



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

# Designing the Fiscal Features of a Federal Form of Government: Autonomy and Equity

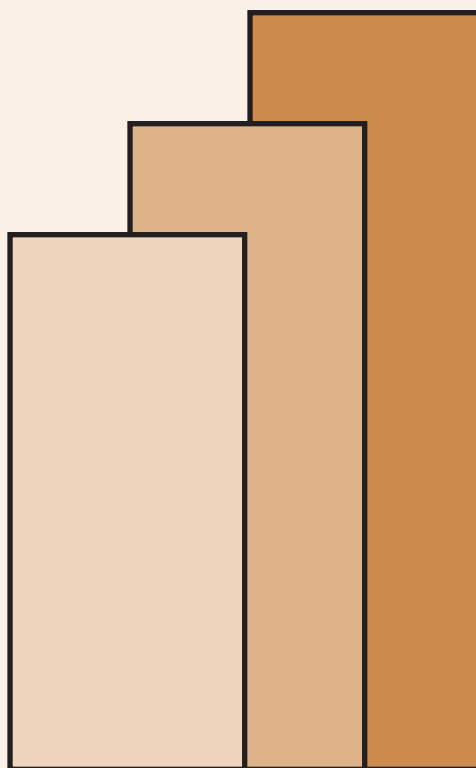
*Rosario G. Manasan*

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For comments, suggestions or further inquiries please contact:

The **Research Information Department**, Philippine Institute for Development Studies  
18th Floor, Three Cyberpod Centris – North Tower, EDSA corner Quezon Avenue, 1100 Quezon City, Philippines  
Tel Nos: (63-2) 3721291 and 3721292; E-mail: [publications@mail.pids.gov.ph](mailto:publications@mail.pids.gov.ph)

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FEDERAL FORM OF GOVERNMENT:  
AUTONOMY AND EQUITY**

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*Rosario G. Manasan*

**Philippine Institute for Development Studies**

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# Table of Contents

ABSTRACT.....	iii
1. INTRODUCTION .....	1
2. OVERVIEW OF THE FISCAL FEDERALISM FRAMEWORK .....	3
3. DESIGN OPTIONS FOR THE FISCAL FEATURES OF PROPOSED FEDERAL GOVERNMENT.....	5
3.1 Expenditure Assignment.....	5
3.2 Tax/ Revenue Assignment .....	11
3.3 Intergovernmental Fiscal Transfers .....	18
3.4 Subnational Government Borrowing .....	25
4. FISCAL COST OF ADOPTION OF FEDERAL FORM OF GOVERNMENT .....	27
5. CONCLUSION.....	28
REFERENCE.....	30

## List of Boxes

Box 1. Distinction between multi-tiered unitary form of government and federal form of government .....	5
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## List of Figures

Figure 1. LGU OSR-to-GDP ratio and local tax-to-GDP ratio, 1985-2016 .....	15
Figure 2. IRA and other components of LGU income as % of GDP.....	22

## List of Tables

Table 1. Gross regional domestic product (GRDP), per capita household income and poverty incidence across regions .....	2
Table 2. Functional assignment under the 1991 Local Government Code.....	7
Table 3. Illustrative design option for assignment of expenditure for proposed Philippine federal model .....	10
Table 4. Estimate of indicative cost of expenditure responsibilities assigned to federal level and state governments as per Table 3 .....	11

Table 5.	Taxes assigned to provinces, cities, municipalities and barangays under the 1991 LGC.....	13
Table 6.	OSR <sup>a/</sup> and local tax revenues for all LGUs combined in pre- 1991 LGC and post-1991 LGC period, by level of local government .....	13
Table 7.	LGU OSR performance, by region, 2015 .....	16
Table 8.	Projected subnational government revenues aggregated at the regional government level (in million pesos).....	18
Table 9.	IRA as % of GDP and % of total LGU income, by level of LGU .....	22
Table 10.	Indicative estimates of SG expenditure needs and SG revenue capacity .....	24
Table 11.	Indicative estimates of per capita SG expenditure needs and per capita SG revenue capacity (in pesos).....	24
Table 12.	Allocation for regional operations in the 2016 GAA budgets of selected departments .....	29

## ABSTRACT

The adoption of a federal form of government was a key campaign promise of President Rodrigo Duterte, a thrust reiterated in his first State of the Nation Address (SONA) in 2016. It has strong support among the members of the super majority at the House of Representatives (HOR), being part and parcel of proposed constitutional amendments that are currently being deliberated by the Committee on Constitutional Amendments. Further, the PDP Laban draft Constitution, which proposes the adoption of a semi-presidential federal system of government, was submitted to the same committee on September 27, 2017, while a different version was presented by ABS Party-list Congressman Eugene de Vera and Pampanga Congressman Aurelio Gonzales Jr. on August 2, 2017.

The federalism discourse in the public arena is oftentimes framed along two strands. First, the adoption of a federal form of government is seen as a means to reverse the unequal allocation of resources between what critics call ‘imperial Manila’ and the rest of the country. Second, advocates view the shift as key to attaining sustainable peace in Mindanao given its potential to secure national unity while protecting regional diversity. The discussion arising from both strands highlights the fact that there is no single federal model, and that the federal model may or may not work in the Philippine context depending on the specific design features of the particular model that is proposed. Given this perspective, this paper focuses on the design options of the fiscal elements of a federal model that will help ensure the realization of potential benefits from adopting a federal system of government.

The economic literature on fiscal federalism suggests that a federal system of government has the potential (i) to increase economic efficiency and societal welfare by bringing government closer to the people, thereby allowing subnational governments (SGs) to better respond to local needs and preferences, and dampening rent-seeking tendencies of local politicians by promoting interjurisdictional competition; (ii) to enhance accountability of lower level governments to the extent that they have some degree of revenue autonomy (i.e., if they raise a significant amount of revenues from local taxes and user charges) and greater citizen participation in local governance; and (iii) to strengthen national unity, helping address ethno-cultural conflict to the extent that it accommodates regional diversity. However, the first two of these potential gains are largely a function of the extent of decentralization, and may be secured through greater fiscal decentralization with or without shifting to a federal form of government. Further, with regards to the third potential benefit, the adoption of a federal form of government does not necessarily prevent the break-up of conflict-ridden states.

Guided by the literature, the paper discusses possible design options along the four pillars of intergovernmental relations: (i) functional or expenditure assignment, (ii) tax/revenue assignment, (iii) intergovernmental transfers, and (iv) subnational government borrowing. These principles are aimed at ensuring that the federal government (FG) and SGs face the right incentives for efficient and equitable delivery of public services and at enhancing accountability of subnational governments to their constituents. The discussion of the same is contextualized by lessons from the country’s past decentralization experience under the Local Government Code of 1991.

The paper also provides estimates of the cost of shifting to a federal form of government under different scenarios in terms of the number of regions. Finally, it concludes with the discussion of why adopting a federal form of government should take into account not only the net benefits of the reform, but also the pre-conditions for its success: (i) reform of the party system so as to institutionalize strong political parties that sanction political turncoatism, (ii) the lowering, if not the outright elimination of the high barrier to entry in the political arena, including presence of political dynasties, and (iii) the reduction in the concentration of the power over resource allocation and resource mobilization in the President (and by extension, the executive branch).

**Keywords:** Decentralization, expenditure assignment, equalization transfers, federal government, fiscal autonomy, intergovernmental transfers, political dynasties, political turncoatism, tax assignment, unitary government, vertical fiscal gap, vertical fiscal imbalance

# DESIGNING THE FISCAL FEATURES OF A FEDERAL FORM OF GOVERNMENT: AUTONOMY AND EQUITY

*Rosario G. Manasan*

## 1. INTRODUCTION

The shift to a federal form of government is one of President Rodrigo Duterte's campaign promises and he reiterated this thrust in his first State of the Nation Address (SONA) in 2016. It has the strong support of members of the super majority at the House of Representatives (HOR), being part and parcel of proposed constitutional amendments/ revision that are currently being deliberated under by the HOR Committee on Constitutional Amendments.<sup>1</sup> On the other hand, the PDP Laban headed by Senate President Aquilino Pimentel III is actively involved in the advocacy and design of a "federalism model" for the Philippines. The PDP Laban draft Constitution which was crafted under the auspices of the PDP Laban Federalism Institute and which proposes the adoption of a semi-presidential federal system of government was submitted to the HOR Committee on Constitutional Amendments in September 27, 2017. Meanwhile, another draft "Constitution of the Federal Republic of the Philippines" was presented by ABS Party-list Congressman Eugene de Vera and Pampanga Congressman Aurelio Gonzales Jr. to the same Committee in August 2, 2017.

The federalism discourse in the public arena is oftentimes framed along two strands. First, the adoption of a federal form of government is seen as a means to reverse the "unequal allocation of resources between what critics call 'imperial Manila' and the rest of the country"<sup>2</sup> that has, in turn, resulted in the persistence of wide regional disparities in per capita household incomes, per capita Gross Regional Domestic Product (GRDP) and poverty incidence. Proponents of the federal movement point out that the share of NCR in the national government budget is disproportionately large, accounting for over 14% of total appropriations under the 2016 General Appropriations Act (GAA), for instance, compared to the combined share of the remaining 7 regions in Luzon (21%), the aggregate share of the 6 regions in Mindanao (13%) and the share of the 6 regions in Mindanao taken together.<sup>3</sup> The cumulative effect of such disproportionately favorable treatment of NCR and its periphery over the years, they note, is reflected in the highly uneven level of economic development across the region and the persistence of poverty with the "rich regions becoming richer and the poor regions, much poorer"<sup>4</sup> (**Table 1**). They then argue that a federal form of government will address this problem by allowing regional or state governments to "retain more of their income" and "channel their own funds toward their own development instead of the bulk

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<sup>1</sup> In October 19, 2016, the Committee voted to have the 17<sup>th</sup> Congress to constitute itself into a Constituent Assembly for the purpose of amending the 1987 Constitution.

<sup>2</sup> <http://cnnphilippines.com/news/2015/03/31/Philippines-federalism-debate.html> accessed 15 July 2016

<sup>3</sup> Malaya, Jonathan. Federalism 101: Concepts, Principles, Possibilities; powerpoint presentation at "Roundtable: Readying Local Government Units Toward Federalism," Department of Interior and Local Government, 20 October 2016; <http://www.philstar.com/headlines/2016/05/31/1588742/federalism-what-filipinos-need-know> accessed 15 July 2016; <http://cnnphilippines.com/news/2015/03/31/Philippines-federalism-debate.html> accessed 15 July 2016

<sup>4</sup> PDP Laban Federalism Institute, "PDP Laban Model of Federalism: Semi-Presidential Federal System of Government for the Philippines" (powerpoint), March 2017.

of the money going to the national government.”<sup>5</sup> However, simply allowing subnational units to keep most of their income may not be enough to undo the huge imbalance in economic and human development across regions at present; nay, it may even worsen the situation given the wide disparity in the tax base across the different regions at present (**Table 1**). This discussion highlights the fact that there is no single federal model and that the federal model may (or may not) work in the Philippine context depending on the specific design features of the particular model that is proposed. To use a cliché, the devil is in the details.

**Table 1. Gross regional domestic product (GRDP), per capita household income and poverty incidence across regions**

Region	2015 GRDP			Per capita HH income (PhP)		Poverty incidence of population (%)			
	in billion pesos	% share	per capita	1994	2015	1991	2006	2009	2015
NCR	5,048	37.9	389,700	37,070	110,792	7.1	4.7	3.6	3.9
CAR	234	1.8	132,892	15,457	69,814	42.7	26.0	25.1	19.7
I	407	3.1	80,654	14,233	59,704	36.6	25.9	22.0	13.1
II	236	1.8	68,136	15,296	61,731	42.8	26.8	25.5	15.8
III	1,184	8.9	105,026	18,481	73,230	21.1	13.1	13.7	11.2
IV-A	2,061	15.5	140,491	21,875	81,075	22.7	10.3	11.9	9.1
IV-B	204	1.5	68,129	13,076	60,857	44.4	40.6	34.5	24.4
V	281	2.1	48,192	11,227	45,877	54.5	44.2	44.2	36.0
VI	547	4.1	72,006	13,418	55,881	39.6	29.1	30.8	22.4
VII	867	6.5	116,791	12,254	58,621	43.6	35.9	31.0	27.6
VIII	270	2.0	61,711	10,740	49,682	50.0	41.5	42.6	38.7
IX	276	2.1	73,795	10,401	47,344	40.3	45.0	45.8	33.9
X	516	3.9	108,506	12,254	54,468	46.6	39.0	40.1	36.6
XI	564	4.2	114,437	14,713	64,072	39.6	30.6	31.4	22.0
XII	356	2.7	76,698	12,802	48,001	53.3	37.9	38.3	37.3
CARAGA	158	1.2	60,552	11,122	50,654	54.3	49.2	54.4	39.1
ARMM	99	0.7	28,262	9,661	26,437	30.5	47.1	47.4	53.7
<b>Philippines</b>	<b>13,307</b>	<b>100.0</b>	<b>131,181</b>	<b>17,564</b>	<b>67,622</b>	<b>34.4</b>	<b>26.6</b>	<b>26.3</b>	<b>21.6</b>

Second, advocates view the shift to a federal form of government as key to attaining sustainable peace in Mindanao given its potential in securing national unity while protecting regional diversity arising from religious, linguistic, ethnic or cultural differences.<sup>6</sup> However, while Bangsamoro experts continue to support federalism as a solution to the Mindanao conflict, they also recognize that there are “there are potential pitfalls [from federalism] that may bring more harm than good in our search for sustainable formula for peace in Mindanao. In pushing for a shift to the federal system which is necessarily national in scope, the majority Filipinos must guard against imposing their will on the minority and in the process violate their [the latter’s] right to self-determination. The Moro people and other indigenous groups must always be considered *sui generis* – a class on their

<sup>5</sup> <http://www.philstar.com/headlines/2016/05/31/1588742/federalism-what-filipinos-need-know> accessed 15 July 2016; <http://www.rappler.com/nation/politics/elections/2016/120166-federalism-pros-cons-explainer> accessed 15 July 2016

<sup>6</sup> No less than President Duterte articulated this thought during the first Presidential debate held in 23 February 2016 (<http://www.inquirer.net/duterte/promises#> accessed 15 July 2016) and then again in a speech he delivered in 30 November 2016, five months after winning the Presidency (<http://newsinfo.inquirer.net/849221/only-federalism-will-bring-lasting-peace-says-duterte> accessed 15 July 2016).



own. Thus, a symmetric federal system that fails to recognize the distinctiveness of the minority may not catalyze peace but more conflicts in the future” (Bacani 2009<sup>7</sup>). Again, this discussion underscores the importance of paying close attention to design of the federal model in ensuring its success.

Given this perspective, this paper focuses on the design options of the fiscal elements of a federal model that will help ensure that the potential benefits from the adoption of a federal system of government are realized. In this regard, the economic literature on fiscal federalism provides some guidance. It posits a framework that delineates the potential benefits that ensues from a federal form of government as well as the elements of the design of the fiscal architecture that supports the achievement of said benefits.

It should be emphasized that the design options offered in this paper are for the most part illustrative. They are intended to highlight the challenging task of establishing internal consistency among the different components of the design based on available data on central and LGU government revenues and expenditures as well as indicators of possible tax bases and expenditure needs across the regions.

## **2. OVERVIEW OF THE FISCAL FEDERALISM FRAMEWORK**

The economic literature on fiscal federalism suggests that a federal system of government is likely to yield potential benefits in the form of (i) increased efficiency and, consequently increased societal welfare, (ii) enhanced local accountability, and (iii) stronger national unity in the face of regional diversity. First, under a federal system, optimal provision of public services is likely to be achieved if the jurisdiction of the level of government responsible for the financing and delivery of a given public service coincides with the geographic area where benefits of said public service are confined (Olson 1969, Oates 1972). Otherwise, government will tend to under-provide services which have positive benefit spillovers to other jurisdictions while over-provision may result if lower level governments are able to secure funding for projects that only benefit the local jurisdiction from higher level governments; i.e., they will tend to ask for more projects relative to situation when they have to finance said projects themselves. Also, greater decentralization under a federal form of government will tend to lead to increased efficiency and welfare to the extent that it brings government closer to the people, thereby allowing lower level governments to respond to the local needs and preferences of their constituents (Oates 1972). This tendency is further reinforced through interjurisdictional competition when the population has the ability to “vote with their feet” to get the “public services-tax package” that they prefer (Tiebout 1956), thereby, dampening the rent-seeking tendency of local politicians (Brennan and Buchanan 1977). Second, the 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). Increased local accountability also results from greater citizen participation in local governance under a more decentralized setting (Ostrom,

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<sup>7</sup> While this article was originally written in 2009, it was republished on the Institute for Autonomy and Governance website in 1 June 2016 attesting to its continued relevance to on-going federalism debate. <http://www.iag.org.ph/index.php/blog/1356-archives-autonomy-and-federalism-as-a-solution-to-the-mindanao-conflict> accessed 15 July 2016.

Schroeder and Wynne, 1993). Third, the federal system is also seen to have the advantage in addressing ethnocultural conflict as it accommodates regional diversity – religious, linguistic, ethnic, or cultural.

The first two of these potential gains are 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. Also, countries with a federal form of government are not necessarily decentralized to the same degree and some of them may even be less than decentralized than those with a unitary form of government. (**Box 1** summarizes the distinction between a multi-tiered unitary government and one with a federal form.) For instance, Germany, which is federal, is more centralized than Canada, which is also federal. Moreover, Malaysia, which is federal, is more centralized than Philippines, which has a unitary form of government.

With regards to the third potential benefit, the adoption of federal form of government does not necessarily prevent the break-up of conflict-ridden states (e.g., pre-1971 Pakistan has split up to the present Pakistan and Bangladesh).

The fiscal federalism literature (e.g., Shah [Perspectives ...] 1991, Shah [Reform of ...] 1994, Shah [Introduction: Principles ... from A Global Dialogue Vol 4] 2007) also provides some guidance in the design of the four pillars of intergovernmental relations: (i) functional or expenditure assignment, (ii) tax assignment, (iii) intergovernmental transfers, and (iv) subnational credit and debt management. These principles are aimed at ensuring that the FG and SGs face the right incentives for an efficient and equitable delivery of public services and at enhancing accountability of subnational governments to their constituents. These principles are discussed in greater detail below together with the design option for each of the four pillars of intergovernmental relations for a federal form of government for the Philippines.

**Box 1. Distinction between multi-tiered unitary form of government and federal form of government**

Under a multi-tiered unitary government, subnational units exercise only the powers that are delegated to them by the central government and the latter can unilaterally withdraw the said powers. In contrast, the division of powers and allocation of resources between federal government (FG) and constituent units (which may alternatively be called state, regional, or provincial governments) are written/ guaranteed in constitution. Neither level of government can unilaterally alter the powers of the other.

Multi-tiered unitary form of government	Federal form of government
Subnational government units exercise <u>only</u> the powers that the central government (CG) chooses to delegate to them	Powers are <u>shared</u> by at least two constitutionally levels of government (i.e., federal/ central government and constituent units); each one has some degree of autonomy in the exercise of powers assigned to them, and each one “deals directly with the citizenry in the exercise of their powers” [ <u>self-rule</u> ]
* CG can <u>unilaterally withdraw</u> powers delegated to subnational government units	* <u>Division of powers and allocation of resources</u> between federal government (FG) and constituent units (state/ regional/ provincial governments) are <u>written/ guaranteed in constitution</u>
	* Neither level of government can <u>unilaterally</u> alter the powers of the other
	* Constituent units are involved in decision-making at the central through representation of constituent units in the second chamber of the legislature [ <u>shared rule</u> ]

**3. DESIGN OPTIONS FOR THE FISCAL FEATURES OF PROPOSED FEDERAL GOVERNMENT**

The design options for the key fiscal elements of a federal form of government offered below do not only take the guiding principles available from the fiscal federalism framework but are also likewise informed by the lessons from the Philippines’ past experience with fiscal decentralized since the enactment of the 1991 Local Government Code.

**3.1 Expenditure Assignment**

The basic principle that guides the assignment of functional or expenditure responsibilities to different levels of government is attributable to Oates (1972): “each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision.” Following this principle, functions and competencies whose benefits are national in scope should be assigned to the federal government. Thus, national defense, foreign affairs, functions related to economic stabilization and macroeconomic management (i.e., monetary policy, currency, and banking; fiscal policy), functions related to the preservation of internal common market (e.g., regulation of international and interstate trade/ commerce) are best assigned to the federal government. At the same time, the economic literature also suggests that functions related to the redistributive role of government be assigned to the federal government (Musgrave 1997). It is argued that generous redistribution

programs carried out by subnational jurisdictions are not likely to be sustainable. This is so because such programs will tend to result in the in-migration of the poor from other areas which may prompt them to increase tax rates in response to the pressure to expand said programs, a move that will likely drive away their richer, more mobile residents (Martinez-Vazquez 1999).

In contrast, public services with little or no benefit spill-over (i.e., public services whose benefits are local in scope) are best administered and financed by lower-level governments. This principle tempered by government's desire to have some degree of uniformity in delivery of "quasi-public goods" and "merit-goods" in line with its equity objectives (e.g., basic education, health and social insurance). In this case, while the provision of these goods/ services are typically assigned to subnational governments because the benefits of these goods/ services generally accrue to residents of subnational jurisdictions, the federal government is often involved in setting uniform standards of service that will apply across all jurisdictions (Shah 1991).

The discussion above necessarily implies that there is "no single best assignment" of expenditure responsibilities in practice in terms of the specific functions that are assigned across different level of government (Martinez-Vazquez 1999). However, establishing utmost clarity in the assignment of functional responsibilities to the different levels of governments is critical if clean lines of accountability are to be established. Also, ambiguity in expenditure assignment is likely to result in either duplication of efforts in service delivery or under-provision of some services.

#### Deficiencies in expenditure assignment under the 1991 LGC

At present, NG-LG relations is weighed down by the overlapping, and at times, unclear assignment of functions across various levels of government (i.e., among the national government and the different levels of LGUs) and results in the waste of resources. A cursory reading the LGC suggests that Section 17 (b) provides an explicit and clear delineation of functions across levels of governments except perhaps in the area of environment and natural resource management (**Table 2**). However, Section 17 (c) allows central government agencies to continue to implement devolved public works and infrastructure projects and other facilities, programs and services provided these are "*funded by the national government under the annual General Appropriations Act, other special laws, pertinent executive orders, and those wholly or partially funded from foreign sources.*" At the same time, Section 17 (f) allows the national government or the next higher level of local government unit to "provide or *augment* the basic services and facilities assigned to a lower level of local government unit when such services or facilities are not made available or, if made available, are inadequate to meet the requirements of its inhabitants". "In effect, Section 17 (c) and (f) obfuscate what initially appears to be a clear cut assignment of expenditure responsibilities. Gonzalez (1996) goes even further to say that the prevailing regulatory framework effectively permits the existence of a two-track delivery system, where both NGAs and LGUs can initiate devolved activities" (Manasan 2005).

**Table 2. Functional assignment under the 1991 Local Government Code**

	PROVINCES	MUNICIPALITIES	CITIES a/	BARANGAYS
<b>AGRICULTURE EXTENSION AND ON-SITE RESEARCH SERVICES</b>	Agricultural extension and on-site research services and facilities which include the prevention and control of plant and animal pests and diseases; dairy farms, livestock markets, animal breeding stations, and artificial insemination centers; and assistance in the organization of farmers and fishermen's cooperatives, and other collective organizations, as well as the transfer of appropriate technology	Agriculture extension related to dispersal of livestock, poultry, fingerlings and seedlings; operation of demonstration farms, improvement of local distribution channels, interbarangay irrigation systems, enforcement of fishery laws	A L L  S E R V I C E S  P R O V I D E D  B Y  P R O V I N C E S  &  M U N I S	Agricultural support services which include planting materials distribution system and operation of farm produce collection and buying stations
<b>NATURAL RESOURCE MANAGEMENT SERVICES</b>	Enforcement of forestry laws limited to community-based forestry projects, small scale mining law and mini-hydroelectric projects	Implementation of community-based forestry projects which include integrated social forestry programs and similar projects; management and control of communal forests with an area not exceeding fifty (50) square kilometers; establishment of tree parks, greenbelts, and similar forest		
<b>ENVIRONMENTAL SERVICES</b>	Enforcement of pollution control law	Solid waste disposal system or environmental management system and services or facilities related to general hygiene and sanitation		Services and facilities related to general hygiene and sanitation, beautification, and solid waste collection
<b>HEALTH SERVICES</b>	Health services which include hospitals and other tertiary health services	Health services which include the implementation of programs and projects on primary health care, maternal and child care, and communicable and non-communicable disease control services, access to secondary and tertiary health services; purchase of medicines, medical supplies, and equipment needed to carry out the services herein enumerated		Health services which include maintenance of barangay health center
<b>LOCAL INFRASTRUCTURE SERVICES</b>	Infrastructure facilities intended to service the needs of the residence of the province and which are funded out of provincial funds including, but not limited to, provincial roads and bridges; inter-municipal waterworks, drainage and sewerage, flood control, and irrigation systems; reclamation projects; Provincial buildings, provincial jails, freedom parks and other public assembly areas and similar facilities	Infrastructure facilities intended primarily to service the needs of the residents of the municipality and which are funded out of municipal funds including but not limited to, municipal roads and bridges; school buildings and other facilities for public elementary and secondary schools; clinics, health centers and other health facilities necessary to carry out health services; communal irrigation, small water impounding projects and other similar projects; fish ports; artesian wells, spring development, rainwater collectors and water supply systems; seawalls, dikes, drainage and sewerage, and flood control; traffic signals and road signs; Municipal buildings, cultural centers, public parks including freedom parks, playgrounds, and other sports facilities and equipment, and other similar facilities		Maintenance of barangay roads and bridges and water supply systems; Infrastructure facilities such as multi-purpose hall, multipurpose pavement, plaza, sports center, and other similar facilities
<b>SOCIAL WELFARE SERVICES</b>	Social welfare services including programs for rebel returnees, relief operations and population development services	Social welfare services including child and youth welfare programs, family and community welfare programs, welfare programs for women, elderly and PWDs, community-based rehabilitation programs for vagrants, beggars, street children, juvenile delinquents, victims of drug abuse; nutrition services and family planning services		Social welfare services which include maintenance of day-care center
<b>HOUSING SERVICES</b>	Programs and projects for low-cost housing and other mass dwelling			
<b>OTHERS SERVICES</b>	Tourism development and promotion programs	Tourism facilities and other tourist attractions, including the acquisition of equipment, regulation and supervision of business concessions, and security services for such facilities		
	Intermunicipal telecommunication services			
		Information services which include investments and job placement information systems, tax and marketing information systems, and maintenance of a public library		Information and reading center
		Public markets, slaughterhouses, and other economic enterprise		Satellite or public market, where viable
		Public cemetery		
<b>PLANNING</b>	Adoption of comprehensive land use plan	Adoption of comprehensive land use plan		Maintenance of katarungang pambarangay
<b>REGULATORY FUNCTIONS</b>		Regulation of any business, occupation or practice of profession within its jurisdiction		
		Enactment of integrated zoning ordinances and approve subdivision plans		

a/ In addition to functions assigned to provinces and municipalities, cities are also assigned functions related to transportation and communication facilities.

Source: Section 17 (b) of 1991 LGC

On the other hand, numerous unfunded mandates results in relevant services either not being delivered at all or not delivered in sufficient quantities. In either case, the welfare of local communities is adversely affected. The most important of these unfunded mandates refer to the implementation of the salary standardization law, the provision of additional benefits to health workers and social workers under their respective Magna Carta legislations. Moreover, LGUs are expected to provide budgetary support, in the form of either additional personnel benefits or outlays for MOOE, to many central government agencies operating at the local level like the police, fire protection bureau, and local courts.

#### Possible design option for expenditure assignment for the proposed federal government

The importance of distribution of powers between the federal government and the state governments is highlighted by Iff and Topperwien (2017, p. 71), thus: “The distribution of power determines the decision-making space of the different tiers of government. ... [It] is at the core of the self-rule design. The distribution of powers will determine in what fields the federal units have a genuine right to self-rule and can therefore define and implement their own policies.”

Constitutions of countries with a federal form of government typically specify (i) a list of exclusive powers that are assigned to the federal government, (ii) a list of exclusive powers assigned to state or regional governments, and (iii) the level of government which is assigned residual powers (i.e., powers which are not explicitly assigned in constitution to either the federal governments or state governments). Many federal constitutions also contain a list of concurrent and/ or shared powers.

In principle, assigning powers exclusively to one level of government bolsters the autonomy of said level of government by giving said level of government the right to define and implement their own policies in the specified area/s of competency. It also provides clarity as to which level of government is accountable is responsible to their citizens for the said function/s (Watts 2008).

The grant of concurrent powers over a given policy area to both the federal government and the state governments “establishes parallel competencies” and, by implication, the possibility of parallel legislation and parallel public service delivery systems. If case both levels of government chooses to “act based on the concurrent competency,” rules have to be put in place to delineate which legislation and/ or delivery system will prevail if there is some conflict between them (Iff and Topperwien 2017, p. 71). Otherwise, coordination issues between the two levels of government would tend to be magnified. In many federal countries, the constitution provides that the legislation of the federal government takes precedence over state legislation, e.g., Australia, Brazil, India, Mexico, and Nigeria) (Boadway and Shah 2009). In others, state legislation is paramount, e.g., provincial legislation prevails over federal legislation in Canada in the area of old-age pensions.

As with concurrent powers, shared powers also give both the federal government and the state governments the authority to exercise legislative and/ or administrative powers over some broad policy areas/ fields. However, in the case of shared powers, each policy area/ function is broken up into distinct tasks/ sub-competencies which, in turn, are assigned exclusively to either the federal government or the state governments. In Switzerland, for example, the federal government and the cantons exercise shared powers over a broad range of policy areas/ sectors. In these areas/

fields, the federal government is assigned the power to legislate national standards while the cantons are assigned the power to enact more detailed legislation and administer the same. Alternatively, the sharing of powers may be defined along national- local dimensions of a broader policy area/ field, e.g., national highways versus state highways and provincial roads.

The system of administrative federalism practiced in Germany, South Africa and, to a lesser extent, Austria and Malaysia may be viewed as an extreme form of shared powers (Iff and Topperwien 2017). In these federal countries, the power to legislate in certain policy areas/ fields is assigned to the federal level while the administration (i.e., power to implement and execute) of the federal legislation is constitutionally assigned to state governments (Watts 2008).

Concurrent/ shared powers may be deemed desirable from the perspective of balancing the potential efficiency gains from decentralized delivery of a given public service against the achievement of national objectives like the necessity to ensure uniformity and equal access to certain merit goods or to address interjurisdictional spillovers (Boadway and Shah 2009). Under a system that allows concurrent/ shared powers, the federal governments may legislate federation-wide standards while state governments are given the power to legislate the details and to deliver the services in a manner that is responsive to the demand of their respective constituencies (Watts 2008). However, the use of shared powers under a system of administrative federalism tends to work against supporting self-rule on the part of state governments. On the other hand, while the use of concurrent powers, unlike that of shared powers, tends to minimize the need to enumerate in detail the various tasks/ sub-competencies that constitute any given shared policy area/ field, clearer lines of accountability are more forthcoming with the use of shared powers.

There is considerable variation in the way the distribution of functional/ expenditure responsibilities is specified in federal constitutions between the federal government and the state governments not only in terms of exhaustiveness of the list of exclusive and concurrent powers but also in terms of which level of government is assigned the residual powers.

The significance of residual powers depends on the comprehensiveness of enumerated list of exclusive, concurrent/ shared powers. The assignment of significant residual power to state governments would highlight their autonomy and the limited nature of powers assigned to the federal government.

Given this background, the following illustrative design option for the assignment of expenditure responsibilities under the proposed Philippine federal model may be characterized as one that pushes the envelope in favor of a more decentralized regime with where exclusive powers assigned to the federal government are very close to the minimum that is consistent with the guiding principles of fiscal federalism (**Table 3**).

**Table 3. Illustrative design option for assignment of expenditure for proposed Philippine federal model**

EXCLUSIVE POWERS OF FEDERAL GOVERNMENT	EXCLUSIVE POWERS OF REGIONAL GOVERNMENT
Monetary policy, currency and banking National defense Foreign affairs Immigration International trade Inter-state commerce Agrarian reform Social insurance Redistributive programs	Supervision of LGUs Fire protection Early childhood education Water supply, sanitation and sewerage Waste management Road traffic management Parks Social welfare/ assistance
<b>SHARED POWERS <sup>a/</sup></b>	
Regional planning Land use management Education (basic, TVET, higher) Labor and employment Health Housing Police Science and technology	Agriculture, fisheries & aquatic resources Environmental management Natural resource management Industry Tourism Road infrastructure <sup>b/</sup> Flood control infrastructure <sup>b/</sup> Transportation and communication
<b>RESIDUAL POWERS</b>	
Federal government	

a/ for the most part, FG role in shared powers involves national level policy development and standard setting but may also involve financing for services with inter-regional externalities

b/ national primary roads and flood infrastructure whose benefits are not confined to state boundaries are assigned to FG

The indicative costs of the assigned functions presented in **Table 3** are estimated based on the actual allocation for these functions in the 2016 General Appropriations Act (**Table 4**). The combined cost of exclusive and shared powers assigned to the federal government is estimated to be equal to PhP 1,149 billion which equivalent to 8% of GDP (or 51% of the national government budget net of debt service). On the other hand, the combined cost of exclusive and shared powers assigned to regional governments (inclusive of those funded from LGU own-source revenue) is estimated to be equal to PhP 1,299 billion which is equivalent to 9% of GDP (or 49% of the national government budget net of debt service). Unless new sources of revenue are assigned to regional governments and LGUs under the proposed federal model, intergovernmental transfers to subnational governments inclusive of their revenue share in federal revenues will have to expand to 59% of total collections from national internal revenue taxes in the current year from the current 22%.



**Table 4. Estimate of indicative cost of expenditure responsibilities assigned to federal level and state governments as per Table 3**

	Exclusive power	Shared power	Total	% of GDP	% of NG budget
Federal govt	632.2	516.7	1,148.9	7.9	50.7
Regional govt	687.8 <sup>a/</sup>	611.8	1,299.6	9.0	49.3 <sup>b/</sup>
<b>Total</b>	1,319.9	1,128.5	2,448.4	16.9	100.0 <sup>b/</sup>

a/ inclusive of functions funded from GAA, IRA & LGU own-source revenue

b/ exclusive SG functions funded out of LGU own-source revenue netted out in computing this ratio

### 3.2 Tax/ Revenue Assignment

The allocation of financial resources to each level of government is important because these resources enable/ constrain governments in the exercise of their assigned responsibilities. Moreover, taxing powers and government spending power are themselves important instruments for affecting and regulating the economy.

In the fiscal federalism literature, the assignment of taxing/ revenue powers to different of government is guided by the following considerations: (i) economic efficiency, (ii) equity, (iii) administrative feasibility, and (iv) revenue autonomy (Shah 2007). The economic efficiency criterion ordains that the tax assignment should be such that subnational governments should not be assigned taxes are exported to residents of other jurisdictions or those that distort the location decisions of firms and households (McLure 1999). The benefit principle of taxation (which suggests that those who benefit from a given government expenditure should pay more of the tax that is used to finance said expenditure program) is likewise consistent with the economic efficiency considerations. From this perspective, the assignment of taxes on immobile factors (e.g., real property tax) and user charges to subnational governments and the assignment of taxes on international and inter-jurisdictional trade and those on mobile factors to the federal government are appropriate.

Equity considerations, on the other hand, require that the progressive taxes (e.g., taxes on personal income and wealth) be assigned to the federal government which is likewise assigned the expenditure responsibilities related to the redistributive objective of government (Litvack, Ahmad and Bird [rethinking...] 1998). Meanwhile, the administrative feasibility criterion indicates that taxes should be are best assigned to the jurisdiction that is able to collect said taxes most efficiently in terms of both collection and compliance cost.

Finally, from the perspective of securing incentives for local accountability to local constituents, the public choice strand of the fiscal federalism literature (e.g., McLure 1999) emphasizes the need to provide subnational units some degree of revenue autonomy. The revenue autonomy criterion requires that each level of government must be assigned sources of "own" revenues whose level they have the power to control at the margin (McLure 1999).<sup>8</sup> The link between revenue autonomy

<sup>8</sup> Related to this, it may be noted that while revenue sharing with the central government (e.g., through the IRA) may provide LGUs with "own" revenues, this scheme does not provide revenue autonomy because subnational governments do not have the power to affect the amount of shared revenues they receive. On the other hand,

and accountability is articulated succinctly by Bird (1999): “If subnational governments are expected to act responsibly, such governments must be able to increase or decrease their revenues by means that make them *publicly responsible* for the consequences of their actions.” A slightly different view on the matter is provided by McLure (1999): “Only by choosing to pay higher or lower taxes can residents of subnational jurisdictions choose the level of public services they want.” On the other hand, Shah (2007 - Principles) argues that revenue autonomy also provides subnational governments incentives to allocate their resources more efficiently and effectively: “If subnational governments are not responsible for raising at least some level of their own revenues, they may have too little incentive to provide local public services in a cost-effective way.”

As with the assignment of expenditure responsibilities, there is no single best assignment of taxing powers in the sense of what particular taxes are assigned to the different levels of government. Oftentimes, the guidance provided by economic efficiency, equity, and administrative feasibility considerations are not consistent with each other. However, the revenue autonomy criterion appears to be of primordial importance in creating the right incentives for local accountability.

#### Deficiencies in revenue/ tax assignment under the 1991 LGC

The 1991 Local Government Code (LGC) assigns eleven (11) taxes to cities, nine (9) taxes to provinces, two (2) to municipalities which are assigned a share in the collections of 3 taxes levied by provinces and one (1) to barangays which are assigned a share in the collections of 3 taxes levied by other levels of local governments (**Table 5**). The LGC also specifies the taxes that LGUs are not allowed to levy and which, by implication, are exclusively assigned to the central government, including (i) the income tax, except when levied on banks and other financial institutions, (ii) VAT, (iii) excise tax on alcoholic, tobacco, petroleum, mineral and non-essential<sup>9</sup> products and automobiles, (iv) customs duties, (v) estate and gift/ donation taxes, (vi) documentary stamp tax, and (vii) taxes, fees and charges on registration of motor vehicles.

The increase in the taxing powers of LGUs under the 1991 LGC is fairly modest, with LGU tax revenues for all LGU in the aggregate rising by only a slim margin from 0.5% of GDP in 1985-1991 to 0.8% of GDP (**Table 6**). First, the taxes assigned to LGUs under the 1991 LGC are essentially identical to those under Presidential Decree (PD) 231 as amended by PD 426 with the exception of two taxes. On the one hand, the 1991 LGC expands the taxing powers of cities and municipalities relative to PD 231 and PD 426 by including the tax on the gross receipts of banks and other financial institutions from interest, commissions and discounts from their lending activities. On the other hand, while PD 231 and PD 426 allowed cities (but not municipalities) to impose a tax on goods subject to the specific tax under the National Internal Revenue Code. The 1991 LGC explicitly prohibits this. Second, while the maximum allowable tax rates for the real property tax (RPT) under the 1991 LGC are essentially equal to those under PD 464, the assessment levels (i.e., the factors applied to the fair market value of real properties to arrive at the taxable value of real properties for purposes of the RPT) for residential land, residential and

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subnational governments are said to have control over their own revenues when they are able to (i) determine the tax rate/s, (ii) define the tax base/s, or (iii) administer tax collection.

<sup>9</sup> Excise tax on non-essential products are imposed on jewelry, perfumes and toilet waters, yachts and other vessels intended for sports and leisure.

agricultural machineries and all types of buildings are lower compared to their counterparts under PD 464.<sup>10</sup> Third, while the number of taxes that LGUs are allowed to levy is not small in number, the size of the base of local taxes outside of the real property tax and the local business tax continues to be insignificant as the bulk of the productive tax bases still rest with the central government (Manasan 2005). Thus, the share of local taxes in total general government tax revenues increased only marginally from 4% in the pre-Code period to 6% in the post-Code period.

**Table 5. Taxes assigned to provinces, cities, municipalities and barangays under the 1991 LGC**

	Cities	Provinces	Municipalities	Barangays
On Business	x		x	x
On Real Property	x	x	a/	a/
On Idle Lands	x	x		
On Transfer of Real Property Ownership	x	x		
On Business of Printing and Publication	x	x		
On Franchise	x	x		
On Sand, Gravel and Other Quarry Resources	x	x	a/	a/
On Amusement Places	x	x	a/	
On Professionals	x	x		
On Delivery Vans and Trucks	x	x		
On Community Tax	x		x	b/

a/ Shares in proceeds of levy of province.

b/ Shares in proceeds of levy of municipalities/ cities

Source: Manasan (2007)

**Table 6. OSR<sup>a/</sup> and local tax revenues for all LGUs combined in pre- 1991 LGC and post-1991 LGC period, by level of local government**

	1985-1991				1992-2016			
	Prov	Cities	Munis	All LGUs	Prov	Cities	Munis	All LGUs
<b>% of GDP</b>								
LGU OSR	0.14	0.30	0.26	0.70	0.14	0.77	0.25	1.16
Local tax	0.07	0.22	0.17	0.47	0.07	0.62	0.15	0.84
RPT	0.06	0.12	0.10	0.28	0.05	0.26	0.06	0.38
Local business tax		0.07	0.06	0.13		0.30	0.07	0.37
<b>% of total LGU tax</b>								
RPT	80.7	56.7	57.8	60.9	74.2	41.2	43.5	44.4
Local business tax	0.0	32.1	33.8	27.7		48.6	44.2	43.6
<b>% of P/C/M to all LGUs</b>								
LGU OSR	20.3	43.1	36.6	100.0	12.3	66.5	21.2	100.0
Local tax	15.8	47.0	37.3	100.0	8.7	73.8	17.5	100.0
RPT	20.9	43.7	35.4	100.0	14.5	68.3	17.2	100.0
Local business tax		54.5	45.5	100.0		82.2	17.8	100.0
<b>OSR-to-total LGU income ratio</b>	16.2	62.9	47.4	49.5	16.4	53.8	21.8	33.5

Author's estimates based on COA AFR data

<sup>10</sup> The reduction in assessment levels is expected to lead to a reduction in RPT revenues other things being equal.

The 1991 LGC has also led to changes in the composition of local taxes. To wit, the share of RPT in total local tax revenues of all LGUs as a group contracted from an average of 61% in 1985-1991 to an average of 44% in 1992-2016. In contrast, the share of the local business tax to total LGU expanded from tax revenues expanded from 28% in to 44% (**Table 6**).

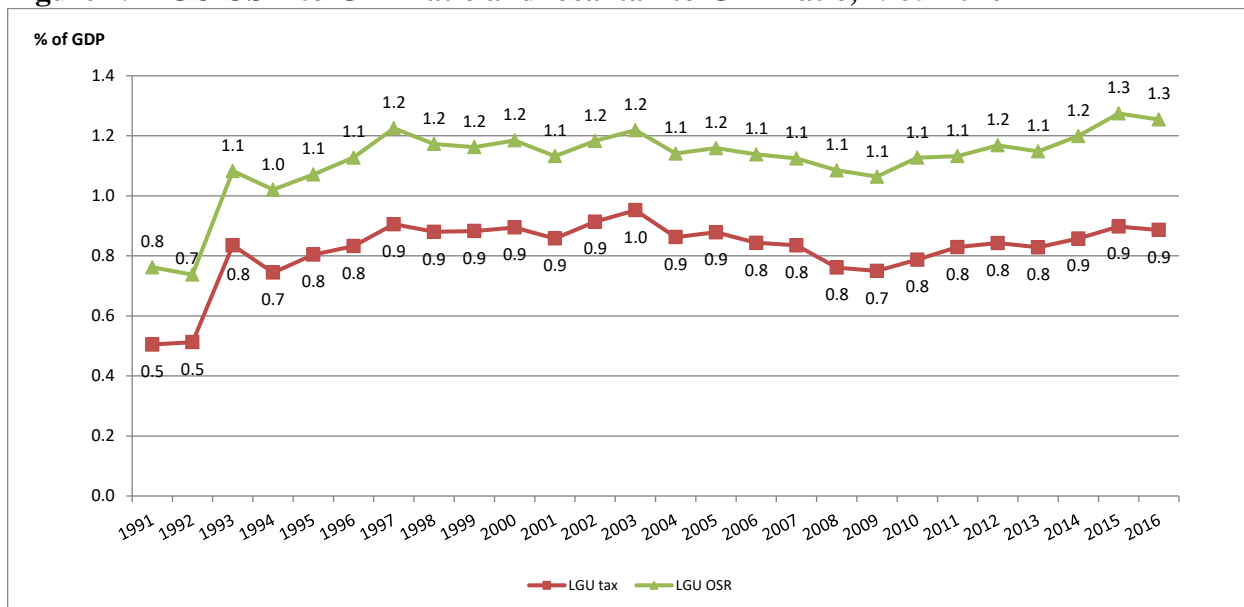
The increase in LGU own-source revenues is also more limited when compared to the expansion in the IRA and other external sources of LGU income. Consequently, LGUs in the aggregate have become less self-reliant (and, therefore, more revenue autonomous) with LGU OSR accounting for a smaller proportion of total LGU income in the post-LGC period relative to the pre-LGC period (**Table 6**). Because of this, many analysts (e.g., Manasan 2007, Llanto 2012) give the 1991 LGC a low score in terms of the revenue autonomy criterion so that downward accountability at the local level is likely to be rather weak.

At the same time, LGUs have not fully maximized the local taxing powers that are assigned to them under 1991 LGC for a number of reasons (Manasan 2003; Talierco 2003). One, the capacity of tax administration systems in many LGUs is weak not only in terms of the technical capability of assigned personnel but also in terms of use of ICT. Two, the 1991 LGC prescribes different local business tax rate schedules for different categories of firms. This provision provides a venue for tax evasion as it provides businesses the incentive to be classified under categories that are subjected to lower tax rates, thereby, undermining the LGU tax take. Three, many local treasurers and assessors report that local chief executive and/ or members of the local Sanggunian are not predisposed to increasing effective local tax rates because of the perceived negative impact of such action on their chances of being re-elected (Manasan 2003). In particular, many provinces and cities have not complied with the 1991 LGC mandate to conduct a general revision of the schedule of fair market value of real properties for RPT purposes once every three years with the first one taking effect in 1994. For instance, as of the end of 2015, the schedule of fair market values of real properties is up-to-date in only a small number of LGUs, 22% of all provinces and 7% of cities. Fourth, the IRA distribution has been found to have a dis-incentive effect on local tax effort (Manasan 2003).<sup>11</sup> For all these reasons, some stagnation, if not a slight deterioration, in the aggregate LGU tax-to-GDP ratio for all LGUs as a group is evident from 2003 to 2016 (**Figure 1**).

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<sup>11</sup> This finding is based on a regression analysis of per capita local tax revenue on per capita household income (as a proxy for the local tax base) and per capita IRA (as a way to check whether intergovernmental grants stimulates or substitutes for local government revenue effort) using panel data for provinces, cities and municipalities for 1995-2000.

**Figure 1. LGU OSR-to-GDP ratio and local tax-to-GDP ratio, 1985-2016**



*Distribution of taxing powers across the different levels of local government.* Nothing much has changed with respect to the assignment of taxing powers across levels of local government *de jure*. Just like PD 231 before it, the 1991 LGC authorizes cities to levy all the taxes that provinces and municipalities are allowed to impose at rates that can be as high as 50% more than the maximum allowable rates for provinces and municipalities in the case of non-RPT taxes. While the 1991 LGC officially bars municipalities from levying the RPT, they are assigned a share in RPT revenues of the province. Other things being equal, the changes in the allocation of the proceeds of the RPT with the implementation of the 1991 LGC are expected to result in some increase in the RPT revenues (both the basic RPT and the additional tax for the Special Education Fund) accruing to provinces and barangays, some diminution in revenues accruing to municipalities while revenues accruing to cities are expected to remain the same.

*De facto*, the 1991 LGC has effectively shifted tax assignment in favor cities and municipalities at the expense of provinces. Thus, LGU OSR and LGU total local tax revenues expressed as a percentage of GDP and as a share of total LGU income are lowest for provinces and highest for cities in 1992-2016 (**Table 6**). As a result, provinces are the least self-reliant while cities are the most self-reliant in the post-LGC period, with OSR accounting for 16% of total LGU income of provinces on the average and 54% of total LGU income of cities on the average in 1992-2016. This development is partly due to the fact that the province is assigned only one (i.e., the RPT) of the two revenue productive local taxes while cities and municipalities are assigned both the RPT and the local business tax. It may also be partly attributed due to the fact that cities, being more urbanized and with more vibrant market oriented economies, tend to have higher real property tax base and local business tax base than municipalities.

There is also a wide disparity in the self-reliance of LGUs across regions (see last column of **Table 7**), a reflection perhaps of the varying level of economic development across the regions. When all LGUs in a region are taken as a group, LGUs in the NCR, Region IVA and Region III are found to be the most self-reliant in 2015, posting OSR-to-total-LGU-income ratios of 78%, 41% and

33%, respectively. In contrast, LGUs in ARMM, Region IVB, Region VIII and Region II are ranked poorly in this regard, with OSR-to-total-LGU-income ratios of 1.8%, 12.3%, 14.5%, and 14.7%, respectively.

**Table 7. LGU OSR performance, by region, 2015**

Region	Existing taxes under LGC, 2015				
	Real property tax	Local business tax	Total OSR	OSR % distn	OSR as % of total LGU income
NCR	21,205	37,341	72,215	41.9	77.8
CAR	411	573	2,292	1.3	16.7
R I	1,502	1,328	6,904	4.0	26.5
II	539	713	2,950	1.7	14.7
III	4,881	4,360	14,999	8.7	32.6
IVA	9,741	8,745	25,086	14.6	41.2
IVB	530	555	2,096	1.2	12.3
V	814	899	3,675	2.1	16.0
VI	2,350	1,719	8,509	4.9	24.3
VII	2,226	3,553	10,284	6.0	24.8
VIII	444	513	3,293	1.9	14.5
IX	451	552	2,533	1.5	16.1
X	1,248	1,548	5,598	3.2	23.8
XI	1,420	2,084	6,118	3.5	27.9
XII	726	766	3,035	1.8	15.0
XIII	462	666	2,523	1.5	15.5
ARMM	30	116	232	0.1	1.8
Phil	48,981	66,028	172,341	100.0	33.8

The discussion above suggests that reform in the area of revenue assignment needs to be focused on the enhancement of LGUs' revenue powers, particularly that of provinces, to promote greater downward autonomy and to reduce their dependence on intergovernmental fiscal transfers. In this way, LGUs will have the incentive to allocate public funds and deliver services in an effective and efficient manner. Related to this, a number of specific amendments to the 1991 LGC have been proposed including: (i) transferring the authority to approve the schedule of market value (SMV) of real properties (which is used as the basis of real property taxation) from the local Sanggunians to the Department of Finance while still retaining the autonomy of provinces and cities to set tax rates and assessment levels so as to depoliticize the needed adjustments in the RPT tax base; if the SMVs of all provinces and cities were to be fully updated; (ii) simplifying the differentiated and graduated local business tax structure that currently applies to different types of business enterprises to a single flat tax rate not exceeding 1.5% of their gross receipts/ sales, a recommendation that is justified on the grounds that the different graduated local business tax rate schedule for different types of businesses complicates local tax administration and provides a venue for tax evasion, and (iii) expanding the taxing powers of provinces by allowing them to impose a surcharge on the national personal income tax (Manasan 2014).

### Possible design option for tax assignment for the proposed federal government

Given this background, the following illustrative design option for the assignment of taxing powers puts emphasis on enhancing the revenue autonomy of subnational units by giving regional governments the power to impose/ levy:

- (i) a residence-based surtax on personal income tax, say, 1% of taxable personal income of residents; this measure is estimated to yield PhP 19 billion a year in 2016 prices, and
- (ii) the motor vehicle user charge (i.e., motor vehicle registration) and drivers' license fees which are assigned to the central government at present;<sup>12</sup> this measure is estimated to generate PhP 13 billion a year in 2016 prices (**Table 8**);

It should be emphasized that these two measures need not increase the total tax burden overall. With respect to item (i), the federal government may reduce the personal income tax rate in order to give regional governments more space to exercise more control over their own source revenue. On the other hand, item (ii) is a tax that is currently being collected by the national government. Essentially, the proposal is intended to transfer the power to levy and collect the MVUC from the central government to regional governments without necessarily increasing tax rates. Taken together, the two proposed measures will increase total own-source revenues of subnational governments by 19%. Despite this, total projected subnational government own source revenue inclusive of these two measures represent 19% of the total cost of expenditures assigned to subnational government, even lower than the 44% share of LGU own source revenues in total LGU expenditures in 2016.

**Table 8** also presents the likely distribution of revenues from these taxes across the different regional or state governments, assuming for the moment that their jurisdictions will coincide with the existing administrative regions. Ideally, this table should reflect fiscal capacity which may be measured in terms of potential revenue, not actual collections as it does right now.<sup>13</sup>

These figures highlight the importance of enhancing further the revenue autonomy of subnational government moving forward. In this regard, the possibility of transferring the authority to levy the excise tax on sin products to regional governments given that it is regional governments which bear the burden of the health care costs related to smoking and the consumption of alcoholic beverages. In like manner, the authority to levy the excise taxes on gasoline and diesel may also be transferred to regional governments who are responsible for maintenance of regional and local roads. Needless to say, if power to levy said taxes are indeed transferred to regional governments, the manner of collecting these excise will have to change – from collection upon removal of products from the factory to collection at point of final sale. The administrative feasibility of such a change will require further study.

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<sup>12</sup> The transfer of the MVUC from the central government to regional governments may be justified from the perspective of benefit taxation since proceeds from the tax is conceivably used to finance the maintenance of regional and local roads.

<sup>13</sup> For **Table 8**, actual collections of MVUC at the national level are distributed across regions on the basis of the number of registered motor vehicles in the regions. On the other hand, the revenues from the proposed surtax on personal income tax are estimated based on personal household income (FIES) in the regions.

**Table 8. Projected subnational government revenues aggregated at the regional government level (in million pesos)**

Region	Proposed new taxes			2016 Total OSR (existing under LGC)	OSR % distn	Projected revenues from old revenue sources + new taxes	% distn
	PIT surtax	Motor vehicle registration	% distn of new taxes combined				
NCR	5,641	5,075	33.5	74,554	41.1	85,270	39.9
CAR	345	240	1.8	2,378	1.3	2,963	1.4
R I	609	511	3.5	6,543	3.6	7,663	3.6
II	637	320	3.0	3,572	2.0	4,529	2.1
III	2,348	1,634	12.4	15,397	8.5	19,380	9.1
IVA	2,283	1,591	12.1	26,973	14.9	30,847	14.4
IVB	631	103	2.3	2,578	1.4	3,312	1.6
V	358	261	1.9	4,044	2.2	4,663	2.2
VI	985	651	5.1	9,097	5.0	10,734	5.0
VII	1,110	952	6.4	11,184	6.2	13,246	6.2
VIII	571	199	2.4	3,590	2.0	4,360	2.0
IX	494	341	2.6	2,737	1.5	3,572	1.7
X	690	396	3.4	6,027	3.3	7,113	3.3
XI	900	454	4.2	6,500	3.6	7,853	3.7
XII	553	477	3.2	3,467	1.9	4,497	2.1
XIII	351	162	1.6	2,661	1.5	3,174	1.5
ARMM	116		0.4	301	0.2	416	0.2
Phil	18,624	13,367	100.0	181,603	100.0	213,594	100.0

Alternatively, the proposed assignment of expenditure responsibilities shown in **Table 3** may be revisited with the end in view of moving some of the functions in the shared powers list to the list of exclusive federal powers.

### 3.3 Intergovernmental Fiscal Transfers

Intergovernmental transfers of one form or the other are ubiquitous in all federal and decentralized unitary states, generally serving as the primary instrument in the attainment of the following objectives:

- (i) To close the vertical fiscal gap,
- (ii) To compensate for the disparities in the fiscal capacities and expenditure needs of subnational governments, and
- (iii) To assist the federal governments influence subnational government spending towards meeting national government objectives, e.g. ensuring common minimum standards in quality, access and level of service in certain service areas.

Because intergovernmental transfers create incentives that affect the efficiency and effectiveness of local public service provision and the accountability of subnational governments, the importance of the design of intergovernmental transfers cannot be overemphasized.



*Vertical fiscal gap.* In many decentralized economies, a vertical fiscal gap (which results when the revenue capacity of subnational governments as a group falls short of their expenditure responsibilities) is evident. Such gaps have been attributed to one or some combination of the following reasons: (i) inappropriate assignment of responsibilities; (2) centralization of taxing powers; (3) subnational governments' pursuit of wasteful tax competition policies; or (4) lack of tax room at the subnational orders due to heavier tax burdens imposed by the national government (Shah 1994 "reform" or Shah 1991 "perspective"). In principle, vertical fiscal gaps are best addressed by expenditure and/ or tax re-assignment, including tax-base sharing. Moreover, the fiscal federalism literature cautions that while unconditional transfers/ revenue sharing may also be considered to rectify the situation, said policy alternative tends to weaken local accountability to taxpayers.

*Horizontal fiscal imbalance.* Disparities in fiscal capacity across regions are largely driven by variations in the economic base available to the regions as a result of the uneven level of economic development across regional jurisdictions (**Table 1**). However, the fiscal capacity of regional governments may also diverge because of differences in their ability to collect taxes as a result of difference in the structure of their local economy (Martinez-Vazquez 2000 "equal"). On the other hand, variations in fiscal need across regions may result from cost differentials due to differences in geographic conditions, poverty incidence and demographic composition.

In the fiscal federalism literature, the justification for the use of equalization transfers to compensate for the disparities in the net fiscal capacity of subnational government is justified on equity and efficiency grounds.<sup>14</sup> On the one hand, the inability of subnational governments to "provide comparable levels of public services at comparable rates of taxation" weakens social cohesion and may be politically divisive (Boadway 2007 in B&S). On the other hand, disparities in net fiscal capacities across regions create incentives for fiscally induced migration which, in turn, results in the inefficient allocation of labor and capital across regions.

Equalization transfers aim to reduce, if not fully eliminate, differences in net fiscal capacities by equalizing fiscal capacity, as measured by "potential revenues that can be obtained from the tax bases assigned to the region if an average level of effort is applied to those tax bases" (Martinez-Vazquez 2000 "equal"), to a specified standard and by providing compensation for differential expenditure needs across regions. As such, equalization transfers provide more resources to regions/ states with lower fiscal capacity relative to their expenditure needs. Ideally, the equalization standard will determine the total pool of funds for the transfer as well as the allocation among recipient units. Shah (2007 in B&S) further underscores the need for a national consensus on the standard of equalization for the sustainability of any equalization program.

Martinez-Vazquez (2000) enumerates the following principles that should guide the design of equalization grants:

- (i) The transfers should take the form of unconditional lump-sum grants because "the objective of equalization is best served by providing subnational governments with the equivalent of their own-revenues, which in principle they can use without any limitations or constraints."

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<sup>14</sup> Disparities in net fiscal capacities across regions create incentives for fiscally induced migration which results in the inefficient allocation of labor and capital across regions.

- (ii) The transfer should “not create negative incentives for revenue mobilization by subnational governments, neither should they induce inefficient expenditure choices. ... In order to avoid these negative incentives it is critically important that the formulas do not try to equalize actual revenues and expenditures but instead fiscal capacity and expenditure needs”<sup>15</sup>
- (iii) The equalization formula should be simple and transparent so that it is easily understood by all stakeholders and “not be subject to political manipulation or negotiation in any of its aspects.”
- (iv) Introduction of equalization transfers should include “hold harmless” or grandfathering provisions so to ensure that there is no diminution in amount of unconditional transfers received by all subnational units relative to the pre-reform period.

While there is agreement in the literature that, in principle, equalization transfers should equalize net fiscal capacity of subnational governments, the design of equalization transfers actually used by different countries show some variation with respect to the inclusion of the two components of net fiscal capacity in the equalization formula. Some countries like Australia and Switzerland incorporate fiscal capacity and expenditure need in the design of their equalization transfers. In contrast, other countries like Canada and Germany do not include compensation for differences in expenditure need in the design of their equalization transfers. Related to this, Shah (2007 B&S) propose that, given the practical difficulties in implementing expenditure needs equalization, equalization transfers focus solely on the equalization of fiscal to an explicit standard and that fiscal need compensation be undertaken through specific-purpose transfers for merit goods.

*Meeting national objectives when spending authority has been decentralized.* There are instances when the central government deems it necessary to set national minimum standards for certain public services which have been assigned to subnational governments because these standards serve a national equity objective or assist in the preservation of the internal common market. Education, health and social welfare services are commonly viewed as merit goods and, as such, there is demand for common minimum standards in quality, access and level of service. On the other hand, the proper maintenance of the road network may be deemed important for the purpose of ensuring the free flow of goods and services across regional boundaries. The fiscal federalism literature suggests that conditional output-based non-matching grants are most appropriate in ensuring that subnational governments do not under-provide merit goods. On the other hand, conditional capital grants with matching rate that varies inversely with local fiscal capacity are considered most suitable to address local infrastructure deficiencies that affect the functioning of the internal common market.

#### Deficiencies in intergovernmental transfer arrangements under the 1991 LGC

The internal revenue allotment (IRA), a formula-based block grant, accounts for the bulk (94%-99%) of all national government transfers to LGUs in 1994-2014. Most of the remaining transfers come in the form of derivation-based special share of LGUs in other taxes like the excise tax on

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<sup>15</sup> Expenditure needs refer to the amount of funding necessary to cover the costs of providing all the responsibilities assigned to the subnational government at a standard level of service provisions taking into account “differences in needs arising from different demographic profiles (percent of the population of school age or retired), geographical and climatological conditions, incidence of poverty and unemployment, and so on” (Martinez-Vazquez 2000).

tobacco products and the VAT and origin-based LGU share in national government income from the exploitation of natural resources. In addition, LGUs also receive sector-specific categorical/matching grants that are administered by a number of sectoral national government agencies and the Department of Interior and Local Government (DILG).

The 1991 LGC increased the aggregate IRA from a maximum of 20% of total collections from national internal revenue taxes three years prior to the current year as mandated under PD 144 to 40% of collections of national internal revenue taxes.<sup>16</sup> As such, under the 1991 LGC, the IRA has not only increased but has also become a more predictable and secure source of funding for LGUs that allows them wide discretion in terms of spending allocation.<sup>17</sup>

Nonetheless, a vertical fiscal imbalance is evident after the implementation of the 1991 LGC given the mismatch between tax assignment and intergovernmental transfers, on the one hand, and expenditure assignment, on the other (Manasan 2003). As pointed out earlier, the cost burden of expenditure assignment under the 1991 LGC weighs more heavily on provinces than on municipalities and cities, in that order, while tax assignment tended to favor cities and municipalities, in that order, more than provinces. On the other hand, the distribution of the IRA across the different levels of LGUs under the 1991 LGC favors cities and barangays relative to provinces and municipalities. Under the 1991 LGC, the inter-tier allocation of the aggregate IRA is 23% to the province, 23% to cities, 34% to municipalities and 20% to barangays. In comparison, the share of provinces in the aggregate IRA under PD 144 was 27%, that of cities 22%, that of municipalities 41% and that of barangays 10%. Thus, the share of provinces and municipalities in the aggregate IRA contracted following the passage of the 1991 LGC while that of cities and barangays expanded. Clearly, there appears to be some inconsistency in the design of expenditure assignment, tax assignment, and intergovernmental transfers and under the 1991 LGC.

Because of the higher LGU share in national internal revenue taxes under the 1991 LGC, the IRA rose from 0.5% of GDP in 1985-1991 to 2.2% of GDP in 1992-2016 and the contribution of the IRA to total LGU income of all LGUs combined went up from 35% to 64% (**Table 9**). However, because of the assignment of greater taxing powers to cities and municipalities and the more buoyant local tax base in cities, plus the smaller share of provinces in the aggregate IRA compared to that of municipalities, provinces are more IRA-dependent than cities and municipalities in the post-1991 LGC period. It is also notable that the weakness in national government tax effort in 2000-2009 has also led to a slight decline in the IRA-to-GDP ratio in 2003 onwards (**Figure 2**).

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<sup>16</sup> The amount of IRA that was actually appropriated in the pre-Code era was 13% of net BIR tax receipts on the average in 1987-1990.

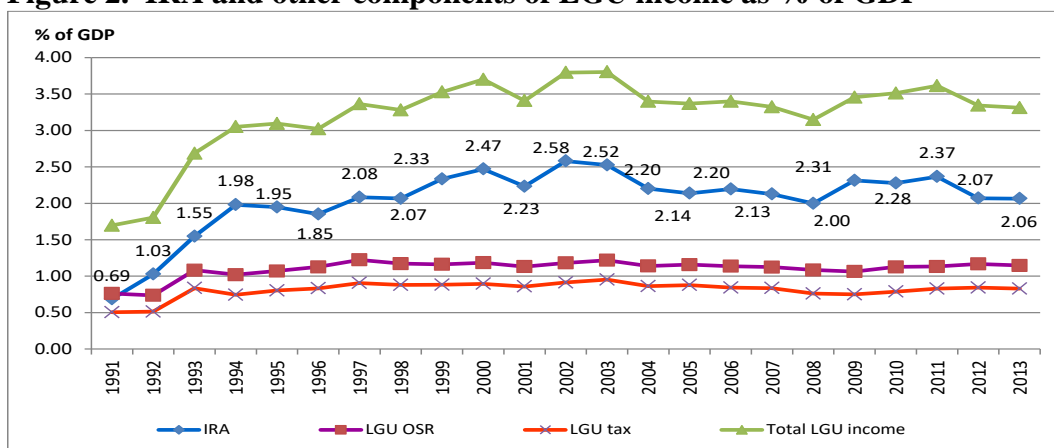
<sup>17</sup> Despite a provision in the 1991 LGC that calls for the automatic release of the 40% IRA share of LGUs in national internal revenue taxes, the national government failed to either appropriate or release the designated IRA amount in 1998-2004 because of fiscal difficulties faced by the national government. However, after two Supreme Court rulings, one in 2000 and another one in 2004, that supported the LGU position, a law was passed in 2006 stating that henceforth the IRA will be automatically appropriated.

**Table 9. IRA as % of GDP and % of total LGU income, by level of LGU**

	1981-1991	1992-2016
<b>% of GDP</b>		
All LGUs	0.5	2.2
Prov	0.3	0.7
Cities	0.2	0.6
Munis	0.2	0.9
<b>% of LGU income</b>		
All LGUs	35.5	63.8
Prov	63.5	79.9
Cities	32.4	44.0
Munis	37.0	75.4

Another weakness of the IRA design pertains to its inability to sufficiently equalize the *net* fiscal capacity of LGUs in the sense of providing more resources to LGUs with lower revenue capacity relative to their needs and less to LGUs with greater revenue capacity relative to their needs. This follows from the fact that the IRA distribution formula only takes into account indicators of expenditure needs like population and land area and does not explicitly consider the revenue raising capacity of LGUs. Note that the IRA is distributed to specific LGUs within each level according to a pre-determined formula that is based on population, land area and equal sharing. Under the 1991 LGC, intra-tier allocation of the IRA to individual LGUs based on population (50 percent), land area (25 percent) and equal sharing (25 percent).<sup>18</sup> There is also some evidence that the IRA distribution formula was counter-equalizing in the case of provinces and municipalities but was weakly equalizing in the case of cities (Manasan 2003). This finding is still generally supported by analysis done for this study using more recent data.<sup>19</sup>

**Figure 2. IRA and other components of LGU income as % of GDP**



<sup>18</sup> In contrast, the weights used under PD 144 were: population (70%), land area (20%) and equal sharing (10%).

<sup>19</sup> When 2012 data is used, the distribution of the IRA across individual cities and across individual municipalities was found to be counter-equalizing. On the other hand, the same data set shows that the distribution of the IRA across provinces is weakly equalizing.

Finally, there is widespread agreement among LGU officials that the share of LGUs in national taxes is not enough for them to deliver the basic services that they are responsible for. Thus, there are proposals to the IRA share from the current 40% of national internal revenue taxes to as much as 50% of all national taxes. Expectedly, said proposals are being opposed by the fiscal oversight agencies because of fears that they will weaken national government control over the fiscal aggregates even while doubts have been raised as to how well LGUs have performed in delivering the services assigned to them (Diokno 2012).

The most important reform needed in the area of intergovernmental transfers from the perspective of the country's past experience in decentralization pertain to the need to introduce a new transfer mechanism in the form of an equalization grant that shall take into account the disparities in the revenue raising capacity or revenue potential of LGUs in line with their expenditure needs.

#### Considerations in the design of intergovernmental transfers under the proposed federal government

If the proposed design option for the assignment of expenditure functions are as outlined in **Section 3.1** and if the proposed design option for the assignment of taxing powers are as discussed in **Section 3.2**, then the vertical fiscal gap is estimated to be equal to about PhP 1,086 billion, 84% of the total expenditure needs of subnational governments or 57% of total revenues from national governmental internal revenue taxes in the current year or 7.5% of GDP (**Table 10**).<sup>20</sup>

It is notable that the assignment of taxing powers to subnational government (i.e., regional governments and LGUs) discussed in **Section 3.1** is still limited relative to the assignment of functional responsibilities to subnational governments discussed in **Section 3.2** such that not a single one of the 17 regions would be self-sufficient. To be sure, the indicative estimate of the fiscal gap for NCR is smallest at PhP 15 billion per year or less than 1.5% of the aggregate fiscal gap. However, while estimates of the fiscal capacity of Region IVA and Region III are high, ranking second and third after NCR, estimates of their expenditure needs are considerably higher than those of the other regions. Consequently, the indicative estimates of the fiscal gap for these two regions are ranked second and third after the ARMM.

The large variations in the indicative estimates of SG expenditure needs and SG revenue capacity in absolute terms (**Table 10**) and in per capita terms (**Table 11**) highlight that one of the more demanding tasks at the technical level in designing the fiscal features of the proposed federal government involves the design of the equalization transfer. Otherwise, pre-existing inequities in the level of economic development across regions may actually worsen with the introduction of the federal form of government.

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<sup>20</sup> The estimates of expenditure need in **Table 10** refer to actual expenditures of LGUs in the case of old SG expenditure functions. In the case of new SG expenditure functions which are proposed to be re-assigned to regional governments under a federal set-up, the estimates are based on actual aggregate spending of the central government at present which is distributed to the different regions using some allocation factor like population, etc. Admittedly, this approach is not ideal and should be treated as indicative only.

**Table 10. Indicative estimates of SG expenditure needs and SG revenue capacity**

	SG expenditure need			SG revenue capacity	Fiscal gap	
	New SG expd functions	Old SG expd functions <sup>a/</sup>	Total SG expd need		level (in million pesos)	% distn
NCR	54,970	45,252	100,222	85,270	-14,952	1.4
CAR	14,427	18,210	32,637	2,963	-29,674	2.7
I	31,372	33,967	65,340	7,663	-57,676	5.3
II	25,852	31,611	57,463	4,529	-52,933	4.9
III	60,811	58,121	118,932	19,380	-99,552	9.2
IVA	72,397	62,479	134,876	30,847	-104,030	9.6
IVB	23,664	26,010	49,674	3,312	-46,362	4.3
V	37,914	34,781	72,695	4,663	-68,031	6.3
VI	46,528	48,044	94,573	10,734	-83,839	7.7
VII	44,465	45,662	90,127	13,246	-76,880	7.1
VIII	32,185	36,225	68,410	4,360	-64,050	5.9
IX	25,383	28,049	53,432	3,572	-49,860	4.6
X	32,538	38,371	70,909	7,113	-63,796	5.9
XI	32,720	39,439	72,158	7,853	-64,305	5.9
XII	30,680	33,641	64,321	4,497	-59,823	5.5
CARAGA	19,556	22,550	42,106	3,174	-38,932	3.6
ARMM	26,366	85,340	111,707	416	-111,290	10.2
Phil	611,828	687,753	1,299,580	213,594	-1,085,987	100.0

a/ refers to LGU expd responsibilities under the LGC

**Table 11. Indicative estimates of per capita SG expenditure needs and per capita SG revenue capacity (in pesos)**

	SG expenditure need			SG revenue capacity	Fiscal gap
	New SG expd functions	Old SG expd functions <sup>a/</sup>	Total SG expd need		
NCR	4,269	3,514	7,783	6,622	-1,161
CAR	8,378	10,575	18,953	1,721	-17,232
I	6,242	6,758	13,000	1,525	-11,475
II	7,490	9,159	16,649	1,312	-15,337
III	5,421	5,181	10,602	1,728	-8,874
IVA	5,022	4,334	9,357	2,140	-7,217
IVB	7,986	8,777	16,763	1,118	-15,645
V	6,540	6,000	12,540	804	-11,736
VI	6,174	6,375	12,549	1,424	-11,125
VII	6,011	6,173	12,184	1,791	-10,394
VIII	7,249	8,159	15,407	982	-14,425
IX	6,993	7,727	14,720	984	-13,736
X	6,939	8,183	15,121	1,517	-13,605
XI	6,687	8,060	14,746	1,605	-13,141
XII	6,750	7,401	14,151	989	-13,162
CARAGA	7,531	8,684	16,215	1,222	-14,993
ARMM	6,973	22,569	29,541	110	-29,431
Phil	6,059	6,811	12,870	2,115	-10,755

a/ refers to LGU expd responsibilities under the LGC

### 3.4 Subnational Government Borrowing

Subnational borrowing is a primary source of finance for local infrastructure which is critical for the delivery of local services. This is so because financing local infrastructure from local taxes and other forms of recurrent revenues tends to be inefficient for a number of reasons. First, if subnational governments have no recourse but to finance local infrastructure from their recurrent revenues, the lumpy nature of most infrastructure investments means the amount of resources needed to finance the same is typically too large to be adequately sourced from their recurrent revenues in any given year. Thus, this situation would tend to result in the underprovision of local infrastructure as local communities wait for several years until their subnational governments have accumulated enough savings before they are able to access and enjoy the benefits from said capital investments. Also, given the close association between infrastructure investment and economic growth, the underprovision of local infrastructure necessarily constrains local economic growth and development. Second, because the benefits from infrastructure investments are spread out over several years, borrowing allows for a more equitable way of financing long-lived infrastructure investments (i.e., those with long life spans) as it provides a venue for the matching of the economic life of the investment with the maturity of the loan. As such, the cost of infrastructure services is essentially paid for by those who use them over the entire life span of the investment. Third, subnational governments which access the credit and capital markets are necessarily exposed to the discipline of the market place as banks and other financial institutions subject them to rigorous creditworthiness assessment and reporting requirements, thereby strengthening fiscal transparency and public financial management (Liu 2008).

However, local government borrowing is associated with risks related to fiscal distress and fiscal insolvency which may result from excessive or inappropriate local government debt accumulation. Excessive borrowing by subnational governments results in adverse externalities not just on the federal government but also on other subnational governments in the form of higher interest rates and higher risk premiums on government debt/ bonds (Fedelino and Ter-Minassian 2000).

The fiscal federalism literature provides some guidance on how to enforce fiscal discipline on the part of subnational governments and avert their excessive borrowing:

- (i) “Tax decentralization is a pre-requisite for subnational credit market access. In countries with highly centralized tax bases, unrestrained credit market access by subnational national governments pose a risk for macroeconomic stabilization policies of the national government as the private sector anticipates a higher-level government bailout in the event of default and does not discount the risks of such lending properly.” Conversely, “intergovernmental transfers in developing countries undermine fiscal discipline and accountability while building transfer dependencies that cause a slow economic strangulation of fiscally disadvantaged regions” (Boadway and Shah 2009).

The same point is raised by Rodden (2005 [Hamilton’s paradox]): “When the center dominates the power to tax and takes on heavy obligations to fund subnational governments, it cannot credibly commit to withhold bailouts in the event of a local fiscal crisis.” “Reformers and institutional designers who wish to capture some of the efficiency and accountability gains commonly associated with decentralized expenditures and borrowing should focus on finding ways to increase the ability of subnational governments to rely on taxes they raise themselves. The challenge of developing local taxation and user

fees under conditions of poverty, capital mobility, and weak institutions is daunting but potentially worth the effort.” He further added that: “Central governments in federations are much more inclined than those in unitary systems to allow subnational governments access to credit markets, even when transfer-dependence is high and the moral hazard problem looms large. This is because the states have such strong representation in the legislature, and more importantly, because the basic rules of the game were negotiated by the states and require their agreement for reform.”

- (ii) “To ensure fiscal discipline, governments at all levels must be made to face financial consequences of their decisions. This is possible if the central governments does not guarantee payment of state and local debt and if the central bank does not act as a lender of last resort to the central government” (Boadway and Shah 2009).
- (iii) Many countries (e.g., Germany, Brazil, India, and Russia) have enacted laws that mandates balanced budgets net of public investment or, alternatively, that borrowing is allowed only for long-term public capital investments.<sup>21</sup> In particular, the South African constitution prohibits borrowing for consumption expenditure (South Africa National Treasury 2001: 192 as cited in Liu 2010).
- (iv) Subnational debt crises in a number of countries (e.g., Brazil, Mexico, India, and Russia during the 1990s led to reforms to strengthen regulatory frameworks for SNG debt financing. That took the form of ex ante borrowing regulations or fiscal rules. “These rules may take the form of quantitative ceilings on borrowing, debt, or debt service of SNGs (often specified in relation to these govt’s revenues, as in Brazil and Colombia); or of procedural rules relating to SNGs’ budget processes. These rules may be embodied in national legislation (e.g., Brazil and Spain) or in SNG constitutions or laws (e.g., some states of the US and some Canadian provinces). The effectiveness of such rules depends on their specificity, comprehensiveness of coverage, and most important, the degree of political commitment to their observance and enforcement. The design of the rules also matters, particularly clear specification of appropriate escape clauses (that is, legal provisions that would waive the application of the fiscal rules under well-specified circumstances, such a national disaster or similar) and of credible sanctions for noncompliance” (Fedelino and Ter-Minassian 2000).

Related to this, Boadway and Shah (2009) argue that “Fiscal rules are neither necessary nor sufficient for fiscal discipline. However, fiscal rules accompanied by “gatekeeper” intergovernmental councils or committees provide a useful framework for fiscal discipline and fiscal policy coordination for countries with fragmented political regimes.”

Provisions related to subnational government borrowing that may be included in the constitution of the proposed federal government

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<sup>21</sup> This is sometimes referred to as the “golden rule.”



- (i) Federal governments shall not guarantee payment of regional government and local government debt. In other words, the federal government is committed not to bail out regional and local governments in the event of the latter default on their debt.
- (ii) Regional and local government may borrow for the purpose of financing capital investments only. (Golden Rule)
- (iii) Legislature shall enact Fiscal Responsibility Law that shall specify quantitative ceilings on borrowing, debt, debt service, or fiscal deficits of subnational government.
- (iv) Legislature shall enact law addressing bankruptcy policy and insolvency mechanisms for regional and local governments.

#### **4. FISCAL COST OF ADOPTION OF FEDERAL FORM OF GOVERNMENT**

The adoption of a federal form of government involves additional cost in the government operation. The elements of this cost include:

- (i) Salaries of governors and vice governors of regional governments and their staff as well as operating expense of their offices
- (ii) Salaries of Senators (second chamber) and their staff as well as operating expense of their offices – 3 to 7 senators per regional government under the original PDP-Laban model
- (iii) Salaries of members of judiciary at the state government level, their staff as well as operating expense of their offices<sup>22</sup>
- (iv) Salaries of state legislators and their staff as well as operating expense of their offices
  - Prior to the enactment of the Organic Act of each region, Regional Consultative Assembly – 3 from each LGU comprising the regional government
  - After enactment of Organic Act of each region, Regional Assembly – 2 from each province and one from each city.<sup>23</sup>

Assuming there are 17 regions, under the PDP Laban model, the estimates of the incremental fiscal cost of setting up a federal form of government range from PhP 44 billion to PhP 51 billion. The estimates of the incremental fiscal cost vary from PhP 53 billion to PhP 60 billion under Senator Nene Pimentel’s proposal. In comparison, the estimates vary from PhP 66 billion to PhP 72 billion if the number of regional government legislators proposed in the BBL were adopted in all the regions. Needless to say, these estimates will rise if the number of regions is increased.

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<sup>22</sup> The cost related to this is not included in the estimates because of the lack of detail on how the judiciary will be affected by the proposed shift to the federal form.

<sup>23</sup> Federalism models other than the PDP-Laban’s propose a bigger of regional level legislators (i) 3 legislators elected by popular vote in each province/ city plus 3 sectoral representatives in each province/ city or a total 1,428 regional level legislators under former Senator Nene Pimentel’s proposal, and (ii) at least 10 legislators per legislative district (40% of whom are elected by popular vote, 50% are party representatives, and 10% are sectoral representatives) or a total of 2,380 regional legislators under the current version of the proposed Bangsamoro Basic Law (BBL).

## 5. CONCLUSION

The discussion so far is focused on the design on the fiscal features of a federal form of government guided largely by the economic literature on fiscal federalism. The exercise undertaken in **Section 3** indicates that there is no single best expenditure assignment in a federal set-up. The same is true of tax assignment. However, it is critical that the expenditure assignment, the tax assignment and intergovernmental transfers are designed in an internally consistent and coherent manner that provides the subnational governments the right incentives to deliver the services assigned to them in an efficient and effective manner and to be more accountable to their constituents. In the context of the Philippines, the analysis also suggests that greater attention should be given to (i) the design of equalization transfers (otherwise, regional disparities may widen) and (ii) securing greater revenue autonomy for subnational governments (otherwise, local accountability may weaken). At the same time, the policy framework for subnational borrowing should be given more space in the federalism dialogue. Otherwise, fiscal discipline might be compromised under a federal model of government. In this regard, it should be pointed out that the greater decentralization of taxing powers to subnational government is a pre-requisite condition for autonomy in subnational governments' access to the credit and bond markets.

Moving forward, it should be stressed that even if initial design of federal model is coherent at the start, the likelihood is high that the initial model will be changed to reflect the particular interests of the framers of new constitution. In this regard, a good understanding of the political economy of attempts to reform the decentralization regime in the Philippines is instructive. Matsuda (2011) pointed out that Congress as an institution is not likely to expand the resource of local governments. To wit: "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" (Matsuda 2011). From this perspective, it matters a lot whether it is the Constituent Assembly or a Constitutional Convention is given the task to amend/ overhaul the Philippine Constitution if the potential benefits from the shift to a federal form of government are to be realized.

The political economy literature likewise suggests the following pre-conditions for success in adopting federal form of government:

- (i) reform of the party system so as to institutionalized strong political parties with "coherent ideological programs and policy platforms and internal organizational discipline" (Matsuda 2014); related to this, government budget support of political parties is also indicated;
- (ii) the lowering, if not the outright elimination of the high barrier to entry in the political arena, including presence of political dynasty (Pilapil 2016); and
- (iii) the reduction in the concentration of the power over resource allocation and resource mobilization in the President (and by extension, the executive branch); this last point may be better appreciated in the light of the discussion below.

Despite the promise of greater fiscal decentralization under the 1991 Local Government Code, resource allocation and revenue mobilization continued to be highly centralized in the post-Code period. In 2015, for instance, the central government has effective control in the allocation of 84%

of aggregate general government spending even as it was responsible for generating 93% of total general government revenues. Beyond these aggregate numbers, the ambit of central government control over spending is manifested in the disproportionate portion of the appropriations intended for the regional operations of various departments under General Appropriations Act (GAA) that is set aside for their central offices (**Table 12**), indicative of the wide degree of discretion that these central offices possess in allocating these amounts to the different regions during budget execution. It should be emphasized that the issue here is not so much that the NCR and its periphery (i.e., Regions III and IVA) receive a disproportionate share of national government spending relative to their contribution to the economy (as measured by GRDP share, for instance) or to their need for public services (as measured by their share in population, for example) because, in fact, this is not necessarily the case especially in recent years. Compare the share of the various regions in the budgets of various departments with their corresponding share in GRDP and population in the last two columns of **Table 12**. Rather, the issue is that, by providing the venue for legislators and local government officials to access additional budgetary resources possibly via transactional politics, the undue concentration of power over fiscal resources that is currently lodged with the executive branch of the central government adds an additional layer of distortions on the incentives for autonomous and accountable subnational units that have already been compromised by the weak structural design of the NG-LGU fiscal relations under present decentralized set up.<sup>24</sup> This discussion, thus, further highlights the equal importance of the design of the details of the fiscal decentralization framework and the overall political context.

**Table 12. Allocation for regional operations in the 2016 GAA budgets of selected departments**

Regions	DA		BEAR		DENR		DPWHa/		DIT		DSWD		DILG		DOH		DepEd		Total		GRDP share	Popn share
	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	17,176	17.0	20,483	5.5	70,514	11.2		
NCR		0.0		0.0	54	0.5	18,105	21.5	6	0.3	748	6.1	156	1.4	3,169	3.1	30,835	8.3	53,073	8.4	37.9	12.8
CAR	1,114	4.0	34.8	0.6	546	4.6	746	0.9	81	4.3	197	1.6	640	5.9	2,609	2.6	7,787	2.1	13,755	2.2	1.8	1.7
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	5,576	5.5	20,893	5.6	32,041	5.1	3.1	5.0
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	3,745	3.7	13,207	3.5	22,256	3.5	1.8	3.4
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	7,463	7.4	31,326	8.4	47,404	7.5	8.9	11.1
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	7,441	7.4	39,600	10.6	56,772	9.0	15.5	14.4
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	4,062	4.0	20,040	5.4	28,740	4.6	1.5	3.0
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	6,717	6.6	24,425	6.5	37,728	6.0	2.1	5.7
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	7,623	7.5	30,375	8.1	44,057	7.0	4.1	7.5
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	7,440	7.4	28,525	7.6	43,075	6.9	6.5	7.3
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	5,121	5.1	23,808	6.4	36,660	5.8	2.0	4.3
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	5,291	5.2	17,839	4.8	33,752	5.4	2.1	3.7
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	5,405	5.3	16,942	4.5	29,817	4.7	3.9	4.7
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	5,011	5.0	16,471	4.4	28,678	4.6	4.2	4.9
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	4,140	4.1	17,122	4.6	28,362	4.5	2.7	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	3,121	3.1	13,521	3.6	21,773	3.5	1.2	2.6
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	101,109	100.0	373,200	100.0	628,457	100.0		

a/ refers only to "various local infrastructure" and "local infrastructure"

<sup>24</sup> This point is important because

## REFERENCE

Bacani, Benedicto. 2009. "Autonomy and Federalism as a Solution to the Mindanao Conflict" in Brillantes, Alex B., Jr., Simeon A. Ilago and Raphael N. Montes, Jr., (eds.), 2009. *The Future of Local Autonomy: Decentralization and Federalism*. Quezon City, Philippines: Center for Local and Regional Governance, UP National College of Public Administration and Governance.