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UP CIDS POLICY BRIEF 2020-09

The Uneasy Relationship Between Transfers and Local Fiscal Governance[1]

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Introduction

Do unconditional transfers make local governments dependent on central government?

This policy brief cautions on current efforts towards decentralization via a federal shift, by taking stock of the ambivalent relationship between fiscal transfers and their welfare implications. Whether under the existing decentralization scheme or in the proposed fiscal framework under federalism, this brief argues that fiscal governance in the Philippines is generally characterized by extreme overdependence on central subsidy. The policy brief proceeds by first discussing the debate on the relationship between fiscal transfers and local development, and shows how literature has been ambivalent. Afterwards, it looks at the local fiscal framework in the Philippines under the Local Government Code of 1991 and in the setup laid down in the proposed federalist constitution. Using fiscal and electoral data, the brief then shows how the internal revenue allotment (IRA) may be dissuading local revenue generation, inadvertently making local governments more dependent on central government. The brief concludes with some policy recommendations on how local fiscal governance in the Philippines can be redesigned to make fiscal independence feasible.

Fiscal transfers and local development

Fiscal transfers refer broadly to any resource flow from one level of government to another, including, but not limited to, taxes shared by a central government authority to its subsidiaries. Typically, there is disparity in the capacity of subsidiary government units at all levels and across regimes to produce infrastructure and services necessary for productive inputs. Theoretically, the grants equalize public service provision by subsidizing the revenue-generating process and helping subsidiary units achieve basic national priorities (Kim and Smoke 2002). However, many problems have long been raised about intergovernmental transfers, among which are distributional inequality, inefficiency in tax administration, and a subsidy-dependency effect among recipient subsidiary governments (Liu and Zhao 2011).

By and large, literature looking at specific country experiences show that while transfers have a role in facilitating the implementation of government policies at various government levels, developmental outcomes are mixed. In Africa, there is evidence that where local government's tax collection capacity is weak and there is little political incentive to enforce, intergovernmental transfers can facilitate local revenue generation especially in rural districts (Masaki 2018). Yushkov (2015), in addition, found

[1] This policy brief is based on the author's paper of the same title which is part of the research project "A Study on the Implications of Federalism in the National Capital Region and Considerations for Forming the Federal Administrative Region" of the University of the Philippines Center for Integrative and Development Studies (UP CIDS), the Department of the Interior and Local Government–National Capital Region (DILG–NCR), and the Local Government of Quezon City. The project is funded by the DILG–NCR.

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that regional dependence on intergovernmental fiscal transfers from the federal center is positively associated with economic growth in Russia. Meanwhile, Gbafi and Sarucs (2004) find that highly populous Turkish municipalities that have higher grant increase rates make more revenue effort for financing local expenditures.

Unfortunately, transfers are also notorious for their susceptibility to political capture, especially in poorer areas (Mendes 2005), particularly in communities where voters lack bargaining power (Wyckoff 1988) and those reeling in poverty (Reinikka and Svensson 2004). Wu and Wen (2013) found that transfer dependency negatively affects expenditure decentralization in Chinese local governments, suggesting that provincial governments are grabbing central grants for their self-interest. Wongpredee and Tatchalerm (2014), on the other hand, show that intense politicking turns intergovernmental transfer systems into a competition for local particularistic interests. Transfers as a distributive component of fiscal decentralization also create uneven income distribution (Aslim and Neyapti 2017) and a common pool problem among subsidiary units (Jia, Guo, and Zhang 2014).

Fiscal transfers and local income generation in the Philippines

The Local Government Code of 1991 was once touted as the most promising legislative device giving life to the Constitutional principle ensuring local autonomy. However, it was not long before policymakers realized the law's limitations—the lack of clarity in functional assignment, limited and unproductive sources of local revenue, inadequate and inequitable intergovernmental transfer mechanism, and weak local government unit (LGU) debt regulatory framework within the law, among others (DILG 2015). In the Department of the Interior and Local Government's own study, the proportion of local tax-to-gross domestic product (GDP) has been found to be very low for all local government units in the aggregate. It is as if the heavy reliance on fiscal transfers, particularly the IRA, has created a disincentive for local government units to generate self-sustainable revenue sources, contrary to the idea of fiscal autonomy under the Local Government Code. This observation finds support in related studies done by independent researchers and international development agencies (see for instance, Manasan 2007; Uchimura and Suzuki 2009).

Local government's over-reliance on IRA can be attributed to at least two features of the Local Government Code. First, the law provides limited taxing powers to local units. Although in paper, subsidiary government units in the Philippines are encouraged to create their own revenue sources, this is far from easy in practice, as the bulk of productive tax bases are still constricted to the national government. Moreover, the already limited taxing powers become more pronounced for provinces and municipalities. However, since the LGU type also determines IRA share, local governments are induced to seek reclassification into cities to attract more IRA despite their obvious lack of fiscal capacity.[3] The DILG (2015) itself observed a rising trend towards conversion of municipalities into cities and the breaking up of existing localities into two or more administrative units since the passage of the Local Government Code. Second, despite decades after the law's implementation, many LGUs still fail to make full use of their already limited taxing powers (Manasan 2007; Uchimura and Suzuki 2009) and tend to be lukewarm about exploring possible tax bases under the law. For instance, many provinces and cities have yet to update the schedules of market values for real property within their jurisdiction even if the law specifically prescribes that it be done every three years.

Policymakers also doubt whether the IRA can narrow inequality across LGUs (DILG 2015). For instance, while the IRA is automatic, its formula does not take into account variations across LGUs in terms of their needs and capacity. Its implementation also creates a vicious cycle of local-to-central government dependency—the very anathema of fiscal autonomy as legislative intent. Moreover, the IRA being a type of unconditional transfer, gives

[3] The Local Government Code of 1991 lists the requirements for the creation of new provinces, cities and municipalities: (a) LGU income, (b) population, and (c) land area. Republic Act No. 9009 amended the income requirement in 2001 to Php 100 million worth of total locally generated income based on 2000 prices. As of 2015, however, the DILG notes that the income requirement the Local Government Code set for municipalities, highly urbanized cities and provinces in 1991 has remained in effect.

local governments little discretion at revenue raising, undermining fiscal and political accountability (see, for example, Boadway and Shah 2009).

Fiscal transfers in the context of Bayanihan federalism

On December 17, 2018, President Rodrigo Duterte issued Executive Order No. 10, creating a consultative committee tasked to draft a federalist charter. The final version of the draft charter released by the committee adopts what it calls "Bayanihan Federalism," under which the Philippines will be a federal republic comprised of 16 federated regions, the Bangsamoro, and the federated region of the Cordilleras. A federated region shall have exclusive power over socio-economic development planning; the creation of sources of revenue; financial administration and management; tourism, investment, and trade development; infrastructure, public utilities and public works; economic zones; land use and housing; the justice system; and local government units. The draft charter devotes an article discussing fiscal powers and financial administration. The draft also makes it explicit that federated regions shall have the power to levy a number of tax, licenses, and fees, as an exception to the federal government's plenary power of taxation.

However, a closer look shows that the taxes federated regions can collect are essentially no different from those already available to local governments under the Local Government Code. Moreover, despite the explicit listing of what regions can tax, the draft is silent to what extent these revenue powers are available to the provinces, cities, and municipalities. The lack of a clear delineation of what subsidiary units can and cannot do implies that problems raised against the current decentralization scheme under the Local Government Code, such as duplication and under-provision of services, will likely persist in the proposed federalist system.

Article XIII, Section 4 of the draft charter proposes federated regions to receive "a share of not less than fifty percent (50%) of all the collected income taxes, excise taxes, value-added tax, and customs duties, which shall be equally divided among them and automatically released." The proposed share is notably higher than the 40 percent currently provided under the Local Government Code. While seemingly addressing an issue of equity, the provision's notion of just share conveniently ignores empirical evidence on the downsides of unconditional transfers.

Another feature of the proposed federalist setup that warrants scrutiny is the Federal Intergovernmental Commission. Under Section 8, a Federal Intergovernmental Commission will be created composed of a chairman and two members appointed by the president, two members from the House of Representatives, two members from Senate, four members appointed by the Council of Regional Governors, one appointee from the Bangsamoro Parliament, one appointee from the Federated Region of the Cordilleras, and the Secretaries of the Department of Budget and Management and Department of Finance. The intergovernmental commission, by design, is susceptible to political manipulation given that membership is by appointment. Of the 15-member body (including the chair), five are immediately politically beholden to the president who appoints them (the secretary of budget, the secretary of finance, the commission chair, and two other members). It is important to put the provision into scrutiny because under Section 9, the intergovernmental commission has the power, among others, to administer the equalization fund, which amounts to not less than three percent of the annual general appropriations. The commission, in other words, can specify which regions should receive aid and how much, under the pretext of achieving "financial viability and economic sustainability" (see Section 5, in relation to Section 9). The distributive nature of the fund is eerily similar to pork barrel.

Empirical analysis

The following analysis is based on annual fiscal spending data for 81 provinces and 144 cities in the Philippines from 1992 to 2016. The data suggests that provinces, on average, source about 80 percent of their income from the national government. There are even provinces who relied completely on central government transfers for a time. Cities are less dependent on IRA but average IRA dependence remains high at 64 percent.

The proportion of locally sourced income over IRA is used to approximate a crowding out effect when LGUs evaluate available revenue sources. **TABLE 1** (on the next page) summarizes the result of panel estimates testing this relationship.

TABLE 1 Panel estimates of a crowding out effect of IRA on local revenue generation

	(FE Model) logINCOME (provinces)	(FE Model) logINCOME (cities)	(RE Model) logINCOME (all)	(Mixed) logINCOME (all)
Main				
IRA over total income	−3.890*** (0.500)	−2.693*** (0.248)	−2.971*** (0.210)	−2.467*** (0.206)
Effective number of candidates	0.0153 (0.0274)	−0.00226 (0.0110)	−0.000180 (0.0138)	0.0148 (0.0124)
Year before the next election	2.974*** (0.0863)	2.356*** (0.0449)	2.626*** (0.0553)	2.717*** (0.0594)
Logged distance from Metro Manila			−0.290*** (0.0440)	−0.216** (0.0681)
LGU type (1 if province)			0.796 (0.455)	1.594*** (0.328)
IRA over total income interacted with LGU type			−1.077* (0.530)	−2.068*** (0.412)
Year fixed effect	YES	YES	YES	YES
Constant	19.02*** (0.402)	18.79*** (0.173)	20.32*** (0.238)	19.47*** (0.373)
N	1860	2496	4356	4356
AIC	2763.5	20.96	NA	4305.7
BIC	2785.6	44.25	NA	4369.5

* $p < 0.05$; ** $p < 0.01$; *** $p < 0.001$
Note: Standard errors in parentheses

Random effects parameters for the mixed model	**Estimate**	**SE**	**95% CI**
Local government level random effects: Identity			
sd(IRA over total income)	1.641	0.375	1.049-2.568
Residual: AR(1)			
Rho	0.971	0.015	0.919-.990
sd(e)	1.404	0.279	0.951-2.073

Note: The random effects model was estimated using feasible generalized least square (FGLS) not maximum likelihood, hence, no AIC and BIC.

Source: Panao 2020

Models 1 and 2 are panel fixed effects models with year fixed effects for provinces and cities respectively. Model 3, on the other hand, is a random effects models with time invariant variables (logged distance, LGU type and the interaction between IRA over total income and LGU type). Model 4 utilizes a mixed panel estimation approach that contains random effects for each local government unit, as well as first order autoregressive errors.[4] All estimates include year fixed effects.

TABLE 1 (above) suggests that IRA's propensity to crowd out local revenue is more pronounced among provinces than in cities. For instance, a 10 percent additional increase in IRA as a proportion of total income among provinces decreases local revenue by 45.3 percent. This effect is almost twice as large as that for cities (24.7 percent). In fact, the direction of the relationship between local income generation and IRA is consistently negative across models. As with the mixed model, the fixed effect model suggests that the crowding out effect is more substantial for

[4] We followed Wooldridge (2002) and tested for serial correlation in the idiosyncratic errors of our panel data model. The test shows that both logINCOME and logWELFARE follow an AR(1) process.

provinces than cities. Whereas a percent increase in IRA as a proportion of total income crowds out local revenue generation by somewhere between three to five percent in provinces, it is just within three percent for cities. The fixed effect models for both provinces and cities, however, indicate correlation with unobserved individual level random effects. Hence, even if conventional tests such as that of Hausman (1978) discriminates in favor of a fixed effect model, the use of a mixed panel estimator is justified. Likelihood ratio tests indicate that the hierarchical model fits better than the usual linear alternative.

Interestingly, electoral proximity appears to motivate local revenue generation as well, possibly to signal good incumbent behavior and as a way to court reelection. However, whether or not incumbent chief executives fought competitive elections does not appear to matter in local revenue generation. Efforts to raise local income appears to diminish the farther the local government is from Metro Manila—the seat of central government in the Philippines—suggesting that as with socioeconomic development, fiscal governance has a geographic dimension.

Policy recommendations

In recent years there have been numerous calls to revisit the law, although most legislative efforts have been limited to reducing LGU responsibilities and suboptimal incremental measures (Matsuda 2011). Currently, there are moves to shift toward a federal system of government via a charter change but fiscal decentralization under the proposed design seems to be inadequate in addressing the problems under the current scheme and casts doubt on its promise of genuine self-governance.

In lieu of federalism, the following are proposed as broad areas of reform through legislative enactment:

(a) Amend the Local Government Code of 1991 to introduce a transfer scheme that takes into account the disparities in the revenue raising capacity and potential of local government units. The current local fiscal setup in the Philippines is characterized by vertical fiscal gaps due to, among others, inappropriate assignment of expenditure responsibilities to local units, heavily centralized taxing scheme, and a system that leaves little room for local governments to exercise revenue creation (Atienza et al. 2020; Morgan and Trinh 2016). In lieu of IRA, it may be necessary to come up with a fiscal equalization program that weighs each LGU's capacity to raise revenues from local tax bases to a national standard level, and compensates only the expenditures and costs that are due to inherent disabilities (e.g., an LGU is geographically isolated or is located in a disaster or conflict area).

(b) Pass an amending law or complementary statute clarifying which are delegated and which are devolved functions. Functions that have been devolved fully are those in which LGUs are exclusively tasked to provide. Delegated functions, on the other hand, are those whose provision is still the central government's responsibility but whose implementation has been tasked to the LGUs. However, both have real fiscal implications. The delivery of delegated functions, according to the DILG (2015), can be better achieved if it is financed through conditional transfers.

(c) Echoing Atienza, et al (2020), future policy trajectories may consider strengthening the role of regional and other local development councils so they become key players in regional economic development. The Local Government Code can be amended to allow regional and local development councils greater participation in local planning, implementation, and monitoring.

(d) While it is important for LGUs to be encouraged to seek their own sources of revenue, pertinent provisions in the Local Government Code, such as Secs. 129 and 186 imply an open list approach granting local governments power to levy fees and charges not already taxed under the National Internal Revenue Code or other applicable laws. This brief agrees with Morgan and Trinh (2016) and recommends setting regulations to make sure LGUs do not find themselves creating a large number of nuisance taxes. Section 186 of the Local Government Code may be amended to specify a close positive list of activities that LGUs can utilize as tax bases.

(e) Article X, Section 6 of the 1987 Constitution mandates that "[l]ocal government units shall have a just share, as determined by law, in the national taxes which shall be automatically released to them." Since a legislation can specify what is just, statutory amendments to the LGC may attach conditionalities to fiscal transfers so that the award depends on such criteria as good governance and fiscal resourcefulness.

These options are possible even within the context of existing institutions. These do not require constitutional redesign, contrary to prevailing political undercurrents. ■

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