – differentiated use of alternative types of transfers likely to improve LGU incentives
  - Subnational credit finance
    - Too much reliance on procedural rules deter optimum LGU credit financing of local infrastructure
    - But, more autonomous SGs under federal form likely to increase fiscal risks unless adequate fiscal rules are put in place

# Design should be informed by lessons learned from Philippine decentralization experience

---

- ❑ Deficiencies in the design of intergovernmental relations under the LGC – political economy
  - legislative overhaul of the LGC – difficult (Matsuda 2011)
    - Congress as an institution is cautious about expanding the resource base of LGUs
      - ✓ “Fiscally stronger LGUs depend less on individual national legislators for financial assistance and hence would result in loss of political leverage for members of the Congress [over the LGUs within their districts]. . . . . if more resources were made available to provinces, governors could emerge as strong political rivals, more so than they are already . . . .”

# Reforming the fiscal decentralization framework – four pillars

---

1. Expenditure assignment
  2. Tax assignment
  3. Intergovernmental transfers
  4. Subnational credit finance
- Internal consistency of items 1-3 just as important as the specific functions and taxing powers that will be assigned to FG and SGs, esp. in terms of addressing potential risk of widening disparities in service provision under a more decentralized regime
  - # 4 – important for fiscal/ macro stability

# Reforming the fiscal decentralization framework – suggested design

---

## 1. Expenditure assignment

- Monetary policy, currency and banking - Independent central bank
  
- Exclusive powers of FG
  - National defense
  - Foreign affairs
  - Immigration
  - International trade
  - Interstate commerce
  - Agrarian reform

# Reforming the fiscal decentralization framework – suggested design

---

## 1. Expenditure assignment

- Exclusive powers of state governments (SGs)
  - Supervision of LGUs
  - Police
  - Fire protection
  - Early childhood education
  - Water supply, sanitation and sewerage
  - Waste management
  - Road traffic management
  - Parks

# Reforming the fiscal decentralization framework -- suggested design

---

## 1. Expenditure assignment

- Shared powers of FG and SGs
  - Regional planning, land use management
  - Law and order (provision of prosecution services)
  - Basic education, higher and TVET education
  - Health
  - Labor and employment
  - Social welfare and social assistance
  - Agriculture, fisheries and aquatic resources
  - Industry
  - Tourism
  - Road infrastructure (with national primary roads exclusively assigned to FG)
  - ENR management
  - Energy
  - Science and technology



# Reforming the fiscal decentralization framework – suggested design

---

1. Expenditure assignment
  - Residual powers – FG

Note: With respect to shared powers, it is important to articulate in constitution/ legislation, principles that guide sharing of power FG and SGs (e.g., FG – policy, standard, oversight and financing, if applicable, of some of the specific competencies; SG – provision or production/ service delivery)

# Reforming the fiscal decentralization framework — suggested design

---

## 1. Expenditure assignment

- Preliminary estimate of costs of FG/ SG responsibilities assignment described above is followed
  - FG - 54% of total NG budget net of debt service or 8.5% of GDP (estimated based on 2016 GAA)
  - SGs (inclusive of what is now distributed to LGUs in the form of the IRA) - 45% of total NG budget net of debt service or 7.2% of GDP (estimated based on 2016 GAA)

# Reforming the fiscal decentralization framework -- suggested design

---

2. Tax assignment – in addition to taxes currently assigned to LGUs right now, SGs shall have power to impose
  - Residence-based surtax on personal income tax – say, 1% of taxable personal income of residents; – PhP 19 billion
  - Motor vehicle user charge or motor vehicle registration fees and driver's license fees – PhP 13 billion
  - Some increase in revenues from existing LGU taxes if pending bills in Congress are passed (e.g., VRA)

# Reforming the fiscal decentralization framework -- suggested design

---

## 2. Tax assignment

- Need to identify more SG taxing powers to ensure some degree of revenue autonomy for SGs
  - Otherwise, need to rethink preliminary expenditure assignment to ensure some revenue autonomy

**Projected SG revenues aggregated at SG level (in million pesos)**

Region	Proposed new taxes			Existing taxes under LGC, 2015				
	PIT surtax	Motor vehicle registration	% distn of new taxes (combined)	Real property tax	Local business tax	IRA	Total LGU income	% distn of total LGU inc
NCR	5,641	5,075	33.5	21,205	37,341	17,404	92,839	18.2
CAR	345	240	1.8	411	573	10,355	13,741	2.7
R I	609	511	3.5	1,502	1,328	16,753	26,080	5.1
II	637	320	3.0	539	713	16,723	20,106	3.9
III	2,348	1,634	12.4	4,881	4,360	29,890	46,031	9.0
IVA	2,283	1,591	12.1	9,741	8,745	33,881	60,917	12.0
IVB	631	103	2.3	530	555	14,572	16,986	3.3
V	358	261	1.9	814	899	18,966	22,949	4.5
VI	985	651	5.1	2,350	1,719	25,222	35,073	6.9
VII	1,110	952	6.4	2,226	3,553	22,095	41,498	8.1
VIII	571	199	2.4	444	513	18,741	22,669	4.5
IX	494	341	2.6	451	552	13,036	15,692	3.1
X	690	396	3.4	1,248	1,548	17,419	23,474	4.6
XI	900	454	4.2	1,420	2,084	15,686	21,897	4.3
XII	553	477	3.2	726	766	16,946	20,276	4.0
XIII	351	162	1.6	462	666	13,188	16,267	3.2
ARMM	116		0.4	30	116	12,231	12,761	2.5
Phil	18,624	13,367	100.0	48,981	66,028	313,107	509,257	100.0

**LGU revenues concentrated in NCR, Regions III and IVA  
 → underscore need for equalization transfers**

# Reforming the fiscal decentralization framework -- suggested design

---

## 3. Intergovernmental transfers

- Need to address vertical fiscal gap – finance should follow function
- Critical that disparities in fiscal capacity be addressed through equalization grants
- Important to use appropriate type of intergovernmental transfer depending on policy objective (e.g., conditional transfers might be suitable if there is a need to incentivize SGs to provide minimum level of services for merit goods like basic education and public health)

# Reforming the fiscal decentralization framework -- suggested design

---

## 4. SG borrowing

- Golden rule – limit use of SG borrowing to the finance of capital investments only
- Firm commitment of FG to “no bail-out” of SG loans
- Need for bankruptcy policy and mechanisms for SGs

# Overview of presentation

---

- Context
- Why reform the fiscal decentralization framework – what are the potential gains?
- Direction of reform
- Costs and risks in shifting to federal form of government
- Conclusion



# Shift to federal form of government comes at a cost

---

## □ Elements of this cost

- Salaries of governors and vice governors of SGs and their staff as well as operating expense of their offices
- Salaries of Senators (second chamber) and their staff as well as operating expense of their offices – 3 to 7 senators per SG as per PDP

# Shift to federal form of government comes at a cost

---

## □ Elements of this cost

- Salaries of state legislators and their staff as well as operating expense of their offices – 3 alternative models
  - RA 9054 - 3 legislators elected by popular vote in each legislative district plus sector representatives whose number should not exceed 15% of total number of legislators elected by popular vote → total number of state legislators = 812
  - Proposal of Sen Nene Pimentel – 3 legislators elected by popular vote in each province/ city plus 3 sectoral representatives in each province/ city = 1,356
  - BBL model – at least 10 legislators per legislative district (40% of whom are elected by popular vote, 50% are party representatives, and 10% are sectoral representatives) = 2,380

# Shift to federal form of government comes at a cost

---

- ❑ Estimate of additional fiscal burden - ranges from PhP 33 billion to PhP 63 billion depending on number of states, size of legislative body at SG level and size of second chamber

# Pre-conditions for success in adopting federal form of government

---

- ❑ Reform of party system so as to institutionalized strong political parties with “coherent ideological programs and policy platforms and internal organizational discipline” (Matsuda 2014)
  - Government budget support to political parties
  
- ❑ Eliminate high barrier to entry in political arena – political dynasty (Pilapil 2016)

# Risks in adopting federal form of government

---

- ❑ Regional disparities may widen if fiscal equalization is weak – risk is high given initial condition is bad to start with
- ❑ Accountability may weaken if there is low revenue autonomy

# Risks in adopting federal form of government

---

- ❑ Without pre-conditions, likelihood of elite capture large
- ❑ Even if initial design of federal model is coherent at the start, likelihood is high that initial model will be changed to reflect the particular interests of the framers of new constitution
  - Recall concerns raised earlier regarding political economy of fiscal decentralization reform

# Conclusion

---

- ❑ Two options to choose from
  - Shift to federal form of government or
  - Reform fiscal aspects of LGC
  
- ❑ Who are the decision makers?
  - Political leaders
  - You and I
  - All of us

# Conclusion

---

## □ How to choose?

- Decision making under uncertainty

- In choosing between these two policy options, one needs to:

- a. weigh relative net benefit (i.e., benefits less costs) of the two policy options and
    - b. assess the probability that reform actually results in the desired outcomes





Philippine Institute for  
Development Studies

*Surian sa mga Pag-aaral Pangkaunlaran  
ng Pilipinas*

Service  
through  
policy  
research

# Thank you

---

WEBSITE: [www.pids.gov.ph](http://www.pids.gov.ph)

FACEBOOK: [facebook.com/PIDS.PH](https://facebook.com/PIDS.PH)

TWITTER: [twitter.com/PIDS\\_PH](https://twitter.com/PIDS_PH)

EMAIL: [rmanasan@mail.pids.gov.ph](mailto:rmanasan@mail.pids.gov.ph)

---

---

Thank You!

---

---