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Federalism: Prospects for the Philippines

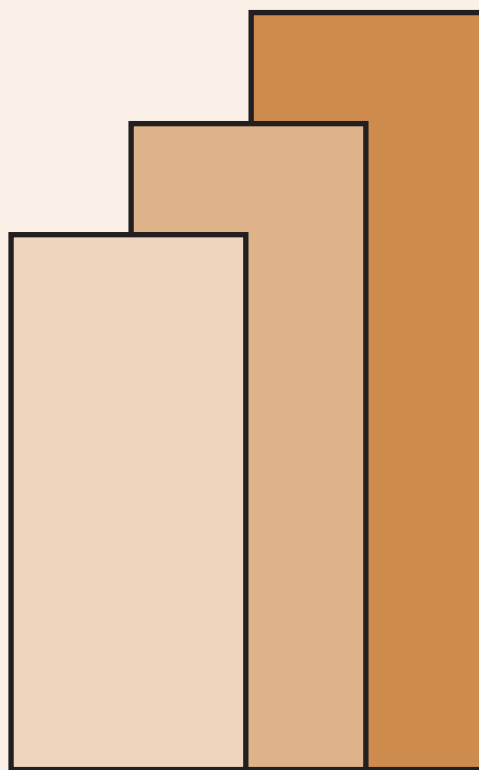
Romulo E.M. Miral Jr.

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Federalism: Prospects for the Philippines

Romulo E.M. Miral Jr.

FEDERALISM: PROSPECTS FOR PHILIPPINES

Abstract

The paper aims to consider potential benefits of federalism to the Philippines within the context of two major development constraints, namely, weak economic growth and poverty. The governance and institutional aspects of these development constraints point to how continued centralization of fiscal powers and the resulting common resource pool problem have weakened government capacity to bring about inclusive development. Decentralization efforts, notably, the enactment of the Local Government Code and the establishment of the Autonomous Region for Muslim Mindanao, have not adequately reduced the common resource pool problem because of the failure to assign sufficient expenditure and revenue raising powers at the subnational levels. Aggravating factors include the overinvolvement of the national government in local government affairs, inadequate revenue raising powers of local governments, and over reliance of local governments to national government transfers, particularly the internal revenue allotment or IRA. Sound alternatives, on the other hand, include tax sharing, appropriate local taxation powers, an equalization transfer system, and a restructuring of IRA to address horizontal fiscal imbalance. Critical to the success of decentralization and fiscal federalism efforts is a strong middle level government, which is absent in the current setup. The establishment of regional governments, its powers and functions and its relation to the national government and local governments, is the most crucial element in the shift from a unitary to a federal form of government. It is recommended that the proposed shift be carried out in two stages. The first stage will deal with assignment of competencies and the relationship between the national government and regional government, with the power to organize the local governments being one of the competencies exclusively assigned to the latter. This shall be the task of the constituent assembly that will be constituted to propose amendments to the Philippine Constitution. The second stage will tackle the regional government and its local governments. Each regional government should come up with its own regional constitution or organic act that could be drafted through a regional constitutional convention.

Keywords: Federalism, Decentralization, Autonomous Region, Local Government

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Acronyms and Abbreviations

ADB	Asian Development Bank
ARMM	Autonomous Region of Muslim Mindanao
ASEAN	Association of Southeast Asian Nations
BOT	Build Operate Transfer
CALABARZON	Cavite, Laguna, Batangas, Rizal, Quezon
CIA	Congressional Initiative Allocation
DBM	Department of Budget and Management
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GOCC	Government-Owned and -Controlled Corporation
IRA	Internal Revenue Allotment
LDC	Local Development Council
MNLF	Moro National Liberation Front
NCR	National Capital Region
NEDA	National Economic and Development Authority
NGO	Non-Government Organization
RA	Republic Act
RAF	Regional Allocatable Fund
RBAS	Regional Budget Allocation Scheme
RDC	Regional Development Council
REDPB	Regional Economic and Development Planning Board
SUC	State Universities and Colleges
VAT	Value Added Tax
VILP	Various Infrastructure Including Local Projects

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1. Introduction

The assumption to power of President Duterte signaled wide-ranging and significant political and socioeconomic reforms, which notably include a proposed shift from a unitary to a federal form of government. President Duterte has openly advocated and called for support from policymakers towards this shift, primarily to maximize regional growth potentials and to resolve decades of unrest in Mindanao.

A major constraint to Philippine development is the concentration of resources and the power to deploy them in the hands of the national government. This has engendered inefficiency in the delivery of government services and has exacerbated regional inequalities by sustaining patronage, corruption, and the growth of political dynasties. Reducing this concentration of resources is an essential initial step in addressing the long-standing problems of poverty and uneven economic growth.

Federalism entails the establishment of bigger middle-level governments that are capable of absorbing more powers devolved from the national government. This facilitates a balanced distribution of resources and power between the national and subnational levels and better coordination and integration in the delivery of government services.

This paper forwards that the critical task is not so much shifting to constitutional federalism, as it is institutionalizing a chief feature of fiscal federalism: the balance between centralization and decentralization. Specifically, this balance requires the clear and stable distribution of powers, functions, and resources among national and subnational governments in a manner that will produce favorable socioeconomic outcomes. There are governance principles that are best promoted by decentralization and local autonomy as there are other governance principles that are best promoted by the central government. Centralization and decentralization can be complementary.

2. Objectives and Organization of the Paper

This paper aims to consider the potential benefits of federalism to the Philippines within the context of its development constraints.

Specifically, this paper aims to

- a. present the governance and institutional aspects of development constraints in the Philippines,
- b. examine the implementation of decentralization in the country, and
- c. consider how the principles and features of federalism could logically address the same constraints.

This paper is divided into 12 sections.

Sections 1 to 6 discuss two long-standing development challenges of the country, namely, poverty and weak economic growth. The contexts of institutions, governance, and the common resource pool are offered to better understand the poor and unequal provision of public goods and services. The regional dimension of these development challenges is also presented to prove that the provision of government services is more sector-oriented than geography-based.

Sections 7 to 10 discuss decentralization, the government's main response to development challenges. The outcomes of administrative decentralization through the creation of the regions and political decentralization through the Local Government Code (LGC) and the creation of the Autonomous Region of Muslim Mindanao (ARMM) are assessed.

Section 11 presents the principles and features of federalism that are relevant to the common resource pool problem. Effects on government accountability, fiscal discipline, and allocative and operational efficiencies are discussed. The section also looks into intergovernmental arrangements that address fiscal imbalances and weak coordination among tiers of government.

The paper concludes with Section 12, which discusses lessons from federalism that can be used to reform past government decentralization measures. However, it also points out that a critical prerequisite to such reforms is the establishment of middle governments. However, this is not possible within the framework of the current Constitution and Local Government Code, and may necessitate a shift from a unitary to a federal form of government.

3. Basic Facts: Philippine Geography and Government Structure

The Philippines is a South East Asian archipelago of more than 7,100 islands. It has a land area of about 300,000 square kilometers and has one of the longest coastlines in the world. The country's population of 103 million consists of 110 different ethnic groups. Its official languages are Filipino and English, although it has more than 170 spoken dialects. About 92 percent of the population are Christians, 5 percent are Muslims, and the remaining 3 percent include Buddhists and animists.

The Philippines has a presidential unitary government system. The national government has three independent branches, namely, the executive, the legislature, and the judiciary. The executive is headed by a popularly elected president. It is functionally organized into sectoral departments, each headed by a cabinet secretary appointed by the president. The legislature, or Congress, is bicameral and composed of the Senate and the House of Representatives. The Senate consists of 24 senators who are nationally elected for a six-year term. The House of Representatives currently consists of 294 members elected for three-year terms, representing legislative districts and party list organizations. The judiciary is composed of the Supreme Court and the lower courts.

The political subdivisions are the 81 provinces, 145 cities, 1489 municipalities, and 42,036 *barangays*. They are collectively referred to as local government units. The *barangay* is the lowest tier of local government. A group of *barangays* comprise a municipality. The more urbanized and developed *barangays* comprise a city. A city is classified either as component or highly urbanized, with the latter being independent of the province. A cluster of municipalities or municipalities and component cities, comprise a province. Each local government is headed by directly elected officials, namely, a chief executive and legislative council members.

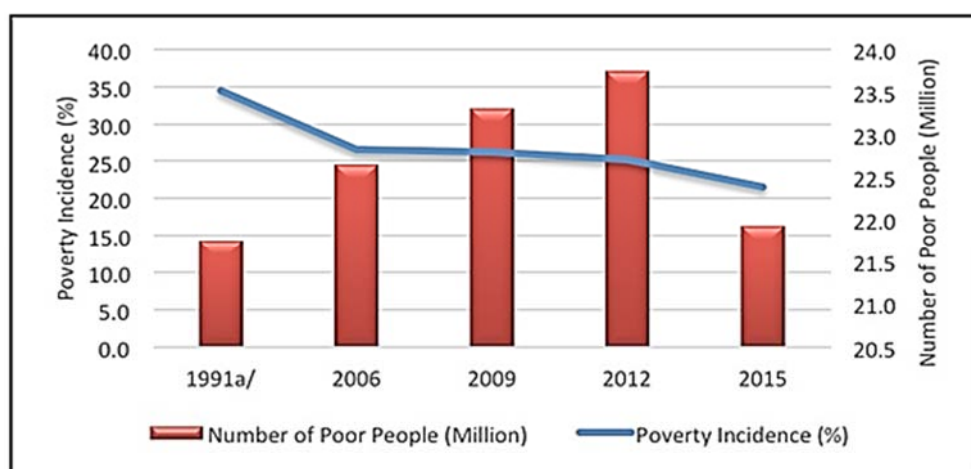
A group of contiguous provinces with a common history, cultural heritage, socioeconomic structure, or natural resource, form a region. The country currently has 17 regions. All but ARMM are administrative regions. Administrative regions mainly serve as focal points for the deconcentration of some planning and administrative functions of the national government, with each executive department having regional offices. Regions are not political units, and they do not have elected officials.

4. Long Standing Development Challenges

4.1 Persistent Poverty

Poverty remains a difficult challenge for the Philippines. In 2015, poverty incidence in the country was estimated at 21.6 percent, corresponding to 22 million Filipinos (Figure 1). The 3.6 percentage point reduction in poverty incidence from 2012 to 2015 was a milestone considering that in the 6 years prior to the period, poverty incidence declined by an average rate of less than 1 percentage point from 26.6 percent in 2006, to 26.3 percent in 2009, and 25.1 percent in 2012. The decline in poverty incidence was less than the population growth so that from 2006 to 2012, the number of poor Filipinos actually increased from 22.6 million to 23.7 million.

Figure 1. Poverty incidence and number of poor people, Philippines, 1991, 2006, 2009, 2012, and 2015.



Source of data: Philippine Statistical Authority, 2015 Full Year Official Poverty Statistics of the Philippines, 27 October 2016

Currently, the Philippines has the highest poverty incidence among its Southeast Asian peers, particularly among the Association of Southeast Asian Countries (ASEAN) 5¹. The country has the highest percentage of the population living on less than \$1.90² a day at 13.1 percent, followed by Indonesia at 11.9 percent, and Vietnam at 3.7 percent. In the 1980s, however, the Philippines had lower poverty incidence at 26.6 percent compared to Indonesia's 70.2 percent. In the 1990s, it had lower poverty incidence at 23.1 percent compared to Vietnam's 42.0 percent (Table 1). Thus, it is unfortunate that the Philippines ends up with the highest poverty incidence at present. Thailand has almost eradicated extreme poverty with only 0.1 percent of its population living on less than \$1.90 a day. Malaysia and Singapore have completely eradicated extreme poverty.

Based on a 2007 framework by the Asian Development Bank (ADB), the chief cause of poverty in the Philippines is the lack of productive employment opportunities, which is brought about by low economic growth and inadequate social safety nets, and made more pronounced by unequal access to opportunities. The causes of low economic growth are low levels of investment and entrepreneurship. Unequal access to opportunities is evidenced by poor access to health, education, and other social services, leading to weak human capabilities. Unequal access is further characterized by an uneven playing field that is the result of poor access to infrastructure, credit, land, and other productive assets.

Table 1. Proportion of population living on US\$1.90 a day, in percent (2011 purchasing power parity), selected ASEAN countries, 1980s to 2010s

Country/Year	1980s	1990s	2000s	2010s
Indonesia	70.2	53.1	25.9	11.9
Malaysia	2.2	1.1	0.4	--
Philippines	26.6	23.1	15.9	13.1
Thailand	16.9	4.3	0.8	0.1
Vietnam	--	42.0	26.0	3.7

Source of data: World Development Indicators database, as updated on 01/03/2017

4.2 Weak Economic Growth

For the period approximating 1980 to 2015, Philippine economic performance paled in comparison with the rest of selected ASEAN countries (Table 2). While its neighbors experienced long periods of sustained economic growth, the Philippines registered dull performance with periodic booms and busts. Per capita gross domestic product (GDP) grew by an average of 1.4 percent. This is only around 1/3 of the average growth of its neighbors, whose growth rates ranged from 3.6 to 4.8 percent. In the last 6 years, however, the Philippine economy performed considerably better with an annual average

¹ The ASEAN 5 consists of the founding members of the Association of Southeast Asian Countries, namely, Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

² US\$1.90 in Purchasing Power Parity (PPP) is equivalent to PhP40; the Philippine Statistical Authority's national poverty line is about PhP60 a day per person.

per capita GDP growth rate of 4.5 percent, making it the second best performing economy in the region.

Table 2. Average annual growth rate of GDP per capita, in percent, selected ASEAN countries, 1980 to 2015

Country/Year	1980-2015	1980-1989	1990-1999	2000-2009	2010-2015
Indonesia	3.78	4.14	3.19	3.71	4.29
Malaysia	3.56	3.05	4.52	2.88	3.96
Philippines	1.38	-0.7	0.38	2.56	4.54
Singapore	4.17	5.56	4.13	2.9	4.02
Thailand	4.16	5.34	4.11	3.57	3.29
Vietnam	4.85 ^a	2.14 ^b	5.63	5.41	4.88

^a For the period 1985 to 2015

^b For the period 1985 to 1989

Source of basic data: World Economic Indicators database, as updated on 01/03/2017

4.3 Income Inequality and Uneven Regional Development

Another major contributing factor to the slow poverty reduction in the Philippines is the unequal distribution of benefits from economic growth. Income inequality in the Philippines is high relative to international norms (Hill and Piza, 2007). Among ASEAN countries, the Philippines ranks second to Malaysia in terms of high income inequality. Table 3 shows that Philippine income inequality, as measured by the Gini index (coefficient), worsened over the years, from 40.9 in the 1980s to 43.0 in recent years.

Table 3. Gini index of income inequality, selected ASEAN countries, 1980 to 2015

Country/Year	1980-1989	1990-1999	2000-2009	2010-2015
Indonesia	..	..	..	39.5
Malaysia	47.3	48.4	46.1	..
Philippines	40.9	44.2	44.3	43.0
Thailand	44.5	44.0	41.0	38.5
Vietnam	..	35.5	38.6	39.7

Source of Source of data: World Development Indicators database, as updated on 01/03/2017

Economic growth and poverty in the Philippines have notable spatial and geographic dimensions. It is widely held that development efforts have been largely concentrated in Luzon at the expense of the Visayas and Mindanao. The National Capital Region (NCR) and the adjoining Regions III (Central Luzon) and IV-A (CALABARZON),³ on the average, account for 61 percent of the Philippines' GDP (Table 4). NCR alone accounts for an average share of

³ Region III is composed of the provinces of Central Luzon, namely, Aurora, Bataan, Bulacan, Nueva Ecija, Tarlac, and Zambales. Region IV-A is composed of the CALABARZON provinces, namely, Cavite, Laguna, Batangas, Rizal, and Quezon.

almost 38 percent of GDP, which is almost three times its population share. It also has the lowest regional poverty incidence, estimated at 3.9 percent in 2015. Central Luzon and CALABARZON rank next to NCR with a poverty incidence of 11.2 percent and 9.1 percent, respectively. ARMM has the lowest GDP share of only 0.7 percent and the highest poverty incidence of 53.7 percent. Also at the tail end are Caraga and Eastern Visayas with 1.2 percent and 2.0 percent share of GDP, respectively, and 39.1 percent and 38.7 percent poverty incidence, respectively.

Table 4. Population, gross regional domestic product, and poverty incidence, by region, Philippines, 2003, 2009, 2012, and 2015

Population, Gross Regional Domestic Product, Poverty, by Region, Philippines, 2003, 2009, 2012, 2015									
Region	Population	Gross Regional Domestic Product				Poverty Incidence			
	Percent Share (%)	Percent Share (%)				Percent			
	2015	2003	2009	2012	2015	2003	2009	2012	2015
Philippines	100.0	100.0	100.0	100.0	100.0	30.0	26.3	25.2	21.6
NCR	12.8	36.1	35.8	36.2	37.9	6.9	3.6	3.9	3.9
CAR	1.7	2.3	2.2	1.9	1.8	32.2	25.1	22.8	19.7
ILOCOS	5.0	2.9	3.1	3.1	3.1	30.2	22.0	18.5	13.1
CAGAYAN	3.4	1.9	1.8	1.7	1.8	24.5	25.5	22.1	15.8
CENTRAL LUZON	11.1	8.0	8.7	9.1	8.9	17.5	13.7	12.9	11.2
CALABARZON	14.3	12.0	16.8	16.8	15.5	18.4	11.9	10.9	9.1
MIMAROPA	2.9	2.1	1.9	1.8	1.5	48.1	34.5	31.0	24.4
BICOL	5.7	2.5	2.1	2.1	2.1	48.5	44.2	41.1	36.0
WESTERN VISAYAS	7.5	6.5	4.1	4.1	4.1	39.2	30.8	29.1	22.4
CENTRAL VISAYAS	7.3	6.9	5.8	6.4	6.5	28.3	31.0	30.2	27.6
EASTERN VISAYAS	4.4	2.3	2.7	2.2	2.0	43.0	42.6	45.2	38.7
ZAMBOANGA PENINSULA	3.6	2.2	2.1	2.1	2.1	49.2	45.8	40.1	33.9
NORTHERN MINDANAO	4.6	4.6	3.8	3.9	3.9	44.0	40.1	39.5	36.6
DAVAO	4.8	4.3	4.2	4.0	4.2	34.7	31.4	30.7	22.0
SOCCKSARGEN	4.5	3.2	2.7	2.7	2.7	38.4	38.3	44.7	37.3
CARAGA	2.6	1.3	1.1	1.2	1.2	54.0	54.4	40.3	39.1
ARMM	3.7	0.9	0.9	0.9	0.7	52.8	47.4	55.8	53.7

Source: NSCB & Philippine Statistics Authority

Balisacan, Hill, and Piza (2006) made the following observations:

- NCR, NCR's neighboring regions, and the province of Cebu benefit from good global connections, and are able to grow more rapidly. Even as these localities enjoy high economic growth rates, however, regional inequality across the country increases. Because of these disparities, NCR, NCR's neighboring regions, and Cebu are considered enclaves.
- Working with scarce infrastructure funds, the Philippine government chose to invest more on ports and harbors, or "*internationally oriented*" infrastructure, neglecting the development of domestic land and water transport systems. This expenditure pattern merely reinforced the economic advantage of the enclaves.
- For at least two decades, Philippine economic geography has been unchanged. Notably, western Mindanao has remained poor, with weak local governance and issues of conflict aggravating its position.

Uneven regional development is further mirrored down to local government levels. Studies show that differences in income and poverty across localities can be explained by geographic factors, such as climate, slope, elevation, sea- or landlockedness, access to key public services (such as infrastructure, education and health services), government policies (notably on agrarian reform and trade), peace and order, and quality of governance.⁴

5. The Context of Governance and Institutions

The persistent development challenges discussed in the previous section make up the socioeconomic backdrop against which reforms at decentralization were designed and initiatives at federalism are being forwarded. Additional information on these development challenges is available in Annex A.

However, since development policy is formulated and implemented by institutions through their practice of governance, it becomes necessary to add a political dimension to the backdrop against which proposals on decentralization and federalism should be analyzed.

5.1 Political Roots, Inclusive and Extractive Institutions

The usual prescription for countries experiencing weak or near-stagnant economic growth focuses on improving resource allocation and facilitating the robust growth of industry. The World Bank (2015), however, proposed that it is well to also consider that weak economic growth may actually have political roots.

Early economic growth phases are typically factor-intensive. Factor ownership is not only a source of wealth but also of power. In a growth model characterized by innovation, barrier-free entry, and competition, the factor-owning elite move to protect their interests by resisting or trying to manage change. This behavior may continue over the long term, effectively excluding majority of citizens from the purview of policy and governance (The World Bank, 2015).

The factor-owning elite logically form the base of extractive institutions. To be able to defend their socioeconomic positions and interests, they undertake rent-seeking activities that earn them disproportionately huge returns. These returns facilitate their direct or indirect participation in political institutions and governance, which in turn, fortify the protection of their economic interests. Conversely, those at the helm of extractive institutions can use their

⁴ These studies were conducted by Human Development Network (2013); Mapa, et al. (2013); Mendoza et al. (2013); Balisacan (2007); Mapa, Balisacan and Briones (2006); Balisacan and Fuwa (2004; 2002); Monsod and Monsod (2003); Balisacan and Pernia (2002); and Lim (2003).

positions to participate in rent-seeking activities, the returns of which, can be used to prolong their tenures in political institutions.

According to Robinson (2013) and Acemoglu and Robinson (2012), extractive economic and political institutions are characteristic of poor countries, while inclusive economic and political institutions are characteristic of rich countries. Inclusive institutions operate to employ society's "*energy, creativity, and entrepreneurship*". This is not possible in extractive institutions because power is apportioned to a few. It can also be shown that in countries dominated by extractive institutions, the central state is often not capable of providing key public goods.

5.2 Political Stability and Corruption⁵

The impact of institutions on the Philippine economy can be illustrated by considering investment vis-à-vis political instability. Periods of political instability were mainly brought about by attempts to shift political regimes, notably, the declaration of martial law or emergency rule, military uprisings, coups d'état, cabinet crises, impeachment, Muslim secessionist movements, and communist-led insurgencies. By disturbing systems of distribution and property rights, political instability is seen to have dampened investor confidence.

It was shown, for example, that for the period 1985 to 2006, as much as 20 percent of the variation in relative shares in foreign direct investment between the Philippines and other ASEAN economies can be explained by variation in political stability. This figure rose to 50 percent during the period following the signing of the Plaza-Louvre Accords in 1987.

As with political instability, corruption also negatively affects economic growth. Corruption demands unpredictable amounts of payoffs, poses uncertainties in the delivery of illegally acquired goods and services, and prevents competition. In the process, investment risk rises, investment choices are obscured, and investment placements are deterred.

For the period 1985 to 2006, perceived corruption alone could explain 25 to 50 percent of the variation in the investment-to-GDP ratio in the Philippines. The World Bank estimates that a total of Php 30 billion, or an average of 20 to 30 percent of every government contract, is lost annually because of corruption or inefficiency. It is thus easy to appreciate why the Executive Opinion Surveys by the World Economic Forum consistently ranked corruption as one of the most problematic factors for doing business in the Philippines. Other factors are poor infrastructure and unreliable government services.

⁵ Unless otherwise stated, the reference for Sections 5.2 and 6.1 is De Dios (2008).

6. The Centralized Government Setup

6.1 Presidential Powers

De Dios (2008) pointed out that political instability and corruption do not only negatively affect the country's economic growth performance, they are also closely connected to the following interrelated factors: alienation of the majority of the people to the formal political institutions, centralization of power in the executive branch, and the intense political rivalry among factions of the elite. Rose-Ackerman, Desierto, and Volosin (2010) further observe that the decree making powers of the Philippine President are extensive and give him prerogatives over a broad range of policy areas, especially under a declaration of a state of emergency. Congressional oversight is an appropriate check-and-balance power, but it is nevertheless difficult to match the extent of presidential powers.

Notably, the President wields unparalleled powers over the national budget. He has line item veto powers and exercises significant discretion over lump sum funds, such as intelligence funds, social funds, and calamity funds, and earnings of government-owned and -controlled corporations (GOCCs). The President can transfer appropriations and augment certain items in the appropriations law by declaring savings in other items. When a re-enacted budget is enforced, the President, on his own, can make decisions on government expenditures, notably on non-recurring budget items. Moreover, he can selectively impound appropriations, as is the case when he withholds the releases of the pork barrel funds of some legislators identified with the opposition.

Rose-Ackerman, Desierto, and Volosin (2010) also observed that the power to reorganize the Office of the President, vested by the Administrative Code, effectively provides him another means to undermine Congressional powers over the national budget. Administrative reorganization involves the transfer of functions and agencies under the Office of the President to other agencies in the executive or the other way around. In the name of administrative efficiency, the President has given discretionary powers to agencies over investments, contracts, public-private partnerships, and specialized economic issues in the energy and mining sectors.

Presidential appointive powers are also nearly all-encompassing and allows the appointment of political allies. In the executive, the President appoints department officials from the secretary to the bureau assistant director. He appoints the members of the Commissions on Election, Audit, Civil Service, and other constitutional bodies, and the board members of GOCCs and regulatory agencies. In the judicial branch, he appoints the justices of the Supreme Court and the judges of the lower courts. The President also appoints numerous members of the military and police establishments.

The disproportionately huge political power of and resources available to the Office of the President make it easy for its incumbent and the ruling elite to secure economic rents and accumulate wealth. This advantage makes the office highly coveted, and historically, has given rise to intense political competition among the country's elite. In the absence of effective checks and balances, these powers can be easily abused, ushering corruption. At the extreme, when corruption reaches intolerable limits and the ruling elite shows signs of perpetuating itself in power, political conflict is heightened and instability emerges.

De Dios (2008, page 35) refers to the above condition as "institutional dysfunction". Socioeconomic inequalities and the concentration of power in the center are used by elite groups to compete for political power. In turn, political power makes it possible for these groups to be beneficiaries of unwarranted reassignments of rights and to collect corruption rents.

6.2 The Common Resource Pool Problem

A common resource pool is a resource that is available for the joint use of numerous individuals (property of non-excludability) but where the consumption of the resource by an individual or group reduces the amount available to others (property of rivalry in use). This nature makes property rights attached to a common resource pool difficult to define. Individuals or groups are thus inclined to use more of these resources but to invest less in their upkeep. The result is the overuse of common pool resources or a condition called "*tragedy of commons*" (Grossman, 2010).

The national government budget has the attributes of a common resource pool. Taxes collected from all taxpayers nationwide are pooled to finance the provision of government services. Some of these services have benefits that are national in scope, such as defense and foreign relations. But most of services funded by the national government have localized benefits. For example, the full benefits from huge physical expenditure items, such as school buildings, roads, bridges, irrigations, and hospitals, are obviously confined to the particular areas where they are located. Since the local residents only partially pay for their costs (as the projects are funded from taxes collected nationwide), it would be to their interest to get as many local projects from the national budget as possible. However, the national budget is also finite, and channeling parts of it to particular sectors/localities/groups necessarily lessens what is available to the rest.

On the financing side, it is also the interest of each sector/locality/group to minimize its share of the tax burden. Indeed, a major reason for the Philippines' weak tax effort relative to its regional peers is the numerous tax exemptions given to various sectors and groups, e.g., senior citizens, persons with disabilities, boy scouts and girl scouts, cooperatives, the power sector,

and the shipping sector. The Philippines' value added tax system, for instance, has the highest number of line exemptions at 143 compared to Indonesia's 37, Thailand's 35, Vietnam's 25, and Malaysia's 14 (Department of Finance, 2017).

The power to control this common pool resource that is the national budget is at the hands of a highly centralized government. For sectors/localities/groups to maximize their shares of the national budget and/or minimize their tax burden, they would have to establish and maintain favorable relationships with the powerful central government. This practice is familiarly within the confines of the patronage system.

6.3 The Patronage System vis-a-vis the Common Pool Resource⁶

Hutchcroft (2014a, page 84) defines patronage as *"the material resource derived from public sources and disbursed for pluralistic benefit for political purposes"*.

In the Philippines, the patronage system permeates all levels of government, from the *barangay* to the national government. Local leaders need the support of national leaders who control the vast resources of government, especially the national budget. National leaders need the support of local leaders who have direct influence over local voters. Local voters look to local and national leaders to provide for community and personal needs. This web of mutual needs forms the base of a bargaining process for patronage. The patronage system in the Philippines is characterized as highly personal, clientelist, and reciprocity-dependent.

As the patronage system plays out, the exchange of political support for short-term benefits becomes the norm. Policy formulation is undertaken by farming out patronage to leaders in proportion to the level of support for a particular policy. Support can be directly exchanged for fund allocations, as in the case of the pork barrel system. Voters do not necessarily choose leaders on the bases of ideology, platform, or policies and programs. Instead, votes are cast based on the distribution of patronage.

The exchange of votes for short-term financial assistance or dole-outs do not only dissipate and misallocate public resources, it also weakens the accountability of public officials. They cease to reckon accountability for their office and the public good after receiving votes in exchange for patronage, believing that they have already delivered their part of the bargain. Over the long term, the development of accountable and authentically democratic political institutions is compromised.

⁶ Unless otherwise stated, the reference for Section 6.3 is Hutchcroft, 2014a.

Magcamit (2016) cited Manacsa and Tan (2012), who referred to the patronage-for-votes exchange as “*reverse accountability*”. Voters are accountable to and therefore elect their respective patrons either because they have received favors in the past or are promised favors in the future.

By sidetracking accountability, patronage shifts the focus of government officials from ensuring the soundness and responsiveness of policies and programs to maximizing personal benefits from government resources. Over time, the formulation and implementation of policies and programs for promoting economic development and reducing poverty are systematically neglected.

6.4 A Public Economics Perspective

From a public economics perspective, the common pool resource nature of the national budget and other national government resources also induces certain dysfunctions.

As common pool resources, the national budget and other national government resources are available for the use of government agencies from the national to the *barangay* levels. They can be used to finance goods and services that have nationwide or localized benefits. The national government can provide local public goods and services, e.g., a school building or a health clinic, either through direct financing or through transfers to local governments. When this happens, although the benefits of local services are confined to particular localities or groups, the cost is shouldered by the entire citizenry and only partially by their beneficiaries. However, voters-taxpayers may wrongly equate the cost of public services that they enjoy to the revenues of their local government or to their share of financing public services. This is referred to as fiscal illusion.

Fiscal illusion thus weakens the link between the benefits and costs of public spending. It also explains why nationally funded local goods and services and national transfers to local governments tend to be high relative to revenues collected by the government. Defending disproportionately huge expenditures results in the enactment of bloated budgets and subsequently, to impounding funds to manage budget deficits.⁷ In the last 56 years (1960-2016), the Philippines’ annual national government budgets were in deficit except for 8 years. The chronic fiscal deficit dragged down the country’s national savings and investment rates. Declining investment rates, in turn, crippled economic growth and poverty reduction.

Furthermore, one of the means of financing the budget deficit is public sector borrowing. Sicat (2007) pointed out that public sector borrowing reduces the amount of loanable funds that can be used by the private sector for its own

⁷ This refers to the power of the President to withhold releases of funds to implement certain programs and projects in the General Appropriations Act.

investment and operation. Consequently, the private sector's capacity to generate higher income can be stunted, which in turn, negatively affects economic growth.

Finally, the over-participation of national government in the direct provision of local goods and services and the overuse of transfers to local governments can also lead to corruption. Notably, overpriced government projects are easily tolerated by recipient local governments and constituents because they are aware only of the benefits of these projects and not the corresponding costs. They fail to internalize the full cost of provision because first, there is no proper appreciation that the cost is paid by all taxpayers nationwide, and second, the cost is actually hiked by inefficiencies and corruption. An accurate accounting of costs is deemed unnecessary, and is left undone.

6.5 Sectoral Versus Spatial Orientation

Government planning and budgeting. The centralization of powers and resources is also manifested in the orientation of government planning and budgeting, which are key components of public financial management.

A review of government planning and budgeting documents shows that these activities are sector-oriented and very weak in spatial or geographic dimensions. The chapters of the Philippine Development Plan, for example, are organized along sectors, e.g., macroeconomy, agriculture, industry, and services, and the national government budget is structured along sectoral departments and agencies.

The Philippine Development Plan is accompanied by regional development plans, which are supposed to provide spatial dimension to the national development plan. However, it is not clear how the regional plans and strategies influence the national government budget since the latter is largely determined by the central offices of national departments and agencies. Moreover, while the budgets of departments have regional breakdowns, a systematic tracking and reporting of actual government expenditures by region is absent.

The Philippine Development Report (2013) pointed out that instead of an integrated structure that factors in demand based on local geography, the national government is organized into "*vertical silos*" by sector and agency and within each agency, by program. Failing to address the impact of geography to human development by defending the sector-oriented planning and budgeting system has curtailed human capabilities, delimited living standards, and prevented market expansion.

The case of Philippine agriculture.⁸ The pitfalls of the highly centralized and sector-based planning and budgeting vis-à-vis the archipelagic geography of the Philippines can be illustrated by the agricultural sector. Based on diversity in temperature, moisture, slope, elevation, soil order, and topography, the country can be divided into 26 categories of agro-ecological zones. Each zone is fitted for distinct cropping and agricultural practices and requires customized assistance to farmers. However, agricultural extension workers cannot sufficiently provide this service. Instead, government agencies and their programs are organized by commodity, e.g., fishery, livestock, rice, and corn, and a one-size-fits-all-localities development strategy for each commodity sub-sector is implemented across the country. The lack of appropriate intervention based on farm type causes wide variabilities in productivity and losses in production. In the case of rice, the foregone yield due to the lack of appropriate extension services has been estimated at 150 percent.

The commodity approach in allocating the agriculture budget also provides inordinate amounts to rice production and its support services. This is especially true in subsidies for acquiring seeds and fertilizers, which are basically private goods. On the other hand, unduly small appropriations are given to research and development and other public goods.

Failures in planning, budgeting, intervention, and support services weigh heavily on the distribution of already scarce financial resources available to the agricultural sector, which is expected not only to provide employment to about two-thirds of the population and assure food security but also contribute to the country's international trade standing. If the performance of the agricultural sector is used as an indicator, the centralized and sector-based strategy for planning and budgeting has not resulted in adequate shares of agriculture to economic growth.

6.6 Integrated Approach to Service Delivery

The integrated approach to delivery starts by identifying the inputs required by specific interventions targeted for the social services and economic activities in a locality. These inputs are then pooled for delivery purposes so that not only are individual localities assured of appropriate interventions, but efficiency in provision is also achieved. Furthermore, there are strong interdependencies among sectors that should factor into the planning, budgeting, and implementation of particular government programs and services. For instance, education outcomes, such as dropout rate, cohort survival rate, and average test scores, and health outcomes, such as malnutrition rate, morbidity rate, and immunization rate, are strongly interrelated. The education and health sectors can enhance their respective outcomes through integration of their programs in localities.

⁸ The reference for this sub-section on agriculture is Human Development Network (2013).

7. Administrative Decentralization in the Philippines

Recognizing the perils of a highly centralized government structure as they have manifested themselves in persistent development challenges, past administrations have attempted to institutionalize variants of decentralization. Decentralization has been a reform by government to enhance public sector governance and to disperse economic development to the regions and to the countryside. The Philippine Constitution adopts local autonomy as a principle and policy of the state.

There are two types of government decentralization, namely, administrative decentralization or deconcentration, and political decentralization or devolution. Administrative decentralization involves the delegation of certain functions of national government offices, such as planning and administration, to its regional, local, and field offices. Political decentralization is akin to local autonomy, and this involves the transfer of power and authority for the performance of certain functions from the national government to subnational units. The Philippines has adopted both administrative and political decentralization.

7.1 Regional and Local Development Councils

Planning is an integral aspect of Philippine public financial management. The government operates on the basis of the six-year medium-term Philippine Development Plan (PDP) that coincides with the term of the President. The Plan contains the development goals, policy directions, and strategies of the government. Its accompanying document is a medium-term Public Investment Program that lists the priority programs and projects proposed by the offices and instrumentalities of the national government to carry out the PDP. The Public Investment Program is updated annually and a component, referred to as the Annual Investment Program, serves as a basis for the formulation of the annual national budget.

The planning-budgeting-programming linkage is a truism that is cited in all budgeting systems worldwide. However, there is wide gap between pronouncements and actual practice, and the outcomes bear this out (e.g. inadequate infrastructures and unmet demands in basic services such as education and health). The *World Economic Forum*, since it started its report on country competitiveness in 2004 up to the present, has ranked the Philippines lower than its regional peers in the provision of infrastructure, and health and primary education. The same inadequate government services have also been cited in the *ADB (2007) report* that examines the major constraints to inclusive economic growth and poverty reduction in the Philippines.

The regional approach to planning was institutionalized to address the problems of poverty and uneven regional growth and to develop public programs that are appropriate to local development needs (Nuqui, 1992).

The regional development council (RDC) coordinates the planning, implementation, and monitoring of programs and projects of the national government, and serves as an extension of the National Economic Development Authority (NEDA) Board. It is composed of regional directors of agencies represented in the NEDA Board⁹ and the Departments of Education, Social Welfare and Development, and Tourism, elected local government officials, and private sector representatives. Each RDC is headed by a Chairman and Co-Chairman who are appointed by the President from among elected local government officials and private sector representatives in the Council. Each RDC is assisted and supported by an Advisory Committee composed of members of the House of Representatives who are also members of the RDC Executive Committee. The counterpart NEDA regional office provides technical support and acts as the secretariat of an RDC. (Executive Order No. 325, April 12, 1996)

The RDC is the primary body that sets the direction of and coordinates all economic and social development efforts in its region. Its major functions are summarized as follows:

- Integration into the regional development plan, of the development plans of the region's provinces, line agencies, state universities and colleges (SUCs), GOCCs, and special development authorities,
- Coordination of all investment programs, physical framework plans, special development plans, and national programs and projects proposed for implementation in the regions, and the promotion of relevant private investments,
- Endorsement of the annual budgets of agency regional offices, SUCs, and special development authorities, and
- Monitoring and evaluation of development projects implemented by national government agencies, local governments, SUCs, GOCCs, and special development authorities in the region.

Local development councils (LDCs) were also created in each local government unit, thus there are provincial development councils, city development council, municipal development council, and *barangay* development council. They parallel the composition of RDCs, and are tasked to assist local governments in formulating their respective plans and programs.

⁹ The NEDA Board is composed of the President as chairman, the Secretary of Socio-Economic Planning and NEDA Director-General as vice-chairman, and the following as members: the Executive Secretary and the Secretaries of Finance, Trade and Industry, Agriculture, Environment and Natural Resources, Public Works and Highways, Budget and Management, Labor and Employment, Interior and Local Government, Health, Foreign Affairs, Agrarian Reform, Science and Technology, Transportation and Communications, Energy, and the Deputy Governor of the *Bangko Sentral ng Pilipinas*.

7.2 Bottom-up Planning Approach

RDCs and LDCs implement the bottom-up planning approach, which begins at the *barangay* level with the preparation of the *barangay* development plans. These plans contain project proposals that are forwarded to municipal development councils for review and incorporation into the municipal development and investment programs. The same process takes place at the city and provincial levels. The approved development plans of provinces and highly urbanized cities are then submitted to their respective RDCs for possible integration into the regional development plan and investment program (Hubell, *et al.*, 1989). The investment program lists priority programs and projects in the region for funding and implementation by both national and local governments.

To reinforce regional planning, major national implementing agencies are required to have a breakdown of their budgets by region. Central offices of national agencies are required to provide their regional offices indicative budget ceilings to guide the preparation of the agency regional budget. The agency regional budget is justified before its RDC for alignment with the regional plan and investment program. Once approved, proposed agency regional budgets are submitted to their respective central offices, where the budgets are evaluated and integrated to come up with the department or agency budgets.

The Department of Budget and Management (DBM) then holds budget hearings to evaluate and prioritize the agencies' proposed budgets with respect to government development priorities, budget ceilings, and macroeconomic targets approved by the Development Budget Coordination Committee. DBM consolidates all department and agency budgets, and submits them to the President and the Cabinet for approval. The President's national government budget is then submitted to Congress for approval and enactment.

7.3 Issues

Absence of meaningful spatial-based planning in the regions. Ideally, an integrated development approach should produce a regional development plan and an investment program that take into account local geography and the potentials and challenges peculiar to localities. Logically, the regional development plan and investment program should lead to the preparation of the regional budget, completing the planning-programming-budgeting cycle of public expenditure management.

Statutorily, however, there is no regional budget prepared under the auspices of the RDC for the implementation of the regional development plan and investment program. The mandate of the RDC is limited to reviewing and

endorsing the budget proposals of the regional offices of national government agencies for the approval of the agency central offices. The resulting regional budget is merely the sum of the budget allocations of the central offices of national government agencies to their regional offices. The substance of regional budgets is thus determined independently of RDCs, and regional budgets are expended by national government agencies.

At the regional level, therefore, there is no provision for strategic cross-sectoral allocation, consultation, coordination, and decisions among national government agencies, local government officials, and private sector players. The spatial-based budgeting that should be taking place in the regions through the RDC mechanism does not materialize, and is limited to indicating the location of agency programs and projects in the region (Mercado, 1999).

Unsynchronized budget execution and misaligned budget allocations. At the regional level, inter-agency coordination in budget execution is also a challenge because national government agencies can have different schedules of downloading the budgets to their regional offices. Furthermore, many RDCs have raised the concern that actual budget allocations for the regional offices of national government agencies are not consistent with annual investment programs and regional budgets that the regions have endorsed (Mercado, 1999).

In reality, not all budget allocations go through the prescribed planning-programming-budgeting process. Among these are allocations under Congressional funds, such as the Priority Development Assistance Fund, infrastructure funds for local projects, and other congressional initiatives for programs and projects identified by individual legislators.

To give RDCs a greater role in budget preparation and review, the Regional Budget Allocation Scheme (RBAS) was introduced in 1995. Under the RBAS, a Regional Allocable Fund (RAF) is set aside for the regions to fund programs and projects that RDCs prioritize. The RAF concept, however, was opposed by legislators who regarded it as a means of raising election money (Mercado 1999). Thus, the RBAS and RAF did not take off the ground.

Inadequate RDC powers. RDCs are mandated to set the direction for and coordinate all economic and social development efforts in the region. However, RDCs can only provide inputs and do not have control or power over regional budgets, raising doubts on the usefulness of the regional development and investment programming exercise that they are tasked to coordinate. The central offices of national government agencies retain the stronger, or the only, influence in the prioritization, allocation, and fund releases relevant to regional projects. Projects for implementation in the regions reflect the preferences and priorities of these central offices, rather than those of the localities in the region. Thus, the budgeting system, although “*regionalized*”, is in essence, agency-based rather than area-based.

RDCs do not have a line of authority over their members. RDC actions are not binding on its members, and on the ground, many RDC meetings are not attended by key local government officials who can make decisions on program and project prioritization. Overall, under the current setup, no entity can be held directly accountable for the development of the region.

As Sicat (2016) points out, the regions were designed merely for the purpose of downloading national government programs and projects to the provinces. The regions cannot raise revenues and are totally dependent on national government allocations to carry out their development plans and investment programs. Clearly, what is needed are regional governments that have full mandates, powers, and accountability for the development of the regions.

8. The Autonomous Region of Muslim Mindanao: A Case Study

8.1 Legal Bases

The Autonomous Region of Muslim Mindanao (ARMM) is the only region in the country with a regional government. The Philippine Constitution mandates Congress to enact a local government code and organic acts for each of the autonomous regions of Muslim Mindanao and the Cordilleras.¹⁰ In 1989, Congress passed Republic Act (RA) No. 6734 or the Organic Act for the Autonomous Region of Muslim Mindanao. In 2001, the Act was amended by RA 9054¹¹. These laws define the autonomous region's basic government structure and devolved to ARMM significant fiscal powers and responsibilities.

The creation of ARMM can be traced back to the peace negotiation process between the Government of the Philippines and the Moro National Liberation Front (MNLF). The peace process started with the 1976 Tripoli Agreement facilitated by the Organization of Islamic Cooperation. MNLF conceded to the establishment of an autonomous area for Muslims in Mindanao and to an end of their armed struggle for Mindanao sovereignty. The Tripoli Agreement provided that the autonomous region was to have a ministerial or parliamentary form of government, its own administrative, economic, and financial systems, its own security force, and the mandate to set up Shari'ah courts and schools, colleges, and universities (Lingga, 2016).

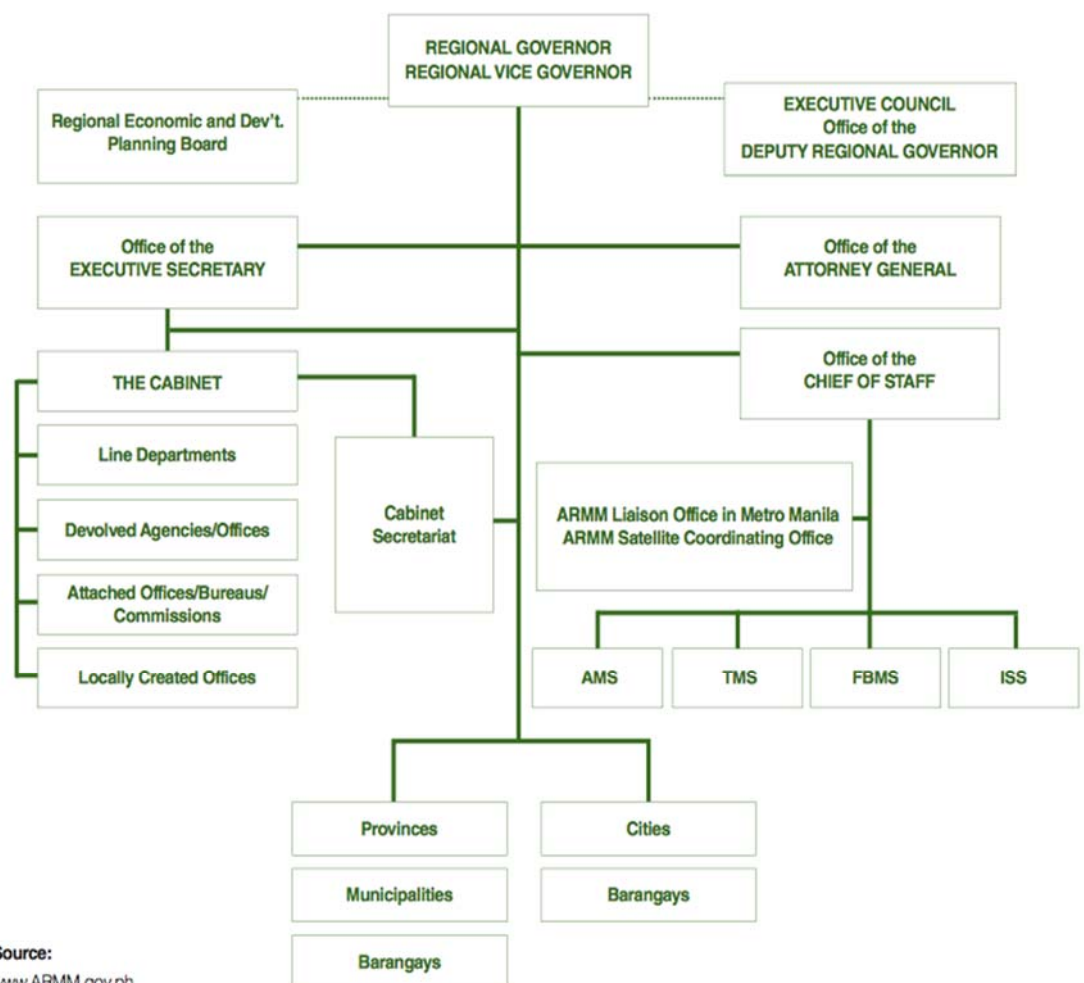
8.2 Government Structure and Powers

¹⁰ Republic Act No. 6766 or the Organic Act for Cordillera Autonomous Region failed to obtain popular approval through a referendum.

¹¹ An Act to Strengthen and Expand the Organic Act for the Autonomous Region in Muslim Mindanao, Amending for the Purpose Republic Act No. 6734, entitled "An Act Providing for an Organic Act for the Autonomous Region in Muslim Mindanao", as amended.

Instead of a parliamentary form of government for ARMM, a structure similar to that of the national government emerged. The executive branch is headed by a Regional Governor and Vice Regional Governor who are popularly elected. There is also a cabinet composed of secretaries who are heads of the regional departments that mirror the executive departments of the national government. There are currently 20 departments, 4 bureaus, and 9 locally created offices. The legislative branch, or the Regional Assembly, is unicameral. It is composed of 3 elected representatives from each of the legislative districts and sectoral representatives whose number cannot exceed 15 percent of the total number of elected members of the assembly.

Figure 2. Government structure, Autonomous Region of Muslim Mindanao



RA 9054 also provides for the creation of the Regional Economic and Development Planning Board (REDPB) that resembles the RDC. The Board is chaired by the Regional Governor. Its members include the Speaker and two other members of the Regional Assembly, the provincial governors, and the city mayors of the provinces and cities within the autonomous region, and 5 representatives from the private sector. The REDPB is mandated to:

- a. plan, monitor, and coordinate all development plans, projects, and programs intended for the autonomous region,
- b. formulate a master plan for a systematic, progressive, and comprehensive development of the region, taking into account the development plans of the province, city, municipality, and *barangay*, and
- c. evaluate and recommend for approval by the Regional Assembly, the annual work programs and comprehensive development plans of the autonomous region.

With the *imprimatur* of the Regional Assembly, regional development plans and programs carry more weight and greater chances of being implemented than the RDC-prepared regional plans and programs. The Regional Assembly has the power to pass the regional budget and all other laws for the region's administration. The Regional Governor, who is tasked to implement the regional development plan and program, has complete supervision and control over all executive agencies and offices in the region.

Unlike the administrative regions in the rest of the country, ARMM is vested with fiscal autonomy. It can create its own sources of revenues and levy taxes, fees, and charges to support its operations, and budget these own-source revenues, including its share of the internal revenue taxes, block grants, and subsidies remitted to it by the national government or any donor.

8.3 Causes of Underdevelopment

Almost 27 years after the establishment of ARMM, the region remains a laggard with the lowest rate of economic growth, highest poverty incidence, and lowest human development index. Poverty incidence is at 53.7 percent, while the Philippine average is 21.6 percent. Life expectancy is below the national average by 14.2 years. Mean years of schooling is 2.5 years lower than the national average. (Monsod, 2017).

The continuing armed conflict in ARMM has made development difficult to pursue. At the same time, underdevelopment contributes to the perceived neglect of the region and fuels unrest. However, other than the prolonged armed conflict, there are governance issues that hinder the effective and efficient delivery of critical government services.

8.4 Public Expenditure Management

Accountability. Weak budget accountability and lack of compliance in reporting are major problems in ARMM public expenditure management. The regional government does not regularly submit budget accountability reports

of DBM-sourced funds. When available, budget reports do not always provide sufficient information on actual spending and corresponding outputs and outcomes. This hinders DBM from correctly responding to the resource requirements of the region. Moreover, since the non-compliance is not sanctioned by the national government, the regional government is not motivated to improve its track record on reporting.

Australia Department of Foreign Affairs and Trade and the World Bank (2015) observe that national government authorities are also somewhat lax with ARMM agencies in the implementation of reporting guidelines because of the latter's autonomous status. They also raise the contribution of patronage politics to the problem, opining that the national government's support to ARMM *sans* accountability on the part of ARMM may be indicative of the exchange of funding support and autonomy for electoral support.

Revenue sources. Another governance issue is the fragmented public expenditure management of resources. The resources available for the development of the region can be categorized into three major categories of funds. The management of these funds illustrate the varied procedures carried out by numerous players. The first fund category is the **regional fund**, which consists of taxes and fees levied by the regional government plus its share in the national government's internal revenue taxes collected in the region. The second category is the **national fund**, which consists of funds appropriated by the national government in the General Appropriations Act for ARMM. The third category is the **local fund** which consists of taxes and fees levied by local government units in ARMM plus their share of the internal revenue allotment (IRA). (Australia DFAT and The World Bank, 2015)

Among the three fund categories, only the **regional fund** is under the full control of the regional government. Its utilization requires that the Regional Governor and his cabinet prepare an annual budget in line with the regional development plan and program formulated by REDPB. The proposed budget is then submitted to Regional Assembly for approval and enactment. The regional fund amounts to only 1.8 percent of the total funds for use in the region¹². This logically raises doubts on the degree of fiscal autonomy enjoyed by the regional government and the resulting capacity to respond to the development needs of the region.

The own-source revenue from taxes and fees levied by the regional government amounts to only 0.6 percent of the region's total funds. The regional government taxes consist mainly of the same taxes imposed by local governments except for travel tax and barter tax, which are not imposed by the latter. Since the regional government is sharing the tax powers with the local governments, i.e., there is joint taxation, it can only impose minimal rates to avoid over taxation.

¹² The figures cited in the discussion on revenue sources are presented in Table 7.

The regional government is precluded from imposing taxes assigned to the national government except for income tax levied on banks and other financial institutions and taxes and fees for motor vehicle registration. Instead, ARMM is entitled to a 70-percent revenue share of the national internal revenue taxes, fees, and charges, and taxes imposed on natural resources collected in the region, of which 35 percent is given to the regional government and 35 percent to the province or city where the revenues are collected. However, ARMM does not get the full amount of its revenue share as mandated under RA 9054. The amount of national internal revenue taxes generated within the ARMM is not fully accounted because large taxpayers doing business in ARMM, in particular, file consolidated tax returns and pay taxes through their head offices in NCR. The revenue share that ARMM gets consists mainly of cash tax payments from small taxpayers paid to BIR revenue collecting officers in the region and taxes withheld by government offices in ARMM.

*Table 5. Principal sources of government funds,
Autonomous Region of Muslim Mindanao,
2011, 2013, and 2015*

Source of Funds	2011		2013		2015	
	Million Pesos	% to Total	Million Pesos	% to Total	Million Pesos	% to Total
Total ARG Appropriations	11,179.6	38.5	13,172.0	39.8	24,299.8	50.5
NGA Sub-Allotments for ARMM	2,721.8	9.4	5,443.5	16.5	4,866.2	10.1
of which: PDAF (actual)	30.5	0.1	8.5	0.0	-	-
Total National Fund	13,901.5	47.9	18,615.5	56.3	29,165.9	60.6
Regional Own Source Revenue	140.0	0.5	52.9	0.2	288.5	0.6
ARG IRA Share	462.0	1.6	462.0	1.4	600.0	1.2
Total ARMM Regional Fund	602.0	2.1	514.9	1.6	888.5	1.8
		-		-		-
Provinces IRA	4,352.5	15.0	4,083.1	12.3	5,286.7	11.0
Cities IRA	354.9	1.2	632.0	1.9	812.2	1.7
Municipalities IRA	6,950.5	23.9	6,551.9	19.8	8,505.2	17.7
Barangays IRA	2,886.1	9.9	2,667.9	8.1	3,443.6	7.2
Total Local Fund	14,544.0	50.1	13,934.8	42.1	18,047.7	37.5
Grand Total	29,047.4	100.0	33,065.2	100.0	48,102.2	100.0

Source of basic data: GAA, NEP, BESF, Office of Regional Treasury - ARMM, and DBM for ARG IRA Share

ARG Appropriations – GAA

NGA Sub-Allotments for ARMM – NEP

ARG IRA Share (built-in appropriations) - DBM (sent file)

Local Fund - BESF

ARMM is somehow compensated for not getting the full amount of its revenue share through the **national fund**, or the fund appropriated to the region by the national government from the annual general appropriations.

This source accounts for 60.6 percent of the region's total funds. However, the regional government does not have full control over this fund because the Regional Assembly does not have any participation in decisions on its allocation and use. Instead, the ARMM regional government acts like a regular line agency that prepares and submits its budget proposal on the basis of the budget ceiling and national budgeting guidelines provided by DBM. The Regional Governor justifies the ARMM budget proposal to DBM, and then to the House of Representatives and the Senate. Again, like national government line agencies, the regional government has to submit budget execution and accountability reports to DBM (and the Commission on Audit) for the release of its budget. The national government line agencies may also allot funds in their budget for programs and projects in ARMM. These programs and projects are either implemented by the line agencies themselves or sub-allotted and transferred to the ARMM regional government in the course of budget implementation. ARMM officials have noted the uncertainty, delays, and their lack of control in the transfer of these funds, conditions that ultimately lead to unutilized budgets and reflect negatively on the absorptive capacity of the regional government.

The last fund category, the **local fund**, accounts for 37.5 percent of funds for use in the ARMM. The local fund, which is attributed to local governments, is totally outside the purview of the regional government. Local funds are budgeted and expended individually by each local government unit. Regional government officials and scholars from ARMM have noted that local governments enjoy greater fiscal autonomy than the regional government. While both regional and local governments are largely dependent on national government transfers, transfers to local governments, such as the IRA, are formula-based block grants that are automatically released to them.

Implications on decentralization. In summary, the funds for use in ARMM are controlled by different players at the national, regional, and local government levels. The regional government has full control of only a very small proportion of these funds. This not only weakens the autonomy of the regional government, but it also poses difficulties in the implementation of the development plan for the region. Furthermore, it will be recalled that the national government budgeting system is structured based on sectors. This does not fit neatly with the budgetary requirements of ARMM's unique cross-sectoral responsibilities (Australia DFAT and The World Bank 2015).

Effective coordination among government tiers requires clear division of responsibilities, adequate funding, and bureaucratic capacity at all government levels. As a whole, the Philippines falls short of these requirements (Balisacan, Hill, Piza, 2006), and the conditions in ARMM are more problematic because of two parallel decentralization processes being carried out in the region. The first is the devolution of some national government powers to the ARMM regional government, and the second is

the devolution of almost the same powers to the local governments within ARMM under RA 7160 or the Local Government Code.

The two decentralization processes pose contradictions and tensions. The functions devolved to ARMM and the local governments in the region are almost similar, except that functions devolved to ARMM are slightly broader and includes education. To help the local governments undertake their devolved functions, the Local Government Code provides them with significant amounts of IRA. Just like other local governments in the country, the local governments in ARMM are given IRA; however, the local governments in ARMM do not perform the devolved functions that other local governments in the rest of the country do because such functions are assigned to the ARMM regional government pursuant to the Muslim Mindanao Autonomy Act passed by the ARMM Regional Assembly. The regional government depends on the national government for funding support to carry out these devolved functions, something that the national government, particularly DBM, is reluctant to provide because funds for these devolved functions are already part of IRA allocated to all local government units.

Moreover, unlike in the administrative regions where personnel performing devolved functions based on the Local Government Code are under the different local government units, the counterpart personnel in ARMM are under the regional government. Historically, thus, Personal Services accounts for around 85 percent of the regional government's budget. This limits funding support for the regional government's other operations, programs, and projects.

Then, too, even with its huge expenditures for devolved-function personnel, the Regional Governor wields very limited influence on the priorities and actions of the local governments in the region. On the other hand, the department heads of the regional government claim that they are excluded from strategic planning and budget formulation of the national government agencies, activities which their counterparts in the administrative regions participate in. This explains a common sentiment that the regional government's line departments do not receive their fair share from the program funds of national government agencies. National agencies purport that since ARMM is autonomous, its exercises on strategic planning and budget formulation should be undertaken independently and separately from the administrative regions. Nevertheless, the regional line agencies do receive their shares in the national government allocation thru the ARMM regional government.

To the extent that the Organic Act provides for the exercise of general supervision by the President over the Regional Governor, the autonomous regional government is often perceived to be at the same footing as local government units outside ARMM. It should be emphasized, however, that the

Administrative Code and jurisprudence define general supervision as seeing to it that laws and rules are followed, an act that is not contrary to autonomy.

Nevertheless, it is useful to gain insight on how local government officials in ARMM regard the regional government. Results of focus group discussions and key informant interviews conducted to gather views on the prospects of federalism in the Philippines (See Annex B) suggest that in spite of the local autonomy that they enjoy, some local government officials are uncomfortable with the additional tier of government occupied by the regional government. The regional government is not perceived as one of the sub-national tiers of government in ARMM; moreover, provincial governments within ARMM are regarded as more connected to the national government than the regional government.

For example, local government officials within ARMM assert that the regional government either hinders the provincial government's access to national government assistance or competes with the province for national government support. Provincial officials from ARMM have also noted that either the regional government has not been very responsive to the needs of the province or does not coordinate its programs with the province.

9. The Local Government Code of 1991

The most significant law passed by Congress providing for government decentralization is RA 7160 or the Local Government Code of 1991. The Code sought to transform local governments into self-reliant communities and active partners in the attainment of national goals by establishing a more responsive and accountable local government structure.

9.1 Devolution of Powers

The Code devolved responsibilities and powers over certain basic services and regulatory functions, including corresponding assets and personnel, from national government agencies to local governments. These basic services are: health (field health, hospital, and tertiary services), social services (social welfare services), environment (community-based forestry projects), agriculture (agricultural extension and on-site research), public works (those funded by local funds), tourism (facilities, promotion, and development), telecommunications services and housing projects (for provinces and cities), and other services, such as investment support.

Education, which by law receives the biggest budgetary allocation, remains a national government function. The only education-related function devolved to local governments is school building maintenance. Education policies, including curricula and qualifications and selection of teachers, are prescribed by the Department of Education. Teachers and other education workers, regardless of locality, are employees of the Department.

9.2 Additional Taxing Powers and Institutional Infrastructure

To enable local governments to carry out their functions, the Code vested them with additional taxing powers and higher shares in the internal tax revenues of the national government. The Code also raised the tax rate ceilings that can be imposed by local governments. Furthermore, it increased IRA from 11 percent to 40 percent. In addition to IRA, the Code entitled local governments to a share in the gross collection of the national government from taxes and proceeds derived by any government agency or GOCC in connection with the utilization and development of natural resources in their territorial jurisdictions. Finally, the Code authorized local governments to finance capital investment projects through borrowing and bonds issuance and to enter into build-operate-transfer contracts with private firms.

The Local Government Code provided the legal and institutional infrastructure for strengthening civil society participation and promoting greater government accountability. It mandated the creation of special bodies, such as the local development council, local health board, local school board, and local peace and order council. It also provided for the representation of non-government organizations (NGOs) and people's organizations in these special bodies. There are also provisions for direct democracy, such as the system of recall, initiative, and referendum. An elected local government official can be recalled from office for loss of confidence by its registered voters. Registered voters of a local government unit may also directly propose an enactment or amendment of a local ordinance. A referendum is required for any law or ordinance on the creation, division, merger, abolition, or alteration of boundaries of local government units. A referendum can also be held to approve, amend, or reject an ordinance enacted by local legislative councils.

Finally, the Code encouraged cooperative arrangements among local government units towards the efficient delivery of services. Local government units may consolidate or coordinate their efforts, services, and resources for purposes commonly beneficial to them. The creation of umbrella-type leagues at the various local government levels, i.e., League of *Barangays*, League of Municipalities, League of Cities, and League of Provinces, are mandated as fora for discussing issues and forging solutions. Local government units are represented in their respective leagues by their chief executives.

10. Assessment of Government Decentralization

10.1 Overall Findings

Mixed results. Twenty-five years of decentralization have produced mixed results. Balisacan, Hill, and Piza (2007) observed that some degree of administrative and political authority have indeed moved from the center to the regions, and some local governments have had remarkable accomplishments.

However, the desired overall and significant transfer of power and resources from the national to the subnational tiers has not been attained, and as such, neither have the concomitant qualities of local governance, namely, efficiency, responsiveness, and accountability.

The observations of the 11th Rapid Field Appraisal conducted by the Asia Foundation run on a similar vein. The 2010 study, which covered 177 local governments (cities, municipalities, and provinces) in 15 regions, speaks of a critical mass of local governments, the attainment of which will mark the definitive change towards improved governance. This critical mass appears to be growing in specific sectors, such as the environment, health and social services, and revenue generation. With the Leagues more actively promoting the interests of its members, it would do well for them to likewise promote good governance practices. Individual local government units can then study these practices, adapt them to their respective localities, and even upscale them to wider jurisdictions. National government assistance, in fact, has been solicited for providing knowledge management support for the propagation of good practices and proven technologies.

The other areas of governance where the promotion of good practices is critical, but has not approached the critical mass, are transparency and participation. While citizen participation in local governance is significant in compulsorily created sectoral bodies, such as local school boards, local health boards, and fisheries and aquatic resources management councils, meaningful participation in nongovernment organizations and people's organizations remain wanting (Asia Foundation, 2010).

The *Gantimpalang Panglingkod Pook* or *Gawad Galing Pook*¹³, an awards program on innovation and excellence in local governance, has given recognition to programs initiated by local governments in the delivery of devolved functions, such as health services, environmental management, and local revenue generation. However, efforts to popularize the winning programs have not resulted in substantial and extensive adoption by other local government units.

Human development. A study by Capuno (2007) pointed out that decentralization has not significantly improved the quality of local governance, as indicated by progress in human development¹⁴. He noted that improvement in human development across provinces has been very slow. The lists of richest and poorest provinces have remained largely the same over the years. Of the 74 provinces with available data, he observed that only 8 provinces showed notable improvement in the human development index between 1990 and

¹³ The *Galing Pook* website (<http://www.galingpook.org>) contains a list and description of the different awards- winning program of the various local governments from 1994 to present.

¹⁴ Local government policies, programs, and expenditures that affect social and economic enterprises also influence progress in human development. Thus, progress in human development (as measured by the human development index) provides an indication of the quality of local governance (Capuno, 2007).

2000. The scores of 63 provinces remained almost the same, and for 3 provinces, even deteriorated during the same period. A related observation by the Asia Foundation (2010) is that a local government's performance is largely determined by the local chief executive's priorities, quality of leadership, and relationship with the local legislative body.

Interregional and interprovincial equity. Manasan and Chatterjee (2003) also observed that decentralization did not have pronounced effects in reducing interregional and interprovincial equity in the country. The variation in the provincial level per capita household income consistently increased between 1988 and 1997 before declining in 2000. They also noted that the speed at which poorer provinces caught up with richer ones was faster during the pre-Local Government Code period (1988-90) compared to the early post-Code period (1991-1997). The speed of convergence hastened in 1997-2000, but this could be attributed to the slowdown in the growth of the richer local governments that were more adversely affected by the Asian financial crisis.

More recent studies by Llanto (2012) and Diokno (2012) both concluded that except for some local governments, which have instituted innovative and effective practices in local service delivery, there is still considerable room for improving service delivery across local governments. Both viewed with concern the creeping re-centralization of health and social welfare services, as manifested in the increasing budgets of the Department of Health and the Department of Social Welfare and Development and the declining share of local government expenditures in these two major devolved services. They underscored the importance of clear delineation of functions and responsibilities between national and local governments, and greater local fiscal autonomy to promote accountability. Both authors also emphasized the need for credible, timely, relevant, and consistent performance indicators that will make local governments more accountable.

10.2 Expenditure decentralization

National government dominance in overall spending. If one looks at the fiscal ratios of the shares of local governments in total government expenditures and total government revenues, a highly centralized government is still evident. The national government continues to dominate government spending. Prior to devolution, the national government accounted for around 87 percent and the local governments for 13 percent of general government expenditures net of debt service (Manasan, 2004). At present, the share of national government expenditures to total expenditures net of debt service is around 83 percent. The share of local expenditures on the other hand, increased to 17 percent. A 17 percent share in government expenditures is still very low and insufficient to deliver a decisive shift of power and resources from the national government to local governments. (Table 6 presents the national and local government shares in total government expenditures for 2009, 2011, 2013, and 2015.)

National government involvement in devolved services. The Local Government Code provides as a general principle that national government agencies are mainly responsible for formulating policies and standards and providing funding support and technical assistance. However, the Code also allows national agencies to implement devolved public works and infrastructure projects and other facilities, programs, and services funded under the annual General Appropriations Act and from foreign sources. The Code further allows the national government to augment the delivery of local government services when a locality's government cannot meet its needs.

It appears that national government agencies and Congress would rather be directly involved in funding/providing devolved services instead of providing local governments with additional transfers or grants for the latter to implement the devolved functions themselves. Capuno, Manuel, and Salvador (2001) estimated that between 1995 and 1999, the Departments of Education, Health, the Interior and Local Governments, and Public Works and Highways had annual total combined expenditures on devolved activities ranging from 7.4 billion to 34.0 billion pesos. Balisacan and Hill (2007) also noted that there has been no serious effort to downsize national agencies and abolish their regional offices in spite of the fact that many of their functions have been devolved to local governments.

Table 6. National government and local government shares in total government expenditures, Philippines, 2009, 2011, 2013, and 2015

	Billion Pesos				Percent Share (percent)			
	2009	2011	2013	2015	2009	2011	2013	2015
National Government	841.3	987.9	1,352.3	1,810.1	75.7	76.3	80.0	82.7
Department	624.4	806.7	1,025.3	1,411.4	56.1	62.3	60.6	64.5
Central Office & NCR	330.2	494.4	383.3	496.0	29.7	38.2	22.7	22.7
Regional	294.1	312.3	642.0	915.4	26.4	24.1	38.0	41.8
Special Purpose Funds Net of Transfers to LGUs & Debt Service	216.9	181.2	327.0	398.8	19.5	14.0	19.3	18.2
Local Government	270.8	306.5	338.8	378.1	24.3	23.7	20.0	17.3
Provinces	63.7	73.1	76.0	89.7	5.7	5.6	4.5	4.1
Cities	111.4	120.3	144.9	150.7	10.0	9.3	8.6	6.9
Municipalities	95.7	113.1	117.9	137.7	8.6	8.7	7.0	6.3
TOTAL	1,112.0	1,294.5	1,691.0	2,188.2	100.0	100.0	100.0	100.0

Source of basic data: Department of Budget and Management, Budget of Expenditures and Sources of Financing (various issues). Bureau of Local Government Finance, Statement of Receipts and Expenditures (various issues).

The Priority Development Assistance Fund. Congress, for its part, has increased the annual allocation for the Priority Development Assistance Fund (PDAF) in the national government budget to fund projects identified by members of Congress until the Supreme Court declared it unconstitutional in 2013. The Fund amounted to P24.8 billion in that year. In addition, members of Congress are

also known to make realignments in the budgets of national government agencies to accommodate their preferred local programs or projects. This practice has come to be accepted as the Congressional Initiative Allocation (CIA). The exact amount that finds its way to the annual national government budget is not known, but includes school building funds and public works allocation. The pork barrel system of allocating resources to members of Congress has not helped in promoting more equitable and efficient infrastructure spending. PDAF is distributed equally by legislative districts regardless of their varying socioeconomic conditions, while CIA is accessed through political negotiation. The pork barrel system has likewise resulted in highly fragmented and ill-executed infrastructure projects, even though many of these, by themselves, are suitable as locally funded projects but not as nationally funded projects (Sicat, 2007).

In 2013, COA came up with a special audit report on priority development programs and projects identified by legislators under PDAF and Various Infrastructure including Local Projects (VILP) that were appropriated in the General Appropriations Act for calendar years 2007 to 2009. Their total appropriations for the period amounted to P79.9 billion. The audit disclosed that the said congressional funds *“were not properly released by DBM and not appropriately, efficiently, and effectively utilized by the implementing agencies”* (COA, 2013). The audit report noted that budget releases out of PDAF were not properly recorded and tracked, thus, the total releases for each legislator could not be ascertained. On the matter of VILP, the COA report noted that actual budget releases exceeded the budgetary appropriations, with some legislators significantly exceeding their allocations. Significant amounts of funds were also released to implementing agencies, which merely transferred them to NGOs even if these NGOs were not included among the list of implementing agencies. It turned out that many of the NGOs entrusted with project implementation, along with their suppliers and reported beneficiaries, were fictitious. There were projects that existed only in paper, while some were implemented below standards or not according to specifications.

Conclusion. It stands to be repeatedly emphasized that astoundingly huge portions of the national government budget, whether from regional offices of national agencies or from Congressional funds, have been allocated to the provision and/or financing of local public goods and services, the provision of which, have been devolved to local governments. The programs and projects behind these goods and services could have been vetted by government officials and private sector representatives in LDCs. These bodies are better informed of local needs and circumstances, and could have done a better job of factoring these into the development plans. Instead, decision making was done by national government officials and politicians who are clearly less informed of local priorities. Moreover, common pool resource properties of the national government budget have been conveniently capitalized on to buy political support of local officials and certain groups and individuals in society.

10.3 Revenue decentralization

National government dominance in overall revenues. The shares of the different government levels in total government revenues have defied decentralization to a higher degree. From 4.9 percent in 1990, the share of local governments in total government revenues increased to only 7.6 percent and 8.1 percent in 2000 and 2010, respectively. In 2015, its share declined to 7.6 percent. On tax revenues, the combined share of all local governments amounted to only 3.8 percent in 1990. This increased to 6.5 percent in 2000, decreased again to 6.1 percent in 2010, and slightly increased to 6.3 percent in 2015. The national government continued to account for the bigger share of total government revenues, from 95.1 percent before the Local Government Code to an average of 92.3 percent after the Code took effect. (Table 7 presents the national and local government shares in total government revenues for 1990, 2000, 2010, and 2015.)

National government revenue powers. The centralization of government revenues can be attributed to the exclusive authority of the national government over the major taxes, such as taxes on income of individuals and corporations, excise taxes, value added tax, travel tax, motor vehicle tax, and international trade taxes. The tax bases and rates for these internal taxes are defined in the National Internal Revenue Code, and administered by the Bureau of Internal Revenue. International trade taxes are separately administered by the Bureau of Customs (Table 7). The two bureaus are organized into regional and district offices, which do not coincide with the administrative regions or local government units.

Local government revenue powers and actual performance. The only major taxes assigned to local governments are real property and business license taxes, with allowable rates and exemptions prescribed by the Code. In addition to local taxes, local governments may also earn income from user fees and the operation of local enterprises, such as hospitals, public markets, and slaughterhouses. Local taxes are administered independently by each local government unit. The local and national tax authorities have no formal links, and do not coordinate with one another in practice.

Table 7. National government and local government shares in total government revenues, Philippines, 2009, 2011, 2013, and 2015

Particulars	Percent Share							
	1990		2000		2010		2015	
	NG	LGUs	NG	LGUs	NG	LGUs	NG	LGUs
Tax Revenues	96.2	3.8	93.5	6.5	93.9	6.1	93.7	6.3
Non-Tax	89.2	10.8	83.6	16.4	76.3	23.7	85.4	14.6
Total Revenues	95.1	4.9	92.4	7.6	91.9	8.1	92.4	7.6
As Percentage of GDP								
	1990		2000		2010		2015	

	NG	LGUs	NG	LGUs	NG	LGUs	NG	LGUs
Tax Revenues	14.1	0.6	14.6	1.0	12.1	0.8	13.6	0.9
Non-Tax	2.5	0.3	2.8	0.3	1.3	0.4	2.2	0.4
Total Revenues	16.8	0.9	17.7	1.3	13.4	1.2	15.8	1.3

Source of basic data: Department of Budget and Management. Budget of Expenditures and Sources of Financing (various issues), Bureau of Local Government Finance. Statement of Receipts and Expenditures (various issues).

Overall, local governments generate only around 34 percent of their income from own local sources; 65 percent of their income comes from national government transfers. Provinces, in the aggregate, generate only 19.4 percent of their annual income from own local sources: 7.6 percent from tax revenues and 11.8 percent from non-tax revenues. Municipalities raise only 18.2 percent of their income on their own: 10.0 percent and 8.2 percent from tax and non-tax revenues, respectively (Table 8). Hence, both provinces and municipalities are highly dependent on national government transfers. Cities are the most financially independent among the different local government levels, but still locally generate just over half of its revenues.

Local government revenue-to-GDP ratio amounted to only 0.9 percent in 1990. It increased to 1.3 percent in 2000, declined to 1.2 percent in 2010, and slightly increased to 1.3 percent in 2015. It is commonly observed that local governments hesitate to tax their constituents because this could be politically costly. Furthermore, majority of local government units do not regularly update their valuation and assessment of real properties.

Table 8. Composition of total local government income, by level and by source, in billion pesos and percent share of total income, Philippines, 2015

Particulars	Levels, in Billion Pesos				Percent Share (%)			
	Total	Prov	Cities	Mun	Total	Prov	Cities	Mun
Total Local Sources	172.34	22.4	119	30.95	33.84	19.37	53.32	18.15
Tax Revenue	122.28	8.76	96.53	16.98	24.01	7.58	43.25	9.96
Real Property Tax	48.98	6.67	35.15	7.16	9.62	5.77	15.75	4.2
Tax on Business	66.03	1.38	55.66	8.99	12.97	1.19	24.94	5.27
Other Taxes	7.27	0.72	5.72	0.83	1.43	0.62	2.56	0.49
Non-Tax Revenue	50.06	13.63	22.47	13.96	9.83	11.79	10.07	8.19
Regulatory Fees (Permit and Licenses)	10.47	0.33	7.13	3.01	2.06	0.29	3.2	1.77
Service/User Charges (Service Income)	12.44	5.76	4.35	2.34	2.44	4.98	1.95	1.37
Receipts from Economic Enterprises (Business Income)	19.98	5.4	7.87	6.7	3.92	4.68	3.53	3.93
Other Receipts (Other General Income)	7.17	2.14	3.12	1.91	1.41	1.85	1.4	1.12
External Sources	336.92	93.21	104.19	139.52	66.16	80.63	46.68	81.85
Of which: Internal Revenue Allotment	313.11	90.83	89.35	132.93	61.48	78.57	40.03	77.98

Total Income	509.26	115.61	223.18	170.46	100	100	100	100
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Source of basic data: Bureau of Local Government Finance, Statement of Receipts and Expenditures 2015

A joint study of the World Bank and the Asian Development Bank (2003) also pointed out that local governments are weak in many areas of tax administration, as evidenced by *a)* the prevalence of non-filers, stop filers, and late filers, *b)* infrequent exercise of audit and enforcement authority, i.e., temporary closures and property auctions, and *c)* limited availability of taxpayer services. Manasan and Avila (2014) noted that many local tax personnel are not technically equipped for their functions, and few local government units have automated their tax assessment and collection processes.

Nuisance taxes. It is also important to point out that many of the taxes assigned to local governments in the Local Government Code are nuisance taxes, so called because the cost of collecting them is higher relative to the revenues that they amount to. From a cost-revenue perspective, local authorities may be justified in not seriously collecting these taxes. However, it contributes to the culture of weak tax enforcement by local authorities and non-compliance by taxpayers.

10.4 National government transfers

Reliance by local governments on national government transfers. Aside from the low fiscal ratios of local governments, there is also the steadily increasing imbalance between local government expenditures and revenue shares, pointing to increasing dependence of local governments on national government transfers. National government transfers to local governments consist of two major types, namely, **general purpose grants** and **specific purpose grants**. General purpose grants include IRA, shares from the utilization of natural resources, and some special taxes. The total amount is prescribed by law, and local governments have wide discretion on their utilization. Specific purpose grants, on the other hand, consist of national government assistance to the local governments; they are tied to the implementation of certain programs and projects classified as national government priorities.

Internal revenue allotment. IRA accounts for the single biggest amount of transfer to local governments, averaging 94 percent of total annual national government transfers from 1992 to 2015¹⁵. It also represents the 40 percent share of local governments in the national internal revenue taxes collected by the Bureau of Internal Revenue (BIR), a national government agency under the Department of Finance. The total annual amount of IRA is computed on the basis of the tax collections of the third preceding year, and allocated to local governments based on a two-step formula provided in the Local Government Code. *First*, total IRA is divided by levels of government: provinces (23 percent),

¹⁵ Figures used/cited in Section 10.4 are found in Table 9.

cities (23 percent), municipalities (34 percent) and *barangays* (20 percent). *Second*, within each level the amount is divided among the different local governments on the basis of population (50 percent), land area (25 percent) and equal sharing (25 percent).

As the primary means of national government transfers to local governments, IRA has been critically assessed vis-a-vis several objectives. *First*, the amount is not sufficient to cover the costs of the devolved functions, including the unfunded mandates passed onto local governments by the national government. *Second*, the distribution tends to aggravate the imbalance between expenditure needs and revenue sources at the different local government levels, in particular, favoring the cities and municipalities over provinces. This imbalance is evident in the contraction of provincial infrastructure investments relative to GDP and the concentration of province infrastructure outlay in small projects at the municipal and *barangay* levels. *Third*, the allocation of IRA does not promote equity. Local governments with higher per capita household income tend to receive higher per capita IRA. *Finally*, IRA tends to substitute for own-source revenues. Per capita IRA and per capita local tax collection across local governments show significant negative relationships, suggesting that units receiving higher allocation tend to be lax in their tax collection effort (Manasan, 2007).

Other national government transfers. Some local governments also receive shares in the gross collection derived by the national government from mining taxes, forestry and fishery charges, and other taxes, fees, and charges from the utilization and development of natural resources in their respective territorial jurisdiction. Distribution is based on formulas fixed by law. These include local government shares in the tobacco excise tax and taxes collected from the Special Economic Zones, and earnings of the Philippines Amusement and Gaming Corporation and the Philippine Charity Sweepstakes. The total combined amount of the local government special shares from these sources has increased steadily from almost zero in 1992 to 3.4 percent in 2008. Unlike IRA, not all local governments receive such shares since only those local governments where income or taxes from natural resource utilization originated are entitled to shares. The local governments' share from the tax proceeds is essentially a form of compensation, as they relinquish to the concerned national government agencies ownership and control over the relevant resources in their locality.

Special purpose grants consist of a motley of funds designed to provide financial assistance to local governments for the implementation of devolved functions and in support of specific policies and programs of the national government. The list of special purpose grants varies with changes in administration. Table 9 shows the different special purpose funds from 1992 to 2015; many of them have been discontinued, or their allocations reduced to minimal amounts.

Special purpose grants pursue three major goals. The *first* is to assist local governments in carrying out certain mandates of the national government. The Local Government Support Fund, Magna Carta for Public Health Workers, and the Premium Subsidy for Indigents under the National Health Insurance Program are examples. The *second* goal is equalization. The Local Government Service Equalization Fund is intended for fifth- and sixth-class local governments, and the Local Government Empowerment Fund assists the 21 poorest provinces and fifth- and sixth-class local governments in putting up counterpart funds for foreign-assisted projects. The *third* goal is to encourage more spending on certain services deemed important by the national government. Special purpose grants under this category are usually designed as matching grants, such as the grant to the Department of Health for the promotion of family planning programs.

Table 9. National government transfers to local governments, by type of transfer, Philippines, 1992, 2000, 2010, and 2015

Particulars	Levels, in Billion Pesos				Percent Share (%)			
	1992	2000	2010	2015	1992	2000	2010	2015
General Purpose	20.3	115.7	265.8	389.9	92.1	95.3	92.6	95.4
Internal Revenue Allotment	20.3	114.3	265.8	389.9	92.1	94.1	92.6	95.4
Special Shares of LGUs in the Proceeds of National Taxes	-	1.4	-	-	-	1.2	-	-
Special Purpose	1.7	5.7	21.3	19.0	7.9	4.7	7.4	4.6
Magna Carta for Public Health Workers	-	-	-	-	-	-	-	-
Local Government Empowerment Fund	-	-	-	-	-	-	-	-
Local Officials Insurance Premium Fund	0.0	-	-	-	0.2	-	-	-
Barangay Officials Death, Disability & Accident Benefits Fund	-	-	-	-	-	-	-	-
Metropolitan Manila Development Authority	-	0.7	1.4	2.1	-	0.6	0.5	0.5
Pasig River Rehabilitation Commission	-	-	-	-	-	-	-	-
Municipal Development Fund	-	3.5	-	-	-	2.9	-	-
Share in the Tobacco Excise Tax R.A. No. 7171	-	-	4.1	4.8	-	-	1.4	1.2
Share in the Tobacco Excise Tax R.A. No. 8240	-	-	0.9	0.4	-	-	0.3	0.1
Share in Utilization and Development of National Wealth (RAs 7160/9513)	-	-	0.7	4.3	-	-	0.2	1.0
Share in the Gross Income Taxes paid by all enterprises w/in the ECOZONES pursuant to R.A. No. 7227/7922/7916	-	-	0.1	0.0	-	-	0.0	0.0
Share in Value Added Tax (R.A. No. 7643)	-	-	0.0	2.2	-	-	0.0	0.5
Share in Franchise Tax R.A. Nos. 8407 / 7593 *	-	-	0.0	-	-	-	0.0	-
Special Financial Assistance to LGUs	-	1.5	4.6	-	-	1.3	1.6	-
Financial Assistance from National Government	1.7	-	-	-	7.8	-	-	-
Local Government Support Fund (Financial Subsidy to LGUs)	-	-	3.9	3.2	-	-	1.4	0.8
Premium Subsidy for Indigents Health Insurance	-	-	-	-	-	-	-	-
Kilos Asenso Support Fund	-	-	-	-	-	-	-	-
Prior Years' Obligation	-	-	5.6	1.8	-	-	2.0	0.4
TOTAL	22.0	121.4	287.1	408.8	100.0	100.0	100.0	100.0

* Share in VAT in lieu of Franchise Tax pursuant to RA No. 8407/7953 (FY 2010, 2015)

Source of basic data: Various BESF (DBM)

10.5 A synthesis of government decentralization reforms

Revenue powers-expenditure functions imbalance. A common weakness of the various government decentralization reforms from administrative

decentralization to the creation of ARMM, and devolution under the Local Government Code is the failure to commensurately decentralize control over public finances and/or revenue raising powers to the subnational levels. Planning and administration were decentralized to the regions, but budgeting decisions have remained largely with the central offices of national government agencies. The RDC is supposed to serve as the primary institution for planning and coordinating all economic and social development efforts in the region, but it cannot lay claim to a regional budget.

ARMM, as its name indicates, is supposed to have a regional government with a degree of autonomy to effectively chart the development of the region on the basis of its unique culture and history. However, due to inadequate revenue raising powers and financial resources, ARMM is relegated to the status of an administrative agency of the national government that submits to the annual budgeting process of the national government. Local governments are considered more autonomous in this regard because they have their separate local budgeting system, and do not have to undergo such process.

However, to the extent that local governments are assigned greater expenditure functions relative to their taxing powers, and are heavily dependent on national government transfers, which are widely perceived to be inadequate, local governments are in the same predicament as ARMM. To make the problem of inadequate funding worse, the national government continues to pass legislation that assign certain spending responsibilities to local government without identifying the source of funds. These are the so called *“unfunded mandates”*.

De facto control of local governments by the national government. The Constitution has enshrined local autonomy as a means to promote more responsive and accountable governance, the assumption being that local governments are more familiar and can better respond to the development needs of their area. Thus, in line with this principle of local autonomy, the Constitution and the Local Government Code mandate that the President exercise mere supervision,¹⁶ and not control, over local governments. Local autonomy, however, is stymied by the limited amount of resources under local government control. Furthermore, when the national government directly provides services already devolved to local governments according the former's own priorities, then provides assistance or transfers to local governments based on its own discretion, it is effectively exercising control over local governments. The adage that there can be no genuine local autonomy without fiscal autonomy cannot be truer than in this case.

¹⁶ Supervision means overseeing or the power or authority of an officer to see that subordinate officers perform their duties. Control, on the other hand, means the power of an officer to alter or modify or nullify or set aside what a subordinate officer has done in the performance of his duties and to substitute the judgment of the former for that of the latter (G.R. No. 132988. July 19, 2000).

The essence of decentralization is to bring decision making and accountability down to the local levels. However, the dependence of local governments on national government transfers raises issues on the accountability of local governments. In the event that national and local priorities do not match, as they are wont to because of the lack of a spatial dimension in national government planning, to whom should the local government officials be accountable? To the national government or to their constituents? Furthermore, how can constituencies be motivated to demand accountability from local leaders in the use of local government funds when a huge portion of it is sourced from the national government?

Loose institutional arrangements. The continued involvement of the national government in the provision of local and/or devolved services has confused institutional arrangements. On the part of the national government, there is slack in its exercise of expenditure powers over devolved functions because the provision of certain services is clearly the responsibility of local governments. Technically, any breakdown in the delivery of the devolved services can be blamed on the local governments. On the part of local governments, however, since in practice, people look to the national government for the provision of devolved services, it is easy for local governments to shirk from their responsibilities. Notably, there is a lack of effort at the local level to raise revenues from own sources because of dependence on national government transfers. Thus, while there is a huge demand on resources for the devolved functions, the lines of accountability have also been rendered hazy, and the efficiency in and level of provision is sacrificed.

Revisiting the common pool resource problem. Ideally, there should be a direct correspondence between the benefits and costs of public spending. The locality that benefits should ably raise revenues, and pay for these benefits. This norm is difficult to establish, however, because national government transfers, the main source of funds of local governments, are collected from the whole population. The common resource pool problem aggravates the non-delineation by perpetuating patronage politics and inducing all spending units, national and local, to overly and aggressively harness resources for their respective jurisdictions. This behavior directly bears on fiscal discipline, and weakens the allocative and operational efficiency of government spending.

If revenue powers are commensurately devolved to local governments on the basis of expenditure functions, the common resource pool can be reduced. The size of national funds available for harnessing by local governments becomes limited. Local governments, this time with more locally generated funds relative to nationally generated funds, can more closely approximate the norm of bearing the costs of its benefits. Moreover, since the bulk of what used to be part of the common resource pool is now compartmentalized across local government units, the resulting local resource pools become easier to define. Transparency and accountability also become easier to practice and monitor (Fabella, 2016).

Highly fragmented subnational/local governments. Another challenge to decentralization in the Philippines is that the huge number of subnational/local government units can lead to highly fragmented service delivery, which is inefficient and produces a sub-optimal mix of services. The Philippines has the highest number and the smallest sizes of first tier subnational governments in East Asia (Table 10). The first tier subnational government in the Philippines, consisting of provinces and highly urbanized and independent cities, number 149 and correspond to an average population of 500,000. Indonesia, which is much larger and more populated than the Philippines, has only 32 first tier subnational governments, corresponding to an average population of 7 million.

Table 10. Vertical organization of intergovernmental systems, East Asia, 2005

Country	Levels of Subnational Government	Number of First Tier Subnational Governments	Average Population of First Tier Subnational Governments (millions, 2002)
Cambodia	2	24	0.5
China	4	32	40.0
Indonesia	3	32	7.0
Philippines	4	149	0.5
Thailand	3	76	0.8
Vietnam	3	61	1.3

Source: Adapted from The World Bank (2005). *East Asia Decentralizes*.

The first tier subnational/local government can be regarded as middle level government in between the national government and the lower subnational government tiers¹⁷. It serves as the link between the national and the lower subnational government levels. First tier subnational governments consolidate the requirements of smaller, lower level governments, and forward them for consideration of the national government. They also serve as medium for the downward channeling of resources from the national government. They coordinate with lower subnational government levels to address problems of spillovers and externalities. It is important for these middle governments to be highly functioning because they provide the counterbalance to the national government, which is expected to dominate the smaller and lower level local governments.

The effectiveness of first tier subnational governments in the Philippines, however, is diminished not only by their number, but also in the manner that intergovernmental fiscal relations is carried out. Both the Organic Act for ARMM and the Local Government Code provide that the President shall exercise supervision over a lower government level through its next higher government level, but in practice, the national government deals directly with all the local government levels. This is especially true in the provision of national government services and transfers to local governments. This practice not only weakens the authority of the first-tier subnational governments over their

¹⁷ In the Philippines, below the provinces are the component municipalities and their barangays, and below the independent cities are their component barangays.

component local governments, but it also contributes to the fragmentation government services, as in the case of the missing middle in public infrastructure provision.

Furthermore, the practice of the national government directly dealing with lower level local governments unduly strengthens the bargaining position of national politicians over local politicians. The former are able to bypass the latter, especially in jurisdictions controlled by their rivals. The mechanism whereby nationally funded programs and projects are used to solicit local votes or political support is then easily established and maintained. Recall that this is highly characteristic of clientelist patronage politics.

Conclusion. Australia DFAT and The World Bank (2015) noted that based on international experiences, autonomy, by itself, is not sufficient guarantee of improved governance and service delivery. Government services are diverse and complicated; they have both national and local dimensions that require coordination and cooperation among players at all levels. Balisacan, Hill and Piza (2006) forwarded that for national and subnational/local governments to achieve harmony and effectiveness, they have to forge relationships based on a clear division of responsibilities, which in turn, should be made operational by adequate funding and bureaucratic capacity. It is apparent, however, that present arrangements in the Philippines are wanting these aspects.

11. The Case for Fiscal Federalism

What does federalism have to offer in response to the development and decentralization challenges that the Philippines faces?

Watts (1996) identifies the following common structural characteristics of federations: *a)* two levels of government, i.e., national and subnational, that directly govern their constituents, *b)* executive and legislative authorities formally defined in the country's constitution, *c)* provision of autonomy for the levels of government through the proper assignment of revenue resources, *d)* representation of subnational governments in federal policy making institutions, *e)* a constitution that can be amended only through the consent of a required proportion of its constituents, *f)* mandated bodies, i.e., courts, or mechanisms, i.e., referendums, to settle disputes among governments, and *g)* institutions tasked to facilitate intergovernmental collaboration for services with shared responsibilities.

11.1 Assignment of Expenditure Functions

Distribution of goals and responsibilities between the national and local governments. While national and local governments may share some functions, certain goals and responsibilities are in the exclusive turf of the national government. Among these are income redistribution, economic growth, macroeconomic stability, and the promotion of efficiency and accountability across levels of government.

Redistribution is not likely to be pursued by local governments acting independently. For example, a local government will hesitate to impose progressive taxation for fear of losing the support of its wealthy constituents. Notwithstanding, there is a growing acceptance of the role and capability of local governments in the equitable provision of public goods and services that target low income groups as beneficiaries. Their proximity to and knowledge of these beneficiaries make them ideal agents for planning and implementing redistributive programs and services.

Economic growth and macroeconomic stability are goals that are universally reserved for the national government. Inflation, unemployment, recessions, and booms tend to be events of national scope. The national government is in the position to internalize the benefits and costs of macroeconomic stabilization policies. Independent stabilization efforts of local governments are likely to be ineffective because of leakages arising from the smallness and openness of local economies (Bomfin and Shah, 1991). Moreover, local governments do not have access to monetary policy, a basic tool of economic stabilization. To grant a local government the power to create money is effectively giving local government unlimited claim on the resources of other localities (Oates, 1968), and granting this power to all local governments would lead to uncontrollable inflation.

On the goal of efficiency and accountability, the literature identifies three major factors that are considered in the assignment of functions to different government levels namely, *a)* the benefit area of a public good, *b)* jurisdictional spillovers or externalities, and *c)* economies of scale of public good provision.

Fiscal equivalence. According to Olson (1969), the achievement of a Pareto-optimal level of public expenditure requires a match between the boundary of government and the benefit area of the public good it provides. This assures correspondence between those who receive the benefits of a public good and those who pay for it. Olson used the term “*fiscal equivalence*” for this condition. Breton (1965) and Oates (1972) used the terms “*perfect mapping*” and “*perfect correspondence*”, respectively.

The basic idea embodied in the fiscal equivalence principle is that all benefits and costs associated with a public good must be considered or internalized in the decision-making process of the government unit responsible for its provision. Public goods that are national must be provided by the national government, those that are regional, by regional governments, and those that are local, by local governments.

Subsidiarity. Complementing fiscal equivalence is the principle of subsidiarity. Subsidiarity proposes that if a function can be performed by the smaller and simpler lower level of organization, that function should not be

assumed by the larger and more complex higher level of organization (Mele, 2004). Following this principle, higher level governments should not exercise functions that can be carried out efficiently by lower level governments, but rather, support and help coordinate the activities of the lower level. Moreover, the lower level governments should be explicitly vested with the mandates relevant to those functions.

As postulated in Oates' decentralization theorem (1972, p.35):

"For a public good -- the consumption of which is defined over a geographical subset of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective subnational government -- it will always be more efficient (or at least as efficient) for subnational government to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions."

Spillover effects. In reality, however, it is difficult to establish full fiscal equivalence. Each public good is likely to have a benefit area that does not squarely fit within the political boundaries of the locality that spends for its provision. Although the establishment of a governmental jurisdiction for each public good is ideal, it is not practicable. What actually exist are multi-purpose governments responsible for the provision of a number of public goods and services, the benefit areas of which extend beyond their boundaries. Spatial externalities and interjurisdictional spillovers, which arise when benefits or costs of public services are received or incurred by non-residents, cannot be entirely eliminated.

Theoretically, since all benefits and costs in the provision of any public good within a country can be internalized by the national government, assigning the provision of all public goods to the national government could possibly eliminate all externalities. However, in the case of local public goods, which benefit only a sub-sector of the population, provision by the national government will result in non-Pareto efficient level. This is because while the benefits of local public goods are confined to a few groups or individuals, its costs are shouldered by the whole population.

Olson (1969) described a resulting activity where minority groups that stand to benefit from local goods and services trade votes or enter into coalitions to become the majority, thereby having their desired public goods provided. He called this "*log-rolling*", and contended that it results in the overprovision of local public goods. Note that this effect is not unlike one of the effects of the common resource pool problem where rivalry in consumption prompts players with connections to the national government to harness unduly huge amounts from the national budget and resources.

Thus, consideration of interjurisdictional spillovers will not necessarily alter the allocation of functions suggested by the fiscal equivalence and subsidiarity principles. Except for public goods that are national in scope, such as economic stabilization, defense, and foreign affairs, and therefore the responsibility of the national government, other public goods should be provided by subnational governments. The problem of spatial externalities can be corrected through intergovernmental grants or, as Coase (1960) suggested, through intergovernmental negotiation and bargaining designed to internalize all benefit/cost spillovers.

Economies and diseconomies of scale. The presence of economies or diseconomies of scale in the production of public goods may lead to a different allocation of responsibilities suggested by either the fiscal equivalence or subsidiarity principle. For example, if significant economies of scale in the production of certain goods are not achievable by independent local governments, but can be achieved by the national government, then centralization in provision may be desirable in spite of the localized benefit area. Tullock (1969), however, made an important distinction between the production of public goods and the provision of public goods. He suggested that the presence of economies of scale in the production of public goods may not necessarily imply an allocation of functions that conflicts with the fiscal equivalence or subsidiarity principle. As Oates (1972) suggested, in some cases, it is possible for local governments to purchase the desired level of public goods from higher-level governments (or another “encompassing” authority or agency) whose expanded operation permits the realization of increasing returns to scale. A number of local governments can also work jointly to produce public goods with increasing returns to scale, and reap for themselves the economies from large-scale production (Walsh, 1992).

Conclusion. In a nutshell, the literature suggests a vertical division of functions among different government levels depending on the benefit span of public goods. This means that the larger the benefit area of a public good, the higher should be the level of government responsible for its provision (as dictated by the principle of fiscal equivalence). However, the higher the level of government, the more limited is its ability to provide services responsively and efficiently (as suggested by the subsidiarity principle and the decentralization theorem), hence favoring decentralized provision of public services by lower level governments. The problem of externalities and interjurisdictional spillovers can be addressed by intergovernmental transfers or negotiation among the governments concerned.

Note that the assignment of functions does not have to be as rigid and exclusive as the principles described above tend to suggest. Some public services may be local based on the size of their benefit area, such as primary education and health care, but because of their impact on income redistribution and welfare, they may also be considered a national government responsibility. In this situation, the national government bears a

legitimate concern for the establishment of certain minimum standards in the provision of these apparently local public goods. In many countries, for example, many key decisions in educational policies are made at the national level. These include construction of school buildings, curriculum design, teacher training, and design and production of textbooks (Mc Lure and Martinez-Vazquez, 2000).

Social protection and welfare is another function that may require co-sharing of responsibilities between the national and subnational government levels. Local governments may have a comparative advantage in the efficient delivery of many social welfare services given their proximity to and familiarity with local residents. However, the capacity of the different local governments for the provision of social services may not match the local residents' demand for these services. This is the case of poorer jurisdictions, which have the biggest demand for social welfare services, but may have the least capacity to provide them. Thus, the national government is expected to provide financial support at the very least.

Interestingly, there is a growing realization, particularly in federal countries, that division of responsibilities along functional lines no longer may be appropriate:

"Such a division of responsibility must be replaced by a horizontal division along activity or program lines, which recognizes the fact that services, such as transport, economic development, urban services, education, health, and welfare services have national, regional, and local dimensions, and cannot be regarded as the sole responsibility of a single level of government if they are to be provided adequately, effectively, and equitably." (Mathews, 1980, p.6)

The assignment of concurrent or shared functions to several levels of government can also provide for greater flexibility. Consider that the demand for services can change over time, as well as the mechanisms by which these services can be most efficiently supplied (McLure and Martinez-Vazquez, 2000). It is important, however, that the specific responsibility and accountability of each government level should be clearly defined. Otherwise, a shared arrangement can lead to duplication or underprovision of the required public services.

Thus, there is no single best assignment of functions that can be prescribed for all jurisdictions at any given time. There are rules and principles that can guide the assignment of functional responsibilities to the different levels of government. However, it is important that with any single government or intergovernmental system for the provision of public goods and services, the assignments of functions and accountability are clear and stable. In federal countries, the assignment of functions to the different levels of government is spelled out in the Constitution.

11.2 Assignment of Taxing Powers

Classifications of tax burdens. The assignment of taxing powers in a multi-level government system has efficiency and equity implications that are independent of functional assignments. In particular, aside from reducing the purchasing power of individuals, taxes impose other burdens which should be minimized. Essentially, these are *a)* administration and compliance costs incurred by collectors and taxpayers, and *b)* the less obvious costs of taxes, known as “*excess burdens*”, which refer to the distorting effects on the economic behavior of taxpayers (King, 1984).

The costs incurred by government in the collection of taxes are generally referred to as **administration costs**. These include the costs of assessors, collectors, and their offices, and the legal costs of dealing with defaulters. Taxpayers also incur costs in addition to their tax payments. These are collectively referred to as **compliance costs**, and include the time spent in completing tax returns and devising ways of reducing tax payments and tax consultant fees. It is widely believed that administration and compliance costs are subject to economies of scale (King, 1984, Oates, 1972, and Breton and Scott, 1978). Administrative complexities and duplication in both assessment and collection can be substantially reduced by centralization. Uniformity in guidelines, standardization of tax forms, and a single taxation office can also facilitate compliance (Martinez-Vazquez and Timofeev, 2005).

Three factors figure prominently in the discussion of the **excess burden** of taxes. These are *a)* mobility of taxpayers or tax bases, *b)* tax competition, and *c)* the possibility of tax exporting by jurisdictions.

When taxpayers or **tax bases** are **mobile**, the progressivity of the tax rates can be severely limited. Progressive taxation can result in the departure of rich taxpayers to other jurisdictions where tax rates are lower, thus dampening the goal of income redistribution. Furthermore, tax rate differentials can serve as stimuli for labor and capital to move to areas where taxes are lower, but where their marginal productivities may be also lower, resulting in inefficient resource allocation.

The mobility of taxpayers and tax bases lead to tax competition among jurisdictions. While tax competition can be an effective constraint against government’s abuse of its taxing powers, tax competition among jurisdictions can also lead to an aggressive tax rate reduction by governments and underprovision of essential public goods (King, 1984 and Feld and Reulier, 2003). A worse situation occurs when tax competition becomes predatory, as when jurisdictions cut their tax rates to provide a haven for residents of other jurisdictions who engage in smuggling, cross-border shopping, misstatement of residence, or shifting of corporate income.

Tax exporting occurs when taxes levied in one jurisdiction are paid partly by residents of other areas. This usually happens when one area can dominate

the market through production and pricing of commodities. Taxes imposed on local production can be shifted to residents of other jurisdictions through higher prices of the output sold outside of the taxing jurisdiction. While tax competition can result in undertaxation, tax exporting, on the other hand, can lead to a regime of high local tax rates. Unduly high taxes, in turn, impede domestic trade and commerce (Walsh, 1992). Jurisdictions which succeed in tax exporting may not have to shoulder the whole cost of their public programs, and may increase them beyond the efficient levels (Oates, 1972 and McLure, 1999).

Thus tax competition and tax exporting can both result in non-optimal tax rates. Rates can be either too low due to tax competition or too high due to tax exporting.

Some guidelines for assigning tax powers across levels of government. Musgrave (1983) provided the following broad guidelines for the assignment of taxing powers to different government levels:

- Highly mobile tax bases, such as company income, should be assigned to the national government. Mobility distorts locational choices, and therefore, resource allocation.
- Middle and especially lower-level jurisdictions should tax those bases which have low inter-jurisdictional mobility, such as land and natural resources to avoid the risk of tax base flight and distorting locational decisions.
- Tax bases that are highly unequally distributed among sub-jurisdictions, such as natural resources, should be taxed by the national government to avoid inequalities and allocative distortions, which may arise from local taxation. Note that this may conflict with the immediately preceding rule. Thus, national government taxation should apply to an excess base only, while leaving a normal or average base for subnational taxation.
- Progressive taxation, which is designed to secure redistribution objectives, should be assigned to the national government to avoid counter-productive and inefficient locational decisions through adverse selection. Examples include high income individuals leaving and poor individuals seeking jurisdictions with highly redistributive policies.
- Taxes suitable for stabilization policy should be central/national, while local taxes should be cyclically stable. The principle is that stabilization is primarily a national government objective. Local stabilization policies are likely to be ineffective due to heavy leakages arising from the openness of local or regional economies. The national government has to coordinate the use of fiscal stabilization with other stabilization tools

over which it has jurisdiction and for which it has the facility, such as monetary and credit policies.

- Benefit taxes and user charges, in principle, do not create distorting incentives. They may thus be appropriately used at both national and subnational levels. Pragmatic evidence, however, tends to suggest that they are better employed at lower government levels, where benefit attribution to particular groups of beneficiaries is more feasible.

Implications and nuances of the assignment of taxing powers. The literature suggests that centralization of taxing powers is important for effective economic stabilization policies. It also has some efficiency and equity benefits. Assigning taxes to lower level governments has limitations that do not apply to the national government. It appears that only non-mobile taxes and benefit and user taxes can be appropriately assigned to lower level governments. For the national government, there are almost no restrictions on the type of taxes that it can impose; moreover, economies of scale in the collection and administration of most taxes favor national tax administration.

However, the benefits from expenditure decentralization or government decentralization based on the principles of fiscal equivalence and subsidiarity tend to assume that local governments possess taxing powers commensurate to their expenditure functions. Bird (1999), likewise argued that if subnational governments are expected to be accountable and responsive, they must be able to finance their expenditures with their own tax revenues.

Taxation plays a very important role in promoting government accountability. Moore (2007) explained that if the state is dependent on broad taxation, it is likely to be more responsive and accountable to its citizens. Since governments' incomes are dependent on the taxes that they can collect from their citizens, governments have a direct stake in the prosperity of their citizens. Thus, they will be more inclined to be attuned to their taxpayers and be rewarded with tax compliance. At the other end, citizen-taxpayers who shoulder the burden of taxation are likely to be more vigilant about the taxes that they have to pay and how their government spends the money. The interests of both parties input into a bargaining process on taxes and the goods and services arising from them. The result is a mutually beneficial "*fiscal (social) contract*," one that ultimately leads to good governance.

The assignment of taxing powers to subnational governments commensurate to their assigned expenditure functions cannot be overstated. It is commonly observed that major taxes have been assigned to the national government, leaving only the minor taxes to subnational governments. McLure (1999) noted, however, that there is generally no reason to assign a given tax to only one level of government. Keeping the major taxes exclusively in the hands of the national government is more of a political choice dictated by the needs and wishes of national governments designing decentralization reforms.

Musgrave (1983) indeed stated that when implemented correctly, multiple tax use or the assignment of a particular tax type to more than one government level can actually simplify administration and reduce cost. The overutilization of a particular tax base appears to be the only caveat to multiple tax use by different government levels.

It is also important to distinguish joint taxation or multiple use taxation, from tax sharing and general revenue sharing. **Joint taxation** refers to the power to tax granted to more than one level of government. In **tax sharing and revenue sharing**, the power to tax is exclusively assigned to one government level, usually the national government. The taxing government then shares the tax proceeds with other government levels.

The idea of joint or multiple use taxation is better appreciated by taking note of the dimensions of tax assignment (McLure, 1999, and Martinez-Vazquez and Timofeev, 2005), namely, *a*) definition and apportionment of tax bases, *b*) determination of tax rates, and *c*) tax administration and enforcement. **Tax base definition** covers the procedures for the computation of the tax base, including the rules for definition of income and expenditures, deductions and exemptions, formulation of the tax schedule, and attribution or apportionment of the tax base to different jurisdictions. **Tax rate determination** refers to the simple decision or choice about the rates to impose on the tax base to determine the liabilities of taxpayers. **Tax administration and enforcement** consist of the various activities in assessing, collecting, and auditing tax payments, and providing assistance to taxpayers to achieve compliance. A government level need not exercise all these powers to enjoy a certain degree of tax autonomy or tax flexibility.

It is interesting that a major constraint often associated with tax assignments to subnational government levels is the difficulty or lack of capacity of the regional and local governments to administer taxes. However, the tax administration function can be delegated to another government level or contracted out to an independent revenue administration agency without loss of taxing power.

The power to define the tax base and organize independent tax authorities certainly increases the tax autonomy of subnational governments. However, these can also result in higher costs of tax administration and compliance for both government and taxpayers. There is thus the need to balance the demands for tax autonomy and tax harmonization. Bird (1999) and McLure (1999) suggested that for many developing countries where capacities and skills for tax administration are scarce, the powers of the subnational governments can be limited to setting the tax rates. It is the national government that defines the tax base, use a common formula to divide the base between subnational jurisdictions, and collect the taxes for both the subnational and national governments based on their respective tax rates. Such harmonization may reduce the autonomy of subnational governments

in their tax policies, but still leave them with substantial influence over economic activities in their jurisdictions (Mintz, 1998), and makes them accountable to their constituents.

11.3 Tax Assignment in Practice

This section discusses the practice in the assignment of the major broad-based taxes to the different government levels. These taxes are imposed on a wide sector of the population and hence, carry the potential to generate significant revenues to finance the government's expenditure requirements, while promoting government accountability and efficiency.

Individual income tax. The individual income tax can be assigned to the national, regional, and local levels of government, as seen in the practices of some countries. There appears to be no impediment to the assignment of the individual income tax to the national government; in all countries, the national government imposes individual income taxes. A major consideration at the subnational levels is the determination of tax bases. Because individuals may live in one jurisdiction and work in another, the first issue to decide when subnational governments are vested with the authority to tax individual income is whether the tax should be **levied at source** (where the individual works) or **levied at residence** (where the individual lives).

In accordance with the benefit-taxation principle, individual income tax is generally imposed on the basis of residence since most of the public services provided to individuals are consumed where people live (McLure, 1999). Note, however, that a significant amount of individual income tax is collected through the withholding system, i.e., taxes are withheld by employers and remitted to the government. This requires channeling revenues collected at origin to the jurisdictions where taxpayers live. Jurisdictions where incomes originate may have little incentive to implement such taxes on behalf of the jurisdictions of residence (McLure, 1999). Thus, independent implementation of individual income taxes by subnational governments clearly poses difficulties.

In the United States, the states have the power to determine the bases and rates of personal income taxes, and set up their own tax collection offices. In some states, local governments are allowed to impose surcharges on the individual income tax of the state. The same practice is observed in Switzerland, except that tax administration is performed by the cantons (states), which also collect the tax for the federal government and the communes (local governments). In Nordic countries, on the other hand, the national government administers the individual income tax for both national and local governments, while allowing local governments to determine their own tax rates. The federal government also administers the personal income tax for the provinces in Canada, with each level of government having the discretion to set the tax rates. The German practice is unique. The Lander

(states) are responsible for the collection of taxes, but do not have the power to set the tax rates or determine the tax bases. In effect, therefore, there are no subnational government income taxes in Germany (Bahl and Cyan, 2010). However, the German Basic Law (Grundgesetz) prescribes that the proceeds from income tax (and corporate profits tax) must be shared equally between the Federation and the Lander.

Corporate income tax. Corporate income tax is another major tax that can yield significant revenues while making the government accountable to the taxpayers. There is no question to its imposition by the national government. However, its imposition at the subnational level poses the same dilemma as the individual income tax. It has to be decided whether the corporate income tax is to be levied by the jurisdiction in which income originates (**source-based system**) or the jurisdiction where the company head office is located or incorporated (**residence-based system**). Furthermore, when corporations operate and earn income in more than one jurisdiction, it is important to establish rules for the allocation of the company income or tax base to the different jurisdictions.

The source-based system is generally favored over the residence-based system. The grounds for the imposition of the subnational corporate income tax, which relate to company operations or business activities, are more akin to the source-based system. Furthermore, the residence-based system of corporate income taxation is prone to intense inter-jurisdictional tax competition. Tax consideration could be a decisive factor in the choice of company residence that may have no resemblance to where the most significant company activities are conducted. On the other hand, competition among local jurisdictions for company residence can drive corporate income tax rates to very low levels resulting in minimal amount of tax revenues collected.

Under the source-based system, corporate income tax is assigned to the jurisdiction where the company operates or from which its income originates. The “*nexus*” or connection of a company to a jurisdiction may be established on the basis of a threshold income generated by a company in a given jurisdiction as in the United States, or on the basis of the presence of a permanent company establishment in the jurisdiction as in Canada and Switzerland (Mintz, 1998). In the case of firms operating in more than one jurisdiction, the tax base or company income is apportioned to the jurisdictions involved.

There are at least two ways of dividing the income of a multi-jurisdictional firm. The *first* method is for a firm’s units (branch or subsidiary) located in different jurisdictions to have separate accounts for tax purposes. However, separate accounting may be difficult to implement especially when the operations of the different units of a company are closely interdependent. There are inherently indivisible costs, such as home office expenses and

research and development, which cannot be easily assigned to the different units. Moreover, separate accounting is prone to tax avoidance or evasion. Substantial amounts of goods and services pass between different units of a company, and they can only be valued on the basis of transfer prices. In many instances, there are no “*arms-length prices*” that could be used to ascertain whether transfer prices used are reasonable. The booking of costs and sales among the different units can be manipulated so that taxable incomes are lodged in the jurisdictions with the lowest tax rates (Mc Lure, 1999; Mintz, 1998).

The *second* method is to consolidate company income and apportion it to its different units and/or jurisdiction based on a formula. Among the factors that usually figure in the apportionment formula are payroll, property, and sales of the different units or jurisdictions in relation to the total company income.¹⁸ In the United States, the three factors have been generally assigned equal weights, although there is a trend among many states to give greater weight to sales in order to prevent discouraging economic activity within their borders. In Canada, the apportionment formula in general includes only payroll and sales which are assigned equal weights (Mc Lure, 1999). In Switzerland, different formulas are used for different industries. For example, industrial enterprises apportion income based on capitalized assets and payroll (Carey, Gordon and Thalmann, 1999), and for retail firms, profit is apportioned according to sales (Kirchgassner, 2007).

In countries such as the United States, Canada, and Switzerland where corporate income tax is imposed at the national and subnational levels, tax administration is carried out in the same way as the individual income tax described above.

Consumption tax. Taxes imposed on the consumption of goods and services are classified as broad-based consumption tax. They can also be imposed on selected goods, in which case, are referred to as excise taxes. Broad-based consumption tax can be imposed at the various stages of consumption, e.g., value-added tax (VAT), or at a single stage, e.g., retail sales tax. An ideal consumption tax is imposed only on final consumption, and should apply only to households and not on businesses. Otherwise, there is the danger of unnecessarily increasing the prices of goods and services. For example, VAT imposed at the different stages in the product life cycle from production to final consumption is borne solely by the consumer or household. The businesses involved in the chain of transactions are all allowed to claim input

18 Mintz (1998) noted that in the US and Canada, gross revenue from sales net of discounts and other adjustments have been measured on a destination basis (at the point of consumption) as long as the corporation has a permanent establishment in the jurisdiction to which there is an allocation. Revenue from exports is usually allocated to jurisdictions on an origin basis. Payroll is measured to include wages, salaries and other taxable amounts of labor compensation. Property includes fixed assets and, in some US states, inventories. Property is measured based on the sum of the historical cost of investment with no adjustment for depreciation.

tax credits on their purchases, and thus, do not pay any tax. It is only the consumer-household who cannot claim any input tax that in the end pays for the whole VAT. The other types of sales tax that do not allow input tax credit can bring about tax cascading effects, which in turn, can result in unreasonable price increases. To avoid cascading effects these sales taxes are imposed only in one stage of the transactions chain, as in the case of the retail sales tax. Moreover, they are also imposed only to households and exempt sales to business.

The consumption tax is a major revenue source for the government, and is generally imposed and administered by national governments. Its use by subnational governments introduces complexities. *First*, the tax base has to be determined. Should the tax be imposed at the origin or source of the product, or should it be imposed at the destination? The origin-based or product-source consumption tax may be easier to administer, but it may induce tax exportation. The destination-based consumption tax is more attuned to the tax-benefit principle of closely linking the costs and benefits of taxation. *Second*, the tax rate would have to be set. Should subnational governments be allowed to impose different tax rates or should the rate be uniform? Allowing subnational governments to impose different rates give them more autonomy and flexibility to respond to local situations, but also makes the tax system more complex. *Third*, sales between jurisdictions would have to be treated either as exports or imports by local tax administrators. Thus, the imposition of consumption tax by subnational governments can make the tax system more complex, and increase administrative and compliance costs (Mc Lure, 1999).

There are only a few countries where subnational governments impose separate consumption taxes, such as VAT. Among them are Canada, which imposes a destination-based VAT, and Brazil, which applies an origin-principle VAT. In the United States, most states impose retail sales tax, and there is no national sales tax (Bahl and Cyan, 2010).

Sales taxes imposed on selected products, such as the excise taxes on alcohol, tobacco, and motor vehicles, are less difficult to administer and provides significant potential source of revenues for subnational governments. To the extent that subnational governments are largely responsible for the provision of health services and traffic and road maintenance, there are social cost justifications for the assignment of these taxes to subnational governments. Still, a major consideration for the assignment of excise tax to subnational governments is their tax administration capacity (Bahl and Cyan, 2010). Differences in tax rates can also induce smuggling.

Property and Land Taxes. Among the major taxes, property and land taxes are regarded to be most appropriate to subnational governments. Their tax bases are largely immobile; hence, differences in tax rates across jurisdictions will not induce any movement in the tax bases. Property taxes imposed by

subnational governments also hue well with the benefit-taxation principle because real property owners/taxpayers directly benefit from the government services and infrastructure that enhance their property and land valuation.

11.4 Fiscal Imbalances and Intergovernmental Transfers

The assignment of expenditure and taxing powers to the different levels of government brings to fore two types of fiscal imbalances that pose critical challenges to government decentralization, namely, vertical fiscal imbalance and horizontal fiscal imbalance.

Vertical fiscal imbalance. Vertical fiscal imbalance refers to a situation where there is a mismatch between expenditure requirements and revenue capacities at **different** government levels. While subsidiarity favors the decentralization of many expenditure functions, traditional public finance and optimal taxation theories suggest the centralization of the major and most productive tax bases.

Vertical fiscal imbalance poses a problem to the achievement of the benefits of decentralization and the efficient operation of the public sector in general. Vertical fiscal gaps aggravate the common resource pool problem (Pisauro, 2002). National government financial assistance or fund transfer to subnational governments to bridge the fiscal gap, however, may cause the latter to underestimate the true social costs of government funds and then to overspend. This is an illustration of “*fiscal illusion*” or the misperception by voter-taxpayers regarding their share of financing public spending (Romer and Rosenthal, 1980, and Winer, 1983).

The heavy reliance by subnational governments on national government grants also weaken local government accountability. Constituents tend to depend on and put pressure on the national government even in matters that are purely of local concern. This tendency is reinforced by the subnational governments, which are encouraged to rely on the politically costless national government grant funds rather than raise their own revenues, which will force them to be transparent and accountable to their taxpaying constituents (Grewal, 1995).

Horizontal fiscal imbalance. Horizontal fiscal imbalance refers to the uneven capacities of the different units **within** a particular level of government, e.g., the states in a federal system, to provide services at a comparable standard. Horizontal fiscal imbalance can originate from both the revenue and expenditure sides of government budgets. On the revenue side, government units may have varying levels of capacities as a result of differences in resources, which usually include advantages of transportation, ports, climate, location, mineral deposits, possession of a stock of capital goods, and the head offices of financial corporations within their jurisdictions. On the

expenditure side, government units may face varying needs due to different socioeconomic and demographic factors. A government unit, for instance, may face relatively greater spending requirements on education and welfare services because of its population's high proportions of school age children and the elderly. Also, there can be cost variations in the provision of infrastructure due to different topographical and geographic characteristics.

Horizontal fiscal imbalance has both equity and efficiency implications. Governments with high fiscal capacities arising from more revenue sources and/or fewer expenditure needs, are in a position to provide their constituents with given levels or standards of services at lower tax rates. At given tax rates, they will likewise be able to provide more and better public goods and services. The result is that individuals who are identical in all respects except their places of residence may be levied different tax rates to obtain the same level and standard of public services, or faced with equal tax payments, may be provided with unequal levels and standards of public services.

On the efficiency criterion, differences in net fiscal benefits serve as incentives for individuals and firms to move from poor jurisdictions with low fiscal benefits to rich jurisdictions in order to share in the fiscal rents. These movements are not efficiency-enhancing because they result in too many people migrating to wealthier jurisdictions, which in turn, result in overcrowding and/or resource drain of the poor jurisdictions.

Intergovernmental transfers. The problem of fiscal imbalances can be addressed in various ways, namely, *a)* reassignment of expenditure functions and/or taxing powers, *b)* credit financing, and *c)* intergovernmental fiscal transfers.

Intergovernmental fiscal transfers are the primary instruments used by government in addressing vertical fiscal imbalance and horizontal fiscal imbalance. They present a way of reconciling the apparent differences in the assignment of expenditure functions and taxing powers among various levels of government and of promoting a reasonable balance of public service provision and tax burdens in all governmental jurisdictions. Transfers take the form of *a)* individual tax sharing, *b)* general revenue sharing, and *c)* grants.

Under **individual tax sharing**, subnational governments receive fractions from particular national taxes originating within their boundaries. While subnational governments do not have any authority in the determination of tax bases, setting of tax rates, and administration of taxes, they are entitled to a share in the taxes collected in their jurisdiction. The sharing percentages may vary from one type of tax to another, but usually, they are uniform across jurisdictions. Through tax sharing, subnational governments can directly benefit from the economic activities in their area, and this can incentivize them to be more development oriented.

Under **general revenue sharing**, subnational governments are given a portion of the combined revenues generated by the national government from its various taxes. General revenue sharing first achieved wide currency in the United States, where it was used to refer to an appropriation by the federal government of a fixed formula-based amount of general purpose grant to state and local governments. The sharing does not take into account the origin or jurisdiction where the revenues are derived.

Mathews (1980) identified three purposes of **intergovernmental transfers**, namely, *a*) responsibility sharing, *b*) vertical fiscal adjustment, and *c*) horizontal fiscal adjustment. The literature suggests that for each purpose, there is a corresponding type or design of grant.

Transfers are divided into two major types, namely, specific and general. As the term implies, **specific purpose transfers** have designated uses defined by the grantor. The types of specific purpose transfers are lump sum and matching. A specific **lump sum transfer** restricts the amount of transfer and the service on which it can be spent. A specific **matching transfer** depends on how much the recipient spends of its own revenues. Matching transfers can either be closed or open ended. The closed matching transfer is given only up to a certain level of expenditure. For open-ended matching transfers, the amount of transfer matches the recipients' expenditure up to the last dollar spent on the aided service. The other major type of transfer, the **general purpose transfer**, has no restriction on its use. The recipient government can use it for any purpose, even to substitute for its own revenue efforts. Some general purpose transfers, however, have revenue effort conditions to prevent substitution (King, 1984).

Specific purpose transfers are usually associated with responsibility sharing. As frequently noted, it is difficult to establish perfect correspondence between the benefit span of public goods and the jurisdictional boundary of governments. Interjurisdictional spillovers of benefits or costs are likely to occur. Subnational governments acting independently are likely to ignore these externalities in their cost-benefit calculation. They are likely to provide these services below optimum levels, in the case of positive externalities, or above optimum levels, in the case of negative externalities. To encourage local governments to provide the optimum levels of these services, specific matching transfers, depending on the magnitude of their marginal spillovers, are usually recommended. Unfortunately, although externalities provide a sound basis for specific matching transfers, in practice, it is extremely difficult to determine the correct transfer or matching requirement (Boadway and Flatters 1982a, and Wildasin 1986).

Another case of responsibility sharing wherein specific transfers are usually employed is the provision of merit goods. Common examples are low-cost housing and public health care, where both national and subnational

governments are likely to be involved. The national government, concerned with establishing a minimum standard of these services across the country, is well advised to provide specific lump sum grants, which are equivalent to the minimum expenditure requirements, to subnational governments that are directly responsible for their provision (Boadway and Wildasin, 1984). Another use of specific purpose grants is for financing central government delegated functions or services to local governments.

A major objection raised regarding specific purpose transfers is that they serve as instruments for the national government to extend its control (Petchey and Walsh, 1993). They can distort the expenditure priorities of subnational governments. However, specific purpose transfers are not necessarily centralizing. In the case of matching transfers, which are tied to the expenditures of the recipient government, the central government also loses control of its budget. Mathews (1980) cited examples of matching transfers becoming in effect a lower-level government device for influencing the level of central government financial assistance. Hence, there is the objection against specific transfers that they result in unrestrained growth of the public sector.

Other criticisms raised against specific transfers include inadequate arrangements for policy coordination, the growth of grant lobbies and grantsmanship, inadequate accountability, and failure to consider the relative needs and capacities of recipient governments. Aspects of intergovernmental transfers other than design are important. They include machinery, which is concerned with fitting the transfer program into budget priorities and the coordination of the policies of the granting and recipient governments (Mathews, 1980).

A **general purpose transfer** is regarded as the most appropriate means for restoring or maintaining vertical fiscal balance. General purpose transfers can be spent by recipient governments for any purpose, as with taxes raised from its own-source revenues (Mathews, 1980 and 1983). Some general purpose transfers, however, may have revenue effort conditions that render them less than perfect substitutes for own revenue sources of the recipient government.

In evaluating whether general transfers meet the requirement of vertical fiscal balance, two major factors are usually considered. The *first* is whether the amount of revenue sharing transfer is sufficient to bridge the gap between the expenditure requirements and revenue sources of governments (Bird, 1990). The *second* is the manner by which the amount of revenue sharing is determined, i.e., whether by unilateral decision of the granting authority or by joint decision by both granting and recipient governments (Mathews, 1980 and 1983). When the amount, structure, and manner of revenue sharing of intergovernmental transfers are jointly determined by the governments concerned, there may not be a problem of vertical fiscal

imbalance. It must be noted that intergovernmental transfer is a second-best solution to the problem of vertical fiscal imbalance. Vertical fiscal imbalance is a problem of non-correspondence in the assignment of revenue-raising and expenditure functions and is best addressed through proper reassignment taxing powers or tax sharing arrangements (Mathews, 1983).

Fiscal equalization transfers provide the main instrument for achieving horizontal fiscal balance, the third major objective of intergovernmental transfers. Fiscal equalization transfers are usually allocated on the basis of a formula that takes into account the relative revenue capacities and expenditure requirements of governments.

The most general fiscal equalization transfer model may be expressed in the form:

$$A_i = E_i^S - R_i^S$$

The fiscal equalization transfer (A) of government i equals the difference between its standardized expenditure (E_i^S) and standardized revenue (R_i^S). The standardization is necessary to eliminate or reduce the effects of preference or policy differences so that equalization transfers reflect only disparities in fiscal factors that are beyond the immediate control of recipient governments (Mathews, 1983).

Mathews (1980, 1983, and 1993) distinguishes two major types of equalization transfers, namely, fiscal performance equalization and fiscal capacity equalization. **Fiscal performance equalization** usually takes the form of a specific purpose transfer, and is concerned with equalizing services across jurisdictions. A **fiscal capacity equalization** transfer is concerned with equalizing revenues needed to provide a standard level of services. It mainly employs general transfers, and does not constrain recipient governments to provide uniform services. Thus, fiscal capacity equalization transfers are more attuned to decentralization and local autonomy.

Musgrave (1961) and Le Grand (1975) considered it appropriate to include revenue effort factors in the formula for the allocation of transfers. The rationale is that governments with little interest in providing services should receive less assistance to prevent free riding. A government should not receive compensation if it is not taxing its residents as appropriately as other governments.

11.5 Government Borrowings

Independent of expenditure and tax assignments, national and subnational governments may resort to borrowing to finance their budget deficits. Government borrowing, however, impinges heavily on the country's

macroeconomic stability, which is the responsibility of the national government. To effectively perform its macroeconomic stabilization function, the national government must have some degree of control or designate an effective regulatory framework to contain government borrowing, including subnational government borrowing.

Subnational government borrowing may come in various forms, including borrowing from the national government and from the financial market. The former can be easily controlled by the national government, but the latter also has advantages. Allowing subnational governments to access the capital market can expose them to market discipline and reporting requirements, strengthening fiscal transparency and good governance. Expanding subnational borrowing also facilitates financial market deepening (Liu, 2008). However, as Liu (2008) noted, subnational government borrowing in the capital market can carry substantial risks, as manifested by experiences of subnational fiscal stress and debt crises in countries, such as Brazil, Hungary, Mexico and the Russian Federation.

A major challenge in subnational government borrowing is the implicit guarantee provided by the national government. Even if subnational governments are assigned adequate taxing powers, they may rationally decide not to raise the revenue needed to finance their spending, and instead resort to borrowing if they believe that the national government would bail them out in case they are not able to repay (Pisauro 2002). In case of a bailout, national government funds are used for the benefits of a subnational government or subsector of the population, which is again, an illustration of the common resource pool problem. Subnational governments would thus have a tendency to over-borrow. At the same time, lenders may not also have the full incentive to exercise due diligence in their lending to subnational governments, since they are aware that that loans to subnational governments are protected by a national government guarantee (Ahmad, Albino-war, and Singh 2005). Thus, subnational government borrowing is fraught with moral hazards and needs to be regulated.

Singh and Plekhanov (2005) referred to Ter-Minassian (1997) on the approaches adopted by various countries to contain subnational borrowing. These may be grouped into four broad categories, namely, *a)* market discipline, *b)* administrative constraints, *c)* rule-based controls, and *d)* cooperative arrangements. Table 11 outlines the approaches adopted in selected countries together with their respective enforcement mechanism and type of sanctions.

Market discipline involves relying on capital markets to contain subnational borrowing. The national government does not impose limitations on subnational government borrowings. Local governments are given the freedom to decide on the amount to be borrowed, where to borrow, and how to use the amount borrowed (Singh & Plekhanov, 2005). There are important

conditions, however, for the financial markets to effectively exert discipline over subnational government borrowings. Singh and Plekhanov (2005) referred to Lane (1993) on these conditions: *a)* free and open markets with financial intermediaries that do not vest privileged borrower status on borrowing governments, *b)* access of lenders to relevant and information about the lender, *c)* no perceived chance of a bailout by the national government in cases of default, and *d)* the borrowing government should have institutions or mechanisms that enable it to properly respond to market signals (Singh & Plekhanov, 2005).

Administrative constraints are undertaken by the national government when it directly controls subnational borrowing. Controls may take different forms. In Lithuania, annual or more frequent limits are set on the overall debt of individual subnational governments. Mexico prohibits external borrowing by subnational governments. In India, individual subnational government borrowings are reviewed and approved by the national government. The national governments of Latvia and Indonesia undertake all borrowings, and provides lending facilities to their subnational governments (Singh and Plekhanov 2005).

Rule-based controls are fiscal rules specified in a country's constitution or laws on government borrowings. Singh and Plekhanov (2005) noted the following areas of restrictions for particular countries: *a)* overall budget deficit for Austria and Spain), *b)* operating budget deficit for Norway, *c)* indicators of debt servicing capacity for Spain, Japan, Brazil, and Korea, *d)* accumulated subnational debt level for Hungary, and *e)* level of spending for Belgium and Germany. Some countries, such as Germany, do not set ceilings, but restrict borrowing for investment. Rule-based controls are clearer, more transparent, and easier to monitor. However, these controls may limit the flexibility to respond conditions that have not been anticipated (Singh & Plekhanov, 2005). Ter-Minassian (2007) further pointed out that fiscal rules, by themselves, cannot result in fiscal discipline *sans* the political will and properly designed intergovernmental fiscal relations.

Cooperative arrangements jointly consider the advantages of market discipline, administrative constraints, and rule-based controls, and facilitate meaningful intergovernmental dialogue towards prudent budgetary decisions on the part of subnational governments. It should be emphasized that international cooperative arrangements do not imply sovereign guarantee for loans acquired by subnational governments (Singh & Plekhanov, 2005).

Table 11. Types of sanctions and enforcement mechanisms for subnational borrowing, selected countries

Country	Type of sanctions	Enforcement mechanism
Austria	Financial: Non-compliant local governments have to pay a fine	Co-operative: Application of sanctions depends on the unanimous decision of

	proportional to the shortfall, up to a ceiling. If compliance is obtained within one year, the fine is returned; otherwise, the funds are allocated across compliant governments.	a commission involving the federal and local governments.
Belgium	Administrative: Limits on subnational borrowing.	Co-operative: The federal government is allowed to limit regional borrowing, following a recommendation of the Supervisory Council and in consultation with regional governments.
Canada	Administrative: In four provinces, ministries and members of the executive council are subject to significant cuts in wages for failure to achieve fiscal targets.	No formal co-ordination. A non-binding budget co-ordination exists via a dialogue among ministers.
Germany	No formal sanctions.	Co-operative: The Financial Planning Council (formed by the federal government, the states [Länder] and representatives of the communities) is charged with monitoring fiscal developments at all government levels and making recommendations in cases of non-compliance.
Ireland	Administrative: Defaulting authorities can be removed from office and replaced by a commissioner appointed by the central government.	Centralized: Subnational governments are monitored and controlled by the Department of the Environment and Local Government.
Italy	Administrative: Limits on the purchase of goods and services; prohibition to hire new staff and to contract debt to finance investment.	Co-operative: The State-Local Government Conferences are involved in the monitoring process.
Spain	Administrative: Non-compliant authorities have to submit a plan for correcting any fiscal deficit.	Centralized.

Source: Ter-Minassian, 2007, as cited by Joumard and Kongsrud, 2003

In Australia for example, the Commonwealth, or the federal government, and the states jointly formulate the macroeconomic objectives and the key fiscal parameters, which include overall deficit targets and the main items of revenue and expenditure. Thereafter, specific limits and financing requirements of the individual subnational jurisdictions are agreed upon. This process is carried out through a loan council consisting of the Commonwealth treasurer and the state treasurers or heads of government. The loan council approves both state and Commonwealth financing requirements, and oversees the implementation of such decisions (Singh & Plekhanov, 2005).

Related to the matter of subnational borrowing is the enhancement of the ability of subnational governments to manage revenues and expenditures and to provide services more effectively. Baltaci and Yilmaz (2006) emphasized the importance of functional internal controls and an audit system that will manage risks, eliminate systemic weaknesses, assist the formulation of strategic development plans, and institute integrity checks.

11.6 Intergovernmental Relations

For federalism to be successful, it should entail more than the mere division of responsibilities between national and subnational governments or identifying which powers are reserved for the national government and those which are to be devolved to the subnational governments. Citing Watts (1996), Majeed (n.d.) maintained that the operations of a federal government is less of rules and formulas for the division of powers and more of the processes and dynamics for unifying the peculiarities of the subnational jurisdictions within the federal context.

Critical cooperation among levels of government. Ultimately, the issue that needs to be addressed is one of cooperation, or how national and subnational governments can work jointly and effectively in making decisions, minimizing service duplication, undertaking regional planning and development, ensuring fair resource allocation, and resolving disputes and deadlocks. Moreover, it is important to determine which level of government authority should be upheld in specific situations. For example, a subnationally formulated policy may not align with national policies. Cooperation among governments is necessary for facilitating reforms for improving the federation's performance and productivity (Business Council of Australia, 2006).

Institutionalizing mechanisms for intergovernmental relations. Intergovernmental relations may be regarded as a system of approaches towards forging cooperative policy making among the levels of government. There is the constant likelihood of division and disagreements in a federation, thus, intergovernmental relations should consciously aim to achieve coordination and cooperation (Business Council of Australia, 2006).

Intergovernmental relation mechanisms do not have the same prominence in federal constitutions as division of powers and competencies. However, federations are established on the philosophy of self-rule and shared rule. The states or regions in federations are autonomous units that exercise self-rule or decision-making powers within the limits set by the constitution. Concurrently, they have vested rights to shared rule; they can participate in the decision-making process at the national level. This philosophy of self-rule and shared rule provides stability to federations. It allows unity amidst diversity, and encourages coordination and cooperation among the constituent states and the federation (Villiers 2012).

Most federations consider a bicameral legislature as a vital institution because it ensures the participation of subnational constituencies in policy making, thereby making the shared rule requirement operable (Watts, 2010). In Germany, for example, most national laws require the approval by the *Bundesrat*, the second legislative chamber composed of state/regional

government representatives, before laws are implemented and delivered by Lander or state governments (Business Council of Australia, 2006).

Watts (2010) further noted the Bundesrat is composed of instructed delegates from the states. Instructed delegates do not act on their own; instead, they are bound to their constituents' preferences. The Bundesrat assumes considerable power and leverage; it exercises suspensive veto power over all federal legislation and absolute veto power over federal legislation on matters of state legislative and administrative responsibilities. Watts (2010) also observes that because most federal laws are implemented by the states, the participation of the Bundesrat in legislation gives the states a voice in the enactment of the laws that they will be tasked to implement.

Country examples.¹⁹ Mechanisms for intergovernmental relations are more distinct in executive and administrative matters dealing with the formulation and implementation of government policies and programs²⁰. These range from formal mechanisms that are entrenched in the constitution or legislation to the informal and *ad hoc* meetings and intergovernmental bodies that have been institutionalized by traditions and practices. In established federations such as the United States, Australia, and Canada, majority of these mechanisms are *ad hoc*. In young democracies, they are more formal. South Africa, for example, passed the Intergovernmental Relations Framework Act in 2005 to guide the conduct of intergovernmental relations.

Mechanisms for intergovernmental relations are also related to the character of federalism. Canada has an **executive federal system** where intergovernmental relations are carried out among the Prime Ministers and the provincial premiers. While a formal structure is provided, and federal and provincial intergovernmental relations ministers are appointed, the dynamics of these relations are actually informal in practice. Negotiations are chiefly carried out in three fora, namely, the First Ministers' Conference, which consists of the Prime Minister and provincial premiers, the Regional Premiers' Conferences, and the inter-provincial Council of Federation. This arrangement allows strong autonomy for the provinces. However, the lack of legitimate provincial senate representation and clarity in the division of powers between jurisdictions jointly contribute to politicized intergovernmental relations. Australia and India have the same federal setup as Canada.

The United States adopts the **presidential federalist model**. Two conditions lead to the absence of formal intergovernmental relations, namely, *a*) federal and state governments are sovereign, and state governments do not participate in national law making, and *b*) the country's numerous and diverse socio-political environments make it difficult to cover all interests and form a

¹⁹ Unless otherwise stated, the reference for this section is Business Council of Australia, 2006.

²⁰ Appendix C contains a survey of intergovernmental relations mechanisms practice in different federal countries.

consensus. *Ad hoc* intergovernmental entities have been formed to tackle specific policy issues. However, they are short-lived and have led to the so-called “*picket fence federalism*”, where each policy field, e.g., bank regulation, has its own setup for intergovernmental relations. The practice has limited relations to a manageable number, but coordination across several policy fields remain difficult. Mexico, Venezuela, Brazil, and Argentina have adopted the American federalist model.

Germany implements the **integrated federal model** that emphasizes collective responsibility for legislation and implementation. As such, intergovernmental relations are institutionalized. The following illustrate this arrangement: *First*, the German Constitution identifies the joint tasks of the federal and sub-federal governments. *Second*, national legislation requires the approval of both federal and sub-federal legislatures. *Finally*, regular consultation fora for coordinating legislation and policy are held, with the Chancellor attending. South Africa has adopted a variant of German federalism.

The European Union has adopted a **cultural federalist model** because of the diversity in the histories, languages, and social, legal, and economic systems of its members. The Union operates based on rule of law; all its actions are backed by treaties ratified democratically by all member states. This facilitates the formalization and strengthening of intergovernmental relations. The Council of Ministers is the Union’s principal intergovernmental decision making body. It makes decisions on proposals forwarded by the European Commission, a cabinet-like body that proposes policies and legislation, and administers and monitors treaties.

11.7 Role of local governments

As used in this section, local governments refer to the tiers of government below the highest subnational tier. There is no explicit recognition of local governments in the constitutions of established federations. The two oldest federal constitutions, the American Constitution (1787) and the Swiss Constitution (1848) have no reference to local governments. The Canadian Constitution (1867) cites local governments merely as a field of competence of the provinces. The Australian Constitution (1901) is also silent about local governments. In the older federations, local governments are mere creatures or agents of the states or the constituent units of the federation (Steytler, 2005). Local governments are creation of state laws and their autonomy is defined by such laws (Chattopadhyay, n.d.).

It was only after World War II that local governments were explicitly recognized in the constitutions of federal countries. Some examples are the constitutions of Germany, Brazil, India, Spain, South Africa, and Nigeria. The constitutional recognition of local governments was motivated by both democratic and development objectives. For example, return to civilian rule

from a long period of dictatorship, prompted the view that local governments should be instruments for promoting and ensuring a broad base of democratic participation. The rise of cities and metropolitan regions in a nation's economy also provides reasons for the recognition of local governments. The increased status and role of local governments, however, has made the assignment of functions among the three levels of government and consequent intergovernmental relations, more complex and critical for effective cooperation in service delivery (Steytler, 2005).

The experience of Switzerland, which amended its constitution to recognize local governments as another tier of government, not on the basis of aspiration but to reflect actual practice on the ground, is enlightening. Under the 1848 Swiss federal constitution, the federal government could only deal with the cantons (state governments), and cannot directly address itself to the communes (local governments) on fiscal or financial matters and the provision of public services. In the same manner, the communes could not bypass cantonal authorities and deal directly with the federal government. Thus, intergovernmental fiscal arrangements could be discussed only either at the federal-cantonal levels or at the cantonal-local levels (Dafflon, 2007). These vertical fiscal arrangements served to strengthen the autonomy of the cantons. However, they also created problems for the larger communes, i.e., cities or agglomerations. The agglomerations - a number of which have more residents than some cantons - are responsible for the provision of certain services that impact on or spill over to other cantons. However, they do not have the authority to negotiate beyond their cantonal government.

The strict vertical fiscal arrangements were relaxed in the 1999 federal Constitution to allow cities and agglomerations to directly participate in federal policies affecting them. Still, direct contact between the confederation and the communes should be the exception rather than the rule. The Federal Council decreed that the canton shall always be the confederation's main partner in the elaboration, implementation, and evaluation of federal policy measures. The confederation cannot deal with agglomerations and cities individually but only with their umbrella organizations. Policy matters can only be decided by the Tripartite Conference involving the confederation, cantons, and the communes' umbrella organization.

12. Conclusion: A Way Forward

Overinvolvement of the national government in local government affairs. The provisions of the Organic Act of ARMM and the Local Government Code on devolved powers to regional and local governments are generally attuned to the principles and design of federalism. In practice, however, the delineation of functions among the different levels of government is not clear. In particular, the national government continues to be directly and heavily involved in the provision of devolved services, acting based on the Local Government Code provision that allows the national

government to augment, in financial and operational terms, services devolved to local governments. At the same time, the national government continues to pass legislation that assigns spending responsibilities to local governments without identifying funding sources. Recall that these are the so-called unfunded mandates.

Furthermore, government decentralization in the Philippines has been carried out mainly by devolving expenditure functions to the subnational governments without commensurately increasing their revenue raising powers. The national government continues to have exclusive control over productive and broad-based taxes, resulting in vertical fiscal imbalance and the common resource pool problem that weakens the link between benefits and costs of public spending, undermines fiscal discipline and government accountability, fuels patronage politics, and breeds corruption and inefficiency. Thus, instead of increasing national government transfers and expenditures on local services to address the imbalance in expenditure need and revenue capacity of local governments, it is more appropriate to reform the assignment of taxing powers towards broadening and increasing the taxing powers of local governments.

Joint taxation, tax sharing. The restrictions on the tax schedule and rates that can be imposed by local governments relative to taxes exclusively assigned to them should be removed. Prescribed schedules and differentiated tax rates have made local taxes more complex and difficult to administer; their removal would allow local governments flexibility and autonomy in the exercise of their taxing powers. As a means of reducing the vertical fiscal imbalance and common resource pool problems, local governments, particularly the provinces, should be allowed to impose taxes that traditionally, have been assigned exclusively to the national government. Prominent examples are the personal income tax and the corporate income tax. Many federal countries have successfully practiced joint taxation. To avoid overutilization of a particular tax base, the maximum tax rates that can be set by the national government for these taxes can be reduced to allow room for local taxation.

An alternative to the joint taxation, albeit with less revenue autonomy to local governments, is tax sharing. Under tax sharing, local governments receive fractions of taxes, such as personal income tax or corporate income tax, collected within their jurisdiction. The sharing percentages may vary from one type of tax to another, but are usually uniform across jurisdictions.

Local taxation. Local taxes are the better means of financing local government services over national government transfers. If local governments are dependent on taxes that they collect from their own jurisdictions, they will have a direct stake in their collection and in the development of their localities. They are thus more likely to be responsive to real needs and act with accountability. At the same time, resident taxpayers/voters are likely to be more vigilant about how their taxes are spent by their local governments. Indeed, this is the essence of decentralization - to bring decision-making and accountability down to the local level.

Tax administration. To minimize administrative difficulties and compliance costs, the Bureau of Internal Revenue can be tasked to administer and enforce personal and corporate income taxes for both national and local governments. The Bureau will use common rules and procedures for the definition of taxable income and the apportionment of tax bases. Based on the tax rates set by the national and local governments, the Bureau will assess, collect, and remit tax payments to individual government units. The powers of local governments will be mainly on the determination of the tax rates. Initially, local government tax rates can be set uniformly to allow for a smooth transition.

Taxation of individual and corporate income by local governments ensures that they directly benefit from the economic growth in their areas through greater tax revenues. It is thus an incentive for local governments to adopt good policies and programs conducive to the growth of business, or at the very least, to actively support the Bureau of Internal Revenue in strengthening tax administration and enforcement. Logically, there are certain aspects of tax administration, such as taxpayer registration and tax enforcement, where local government units can effectively assist the Bureau. They have more intimate knowledge of their areas, hence, can easily detect individuals and business activities outside the tax net. They can also help in tax enforcement by requiring tax identification numbers from individuals and firms transacting with them. Local governments can also provide valuable third-party information for the detection of tax leakages and proper assessment of tax liabilities. Finally, with direct stake in the taxes collected in their respective areas, local government units can be natural oversight bodies to the Bureau's tax collection effort.

Equalization transfer system vis-a-vis local taxation. However, as the incomes of local governments increasingly come from own-source revenues, it is likely that the disparities in the fiscal capacities of local government units will become pronounced. The more developed ones will be able to generate more revenues for the same tax rates and provide better economic and social services. It is, therefore, important to put in place an equalization transfer system that will minimize or make the disparities in fiscal capacities of local governments tolerable. The objective of an equalization transfer system is not to provide uniform services or produce even economic growth but to ensure that all individuals, regardless of their place of residence, are entitled to a certain standard of government services. Economic growth cannot be expected to be even across space but it does not preclude geographic convergence of living standards (Human Development Network, 2013).

Internal revenue allotment. Various studies show that IRA, which is the major form of national government transfers to local governments, does not effectively address the problem of horizontal fiscal imbalance. On the contrary, IRA tends to aggravate horizontal fiscal imbalance because local governments with higher per capita household income (or higher revenue capacities) tend to receive higher IRA shares. To promote equity, it is suggested that the IRA formula explicitly takes into account revenue capacity and expenditure need indicators. Moreover, it is recommended that the total IRA amount be first allocated by province as a geographic unit, taking into account revenue capacity and expenditure need indicators of the provinces. The

provincial allocation can then be divided between the province and its component municipalities, e.g., province – 30 percent, municipalities – 70 percent. The total allotment for municipalities could then be divided to individual municipalities using a formula that also takes into account their relative revenue capacities and expenditure needs.

Aside from promoting equity, the proposed IRA formula also removes the incentive for the creation of additional local government units, thereby curtailing the fragmentation problem. The present IRA allocation formula reinforces the motivation to create local governments as a means of increasing a locality's/politician's claim on or share of the national government budget or the common resource pool. As preciously pointed out, local governments generate only around 34 percent of income from own local sources, and 65 percent of their income are from national government transfers. Insofar as its benefits are confined to its constituents, a local government is a local public good. However, the whole population shoulders a huge portion of its costs. Thus, many local governments are created not to increase efficiency in the provision of government services, but simply to access or get more from the common resource pool. This has resulted in a highly fragmented local government system, with many local government units lacking basic governance capacities in areas such as development planning, public financial management, and tax administration.

Regional governments. Many of the governance problems cited in this report and the recommendations put forward can be addressed by amending the Local Government Code and effectively implementing it. However, there are certain structural and institutional challenges that constrain mere amendments to the Code, but which a shift to a federal form of government could possibly address.

The Philippines has the highest number and the smallest sizes of first-tier subnational government in East Asia. Decentralization of expenditure functions and revenue raising powers to reduce the size of the common resource pool is constrained by the size and administrative and technical capacities of the first-tier subnational governments. The provinces and cities are too small to absorb many of the expenditure functions and revenue raising powers of the national government. Thus, the proposal for a federal form of government, which provides for the creation of bigger subnational government, such as a regional government, makes sense. More national government expenditure functions and revenue raising powers can be assigned to regional governments, thereby breaking up and reducing the size of the common resource pool. At the regional level, the size of the common resource pool as well as the number of claimants will be smaller, rendering the incidence of costs of and benefits from government spending more visible and thus promoting greater vigilance and accountability.

The creation of regional governments, however, increases the number of subnational government levels to five, namely, the region, province, city, municipality, and *barangay*. At present, the Philippines already has among the highest number of subnational government levels at four, equaling China, which is a much bigger country. The implications on efficiency and effectiveness of having too many levels of

subnational governments needs to be studied carefully, with the possibility of converting some of these levels into administrative units. The consolidation of small local government units into fewer but bigger units could also help reduce the problem of political dynasties, as small local government units are prone and easy prey for political dynasties.

The federal form of government and the creation of the regional government should be able to establish a strong “middle level government” that can facilitate better coordination, both vertical and horizontal, between and among the different levels of government. The federalism literature refers mainly to two levels of government, namely, the federal government and its constituent states. However, each state has local governments comprising it. In the established and older federations, local governments are creatures or agents of the state. The federal government can only deal with the state and cannot deal directly with local governments on fiscal and financial matters and the provision of public services. In the same manner, local governments cannot bypass the states and deal directly with the federal government. Only the states can directly deal with both the federal government and the local government units. Thus, the states serve as the middle level governments that play a pivotal role in facilitating coordination and cooperation among all levels of government from the federal down to local government levels for the efficient delivery of government services.

Final considerations. In contrast to decentralization, wherein the central government determines the functions and powers to be devolved to local governments and can withdraw them back, in federalism, the functions and powers are constitutionally assigned to the different government levels and cannot be unilaterally changed without the process of constitutional amendment participated in by all government levels. There is no single model of federalism, but there are certain established principles that guide the assignment of competencies to the different government levels, such as subsidiarity, fiscal equivalence, and self-rule and shared-rule. There is a high degree of permanence in the assignment, hence accountability is established. Moreover, recognizing the powers and limitations of each government level, institutions are built and developed to facilitate coordination and cooperation among the different government levels. Among these institutions are regional representations in federal policy making usually through a second chamber of the federal parliament, the creation of a constitutional court to rule on disputes between governments, the provision of equalization or solidarity transfers, and the establishment of intergovernmental ministers’ conference and councils.

The establishment of regional governments, its powers and functions and its relation to the national government and local governments, is the most crucial element in the shift from a unitary to a federal form of government. It is recommended that the proposed shift be carried out in two stages. The **first stage** will deal with assignment of competencies and the relationship between the national government and regional government, with the power to organize the local governments being one of the competencies exclusively assigned to the latter. This shall be the task of the constituent assembly that will be constituted to propose amendments to the Philippine

Constitution. The **second stage** will tackle the regional government and its local governments. Each regional government should come up with its own regional constitution or organic act that could be drafted through a regional constitutional convention.

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Annex A

Background on the Philippine Economy

The following background offers additional context for the consideration of ideas presented in this paper.

Foreign direct investment and exports. Various studies point out that the rapid growth experienced by leading Southeast Asian countries was accompanied by structural transformation driven by export growth and foreign direct investment (FDI). Usui (2012) identifies the three dimensions of this transformation, namely, a) change in the mix of outputs from low productivity to high productivity outputs, b) movement of the labor force from traditional and primary sectors to modern industry, and c) diversification of the export basket. Furthermore, structural transformation took place in production and employment, creating needed jobs that sustained growth and reduced poverty in the long run.

A review of FDI data for the period 1981 to 2015 further shows that the Philippines, together with Vietnam, received the lowest amount and share of total FDI among the ASEAN 5. Although the amount of FDI in the Philippines grew, its growth rate continued to lag behind other countries in the region. From 6.1 percent from 1981 to 1989, its share of total FDI further declined to 5.8 percent from 1990 to 1999, to 3.9 percent from 2000 to 2010, and to 3.1 percent from 2010 to 2015. (Table A.1)

*Table A.1. Net inflows of foreign direct investment,
in current US million dollars and as a percentage of GDP,
Selected ASEAN Countries, 1981 to 2015*

Country/FDI/ Year	Current Million US\$				Percentage of GDP			
	1981- 1989	1990- 1999	2000- 2010	2010- 2015	1981- 1989	1990- 1999	2000- 2009	2010- 2015
Indonesia	3,083	21,576	28,291	125,514	0.4	1.2	0.5	2.4
Malaysia	8,713	41,314	43,504	67,779	3.2	5.8	3.0	3.8
Philippines	2,247	11,882	15,795	21,605	0.7	1.8	1.4	1.4
Singapore	17,832	84,765	218,890	360,380	9.6	11.4	16.5	21.2
Thailand	4,891	31,457	63,607	60,034	1.0	2.5	3.3	2.6
Vietnam	54	13,378	35,291	53,698	..	6.8	5.0	5.7

Source of data: World Development Indicators database, as updated on 01/03/2017

The Philippines also lagged behind its regional peers, except for Indonesia, in export of goods and services (Table A.2). From 1980 to 2009, Philippine exports grew at an average rate of 6.4 percent per decade, higher than Indonesia's 5.0 percent but lower than Malaysia's 8.8 percent, Singapore's 10.2 percent, and Thailand's 10.3 percent. Vietnam's exports grew fastest for the period 1990 to 2009, with an average annual growth rate of 17.0 percent. Philippine exports performed better in the recent years of 2010 to 2015, growing by 7.8 percent, next only to Vietnam's 12.8 percent. The strong performance of Philippine exports in recent years can be largely attributed to its booming business process outsourcing sector. However, export of goods and services by the Philippines did not reach 50 percent of GDP compared to other countries in the region whose exports to GDP ratio ranged from 68 to 193 percent.

FDIs and exports did not only directly contribute to the high economic growth of the leading economies of the region; more significantly, they played a vital role in an economy's structural transformation. Many studies also attest that FDIs increase the investment rate or capital stock of a host country, while facilitating technology transfers (Hsaio and Hsaio, 2006). Exports allow countries

to overcome the constraints of small domestic markets and to benefit from economies of scale. Increased investments, technology transfers, and economies of scale enabled leading Southeast Asian countries to develop their industry sectors, particularly manufacturing.

*Table A.2. Export of goods and services,
average annual growth rate and as a percentage of GDP,
Selected ASEAN Countries, 1980 to 2015*

Country/FDI/ Year	Average Annual Growth (%)				Percentage of GDP			
	1980- 1989	1990- 1999	2000- 2009	2010- 2015	1980- 1989	1990- 1999	2000- 2009	2010- 2015
Indonesia	1.6	5.4	8.0	5.8	26.6	30.8	32.4	24.0
Malaysia	9.2	12.7	4.6	3.1	57.9	91.2	108.3	78.6
Philippines	7.8	7.2	4.2	7.8	24.7	36.8	44.5	30.5
Singapore	11.6	11.0	8.1	6.1	173.9	170.7	207.4	192.8
Thailand	13.6	10.8	6.7	5.2	25.9	42.5	65.8	68.6
Vietnam	..	19.5	14.4	12.8	10.1	37.6	59.4	81.9

Source of data: World Development Indicators database, as updated on 01/03/2017

Structural changes. The GDP growth of leading ASEAN countries was accompanied by decreasing shares of agriculture and increasing shares of industry (Table A.3). This was also the path earlier followed by major developed countries. The Philippine economy, on the other hand, took a different direction. The share of industry declined even as the share of agriculture was also declining. As the shares of agriculture and industry took on this downward trend, the share of the services sector was increasing. Fabella (2013) referred to this phenomenon as “*development progeria*” or premature aging. In effect, the Philippines skipped the industrialization phase that is generally associated with high rates of investment, economic growth, and employment.

*Table A.3. Shares of agriculture, industry, and services in GDP, in percent
Selected ASEAN Countries, 1980 to 2015*

Country/Year	1980-1989			1990-1999			2000-2010			2010-2015		
	A	I	S	A	I	S	A	I	S	A	I	S
Indonesia	24.2	39.9	40.4	18.4	42.8	41.4	14.5	46.1	39.3	13.5	42.5	41.5
Malaysia	20.5	39.5	40.0	13.1	42.5	44.3	9.0	45.0	45.9	9.6	37.2	53.2
Philippines	23.9	36.8	39.3	19.9	33.0	47.0	13.0	33.7	53.3	11.6	31.4	57.0
Singapore	1.0	35.0	64.0	0.2	33.5	66.3	0.1	31.3	68.6	0.0	26.2	73.8
Thailand	17.9	32.0	50.1	10.0	37.3	52.7	9.2	38.2	52.5	10.7	37.5	51.8
Vietnam	41.4	26.3	32.3	30.2	28.9	40.9	20.3	36.9	42.8	18.3	32.9	38.1

Source of data: World Development Indicators database, as updated on 01/03/2017

It is notable that the increasing shares of industry’s gross value added to GDP in fast growing ASEAN countries were also accompanied by the growth of industry’s shares in total employment (Table 6). From 11.4 percent of total employment in the 1980’s, Indonesia’s employment in industry increased to 20.6 percent in recent years, while Thailand’s increased from 12.1 percent to 20.3 percent. Vietnam’s employment in industry increased from 11.7 in the 1990s to 21.2 percent in recent years. The Philippines’ industry share of employment, on the other hand, marginally increased from 14.5 percent in the 1980s to 15.3 percent in recent years, resulting in the lowest share of industry in total employment in the region.

As Usui (2012) pointed out, the movement of labor from the low productivity agriculture sector to the high productivity industry sector in ASEAN countries was a major factor in the growth of labor productivity, which in turn, led to fast economic growth, better employment, and low poverty rates. Unfortunately, the Philippines did not take part in this structural transformation.

Table A.4. Shares of agriculture, industry, and services in total employment, in percent, Selected ASEAN Countries, 1980 to 2015

Country/Year	1980-1989			1990-1999			2000-2010			2010-2014		
	A	I	S	A	I	S	A	I	S	A	I	S
Indonesia	55.4	11.4	32.4	47.9	16.6	35.4	43	18.4	38.5	35.8	20.6	43.6
Malaysia	31.6	24.1	44.2	20.9	31	47.6	14.9	30.4	54.8	12.5	28	59.5
Philippines	49.6	14.5	35.9	43	16	41	36.1	15.5	48.4	32	15.3	52.7
Singapore	0.8	35.9	62.9	0.5	32.4	67.1	1	24.7	74.6	..	23.2	75.7
Thailand	65.3	12.1	22.5	54.6	16.9	28.4	43.6	19.9	36.5	40.2	20.3	39.4
Vietnam	..	..	..	66.3	11.7	22	60.1	15.8	24.1	47.1	21.2	31.8

Source of data: World Development Indicators database, as updated on 01/03/2017

It is further significant that the Philippines had the highest annual rates of unemployment among the ASEAN 5 in almost 4 decades (Table A.5). Its economic growth rate in the 1990s and early 2000s was characterized as jobless growth with unemployment rates rising to 8.5 percent and 9.5 percent, respectively. From 2010 to 2015, however, the country's economic growth was not only higher, but was also accompanied by lower unemployment rates, averaging at 7 percent. From 7.4 percent in 2010, the Philippines' unemployment rate went down to 6.3 percent in 2015, and further down to 5.5 percent in 2016. This 2016 figure is the lowest rate achieved over the last 40 years, albeit still one of the highest in the region. Moreover, the unemployment rate remained very high at 18.3 percent, indicating that a significant number of Filipinos still need to work more hours to meet their needs.

Table A.5. National estimates of total unemployment, as a percentage of total labor force, selected ASEAN countries, 1980 to 2015

Country/Year	1980-1989	1990-1999	2000-2009	2010-2015
Indonesia	2.7	4.7	9	6.4
Malaysia	5.7	3.4	3.4	3.1
Philippines	6.6	8.5	9.5	7
Singapore	3.7	2.5	4	2.7
Thailand	3	1.9	1.6	0.8
Vietnam	..	2.3	2.3	1.9

Source of data: World Development Indicators database, as updated on 01/03/2017

Annex B

**Highlights of Key Informant Interviews (KIIs) and Focus Group Discussions (FGDs)
Conducted in ARMM, November 14-17, 2016**

Powers of the regional government.

Institutional Design Elements	Preliminary Findings
Autonomy in governance	1. The autonomous region has no real autonomy. The Regional Legislative Assembly (RLA) cannot pass a law that overrides a national law. It is considered only a “paper autonomy.” 2. The laws passed by the RLA are subject to the test of constitutionality, hindered by a wide scope of the National Government’s (NG) exclusive powers stated in the Organic Act, or not honored or implemented by national government agencies (NGAs). Acts of the Autonomous Regional Government (ARG) are questioned in courts or constrained by the central government agencies. 3. The ARG does not have its own Civil Service Commission (CSC) office. 4. In terms of power to enact their own budgets, the barangays can be considered more autonomous than the ARG.
Revenues	1. The Autonomous Regional Government (ARG) has no power to compel businesses operating in the ARMM to pay their taxes in the region, not in Manila. 2. The Bureau of Internal Revenue (BIR) and the Bureau of Customs (BoC) have not been devolved to the Autonomous Regional Government (ARG). The ARG has no authority to collect national taxes. 3. The RLA can pass tax laws, but it cannot override what is provided in the National Internal Revenue Code (NIRC). 4. Almost all National Government (NG) taxing powers were retained by the NG. The ARG has no devolved NG taxing powers.
Budgeting	1. The fiscal autonomy of the ARG is weak. It is weakened by the practice of requiring the ARG to submit its proposed annual budget to the Department of Budget and Management (DBM) and to defend its proposed budget to the Philippine Congress. 2. The ARG incurs large expenses presenting and defending its annual budget in Manila. 3. It is really up to the Philippine Congress what budget to give to the Autonomous Region of Muslim Mindanao (ARMM). 4. The Regional Legislative Assembly (RLA) has very limited power of the purse, which extends only to “Local Funds” comprising the autonomous region’s share from national internal revenue taxes collected in the ARMM and other taxes and fees imposed by the ARG. Local funds constitute only around 5% of the total ARMM annual budget, funded by the National Government’s (NG) regular assistance to the region.

Powers of the regional government, CONT.

Institutional Design Elements	Preliminary Findings
Budgeting, CONT.	5. For the regular NG assistance to the ARMM, budgeting is characterized not only by the dominance of the ARG's executive branch, the DBM, and the Philippine Congress, but also the marginalization of its legislative branch which supposedly has the power of the purse. - Regional line agencies present and defend their budget proposals before the Office of the Regional Governor (ORG). - The Regional Planning and Development Office (RPDO) consolidates the budget proposals of regional line agencies. - The ORG prepares and submits the proposed ARMM budget to the DBM. This is the ARMM budget funded by the NG's regular assistance to the autonomous region. - The DBM scrutinizes the budget proposal of the ARG and consolidates the "revised budget" in the National Expenditure Program (NEP) which is submitted to the Philippine Congress, for budget authorization. - The ARG defends its proposed annual budget included in the NEP before the Philippine Congress. - Only the public works component of the approved budget of the ARMM in the General Appropriations Act (GAA) is submitted to the RLA for budget authorization via the Regional Public Works Act that it needs to enact to authorize the disbursement of funds. - The ARG's line agencies especially the devolved National Government Agencies (NGAs) often align their programs with the programs of their former mother agencies. - They also prepare and submit Major Final Outputs (MFOs) and performance indicators (PIs) similar to what NGAs are doing. The MFOs and PIs of ARG regional line agencies and key officials suggest that the ARG's budget accountability is to the NG, which provides the funds for its operations, not through its RLA.
Local governance	- In line with its power to create Local Government Units (LGUs) under the ARMM Organic Act (RA 9054), the RLA created 15 local government units (LGUs). These LGUs, however, were disqualified by the DBM from receiving Internal Revenue Allotment (IRA). In one case, it created a province (Shariff Aguak), but this RLA act was declared unconstitutional by the Supreme Court. - The RLA enacted the ARMM Local Government Code (Muslim Mindanao Autonomy Act No. 25), which is patterned after the Local Government Code of 1991. This regional code, however, has not substantially addressed a number of key issues in intergovernmental relations between the Regional Government and its constituent Local Government Units (LGUs). - The existing legal framework for local governance in the ARMM is built on conflicting legal provisions contained in RA 7160, RA 9054 and the MMA Act No. 25.
Private sector development	The ARG has exercised its power to grant tax incentives to investors. However, it does not have the autonomy to grant tax incentives that extend for more than six years. Its major concern in the last 20 years is the delay in the grant of these tax incentives because it has to get the endorsement of some NGAs (i.e., DOE, DOF) to certain tax incentives.

Powers of the regional government, CONT.

Institutional Design Elements	Preliminary Findings
Transport	1. The Land Transportation and Franchising Regulatory Board (LTFRB) in the ARMM is a crippled agency compared to similar offices in other administrative regions. 2. The LTO office of the ARMM can only issue typewritten registration papers which are not honored in areas outside the ARMM. 3. Residents have their cars registered in the LTO offices in Iligan or Zamboanga, not in the ARMM's LTO which can only issue type-written registration papers that are not honored outside the autonomous region. 4. The national LTO has not turned over to the LTO-ARMM the computerized-licensing system/facility. D 5. The Department of Transportation and Communications (DOTC) is one useless regional line agency in the ARMM.
Education	1. The ARG has some difficulty finding Madaris teachers who meet the Civil Service Commission's eligibility requirements. To address this problem, the RLA passed a regional civil service code that lowers eligibility requirement for appointment in government positions, but this law was not implemented by the Civil Service Commission. 2. Regional offices of the Department of Education (DepEd) have full staffing complement compared to the autonomous DepEd office in the ARMM. 3. The budget of the DepEd-ARMM is included in the ARMM's annual budget included in the General Appropriations Act (GAA).
Natural resources	1. The ARG and the various local governments in the ARMM have no control over Lake Lanao, which is covered by the national government's watershed program. The government agency (Lake Lanao Development Council) regulating the lake's uses is located in Region 10, not in the ARMM. 2. There are so many drilling operations in the Sulu Sea or within the ARMM's territorial jurisdiction, but the ARG no control over these or does not derive revenues from these activities. Drillers get their permits from the NG not from the ARG.

National-regional intergovernmental relations.

Institutional Design Elements	Preliminary Findings
National government treatment of the ARMM	1. The NG treats the ARG similar to any national government agencies (NGAs). 2. The ARG has become more like an implementing agency of the NG. 3. National government agencies and programs and functions were devolved to the ARG, but not the required budgets to enable the ARG to carry out these devolved functions.

National-regional intergovernmental relations, CONT.

Institutional Design Elements	Preliminary Findings
Functions of regional line agencies	The attached agencies of the Department of Interior and Local Government (DILG) did not form part of the devolved DILG-ARMM.
Support of national government agencies (NGAs)	1. Inequitable share of the ARG from the program funds of NGAs. The ARG's regional line agencies (e.g., the DOLE, DILG, DTI) received smaller shares of the NGAs' program funds compared to the respective regional offices of these NGAs operating in administrative regions in the country. The autonomous status of ARG's line agencies is being used as a justification for the smaller share of the NGAs' program funds. 2. The ARG's line agencies (i.e., former regional offices of NGAs) are treated like they are separate rather than autonomous parts of a national system for delivering public services. 3. The NGAs often channel their minimal allocation for ARG's line agencies through their regional offices in neighboring administrative regions (Region 9, 10 or 12). 4. The NGAs' regional offices in neighboring administrative regions of the ARMM download the fund allocation for the autonomous region too late, often in the last quarter of the year. It is not an uncommon case that the availability of these downloaded funds for budget execution, lapses (i.e., they are reverted back to the National Treasury). 5. For some NG programs (e.g., the national DTI's "Negosyo Centers"), the ARG line agency does not get allocation at all while all regional offices of the DTI operating in the administrative regions are given their respective budget allocation. For instance, Caraga Region's "Negosyo Center" received a P35 million budget, but the DTI-ARMM gets none. 6. Some NGAs do not have any offices in the ARMM. For instance, the ARMM is the only region in the country with no regional Population Commission or POPCOM office.
Agriculture	The national Department of Agriculture (DA) channels its allocation for the DA-ARMM through its regional offices in administrative regions near the ARMM.
Public works	1. The administrative regions get more funds for the maintenance of national roads compared to what the DPWH-ARMM is getting. 2. Before the ARG finalizes its budget proposal, it submits a preliminary budget proposal to the DBM, which then sets the overall budget ceiling for the ARG including the ceiling for its infrastructure spending for the coming fiscal year. For 2016, for instance, the budget ceiling for infrastructure is set at around P8 billion. 3. In addition, the ARG can also propose projects outside the infrastructure ceiling. In 2016, it proposed around P10 Billion-worth of infrastructure projects outside the DBM's ceiling. These projects outside the infra budget ceiling are implemented by the DPWH national office through its regional offices operating near the autonomous region. 4. While the maintenance of national roads in the autonomous region is the responsibility of the ARG, the DPWH national office still can influence the DPWH-ARMM, which implements infrastructure projects following national standards. However, the DPWH-ARMM no longer reports to the DPWH central office.

National-regional intergovernmental relations, CONT.

Institutional Design Elements	Preliminary Findings
Health	1. There is a large disparity in terms of staff complement between the DOH-ARMM and the DOH regional offices in administrative regions. 2. The DOH-ARMM has never been invited by the DOH central office in its technical budget hearings. It is treated as a separate entity that does not form part of the national system for delivering health services. 3. If the DOH central office provides budget support to the DOH-ARMM, such support is given as a cash advance not a sub-allotment. Such support forms part of the budget of the DOH Secretary, not a line item in the General Appropriations Act unlike the budgets of DOH regional offices in administrative regions. There is thus no fixed and demandable amount of budget support for the ARMM.
Civil service	The RLA has the power to enact a Regional Civil Service Law (Sec. 2, Art. XVI). However, the regional civil service code that it enacted was not implemented by the Civil Service Commission (CSC).
Intergovernmental relations (IGR) bodies	1. The Oversight Committee mandated under the ARMM Organic Act has not been convened to review the implementation of the organic act. There are many provisions in the ARMM Organic Act that have not been implemented at all. 2. The representation of the ARMM in national government as mandated in the Organic Act has not been implemented at all.
Creation of local governments	1. The RLA exercised its concurrent power with the Philippine Congress to create local government units (LGUs). However, the eight municipalities it created were not entitled to receive Internal Revenue Allotment (IRA) from the National Government. 2. The IRAs of the mother municipalities decreased. However, the IRAs deducted from these mother municipalities were withheld by the DBM, but not given to the new LGUs created by the RLA.

Regional-local intergovernmental relations.

Institutional Design Elements	Preliminary Findings
Views on the relevance of the ARG to local development	1. The ARG is inertia to development. It does not have much budget. Its existence also hinders the Provincial Government's access to National Government (NG) assistance. It contributed more to negative than positive change. 2. The ARG is viewed somewhat by the provincial government as not part of the family. In fact, the provincial governments in the ARMM are more connected to the National Government than to the ARG.

Regional-local intergovernmental relations, CONT.

Institutional Design Elements	Preliminary Findings
Regional government's support to ARMM LGUs	1. There is a perception that the ARMM budget has failed to reflect the needs of ARMM provinces. 2. The Provincial Government seldom gets assistance from the ARG. 3. The ARG's budget process is too centralized, heavily influenced by the Regional Governor's preferences. 4. The ARG has not devolved key regional line agencies (e.g., Provincial Agriculturist Office) that form part of the Provincial Government under the Local Government Code of 1991. 5. Outside the ARMM, the salaries of Social Welfare Officers, Provincial Health Officer, and Provincial Agriculturists are shouldered by the provincial governments. In the ARMM, it is the ARG that pays for the salaries of these provincial officials.
Framework for governing ARG-LG IGR	There is confusion as to which legal framework (i.e., the Local Government Code of 1991, the ARMM Organic Act, or the ARMM Local Government Code) governs the LGUs in the ARMM.
Development planning and coordination	1. Infrastructure projects are the main topics discussed in the Regional Planning and Development Board of the ARMM. 2. The regional line agencies and their officials are accountable and report to the ARG although some of them (e.g., Provincial Health Officer) are supposed to be under the supervision and control of the Provincial Government pursuant to a Supreme Court decision (Pandi vs Saber). 3. ARG coordination with the provincial government of Maguindanao is simply informing them about the ARG's programs. 4. There is not enough coordination between the ARG and the provincial and municipal governments in the ARMM in the delivery of basic services.
Education	There are many dilapidated schools in the province of Maguindanao. Teacher positions, classrooms and textbooks are severely lacking. However, the ARG cannot do something about this problem.
Health	1. The ARG got the NG budget for devolved health functions. 2. The DOH-ARMM is the one financing the provincial hospitals in the region. This is contrast to provincial governments outside the ARMM that finance the operations of provincial hospitals. 3. The budget of the DOH-ARMM is around P1.2 Billion. This amount pays for around 1,588 medical personnel including doctors in provincial hospitals and even midwives assigned in the various barangays of the ARMM. 4. The Provincial Government of Maguindanao is amenable to the further devolution of the ARG's health function if the budget for this devolved function is also given to them.
Agriculture	1. The ARG pays for the salary of the Provincial Agriculturist. Because of this arrangement, the Provincial Agriculturist does not coordinate the ARG's agriculture programs with the Provincial Government of Maguindanao. 2. Considering that around 80 percent of Maguindanao's economy revolves around agriculture but the Provincial Government has no control and supervision of the Provincial Agriculturist paid for by the ARG, the Provincial Government decided to create its own Office of the Provincial Agriculturist. 3. The Provincial Government thinks that DA-ARMM has weak capacity to implement region-wide programs.

Regional-local intergovernmental relations, CONT.

Institutional Design Elements	Preliminary Findings
Public works	The Regional Economic Development and Planning Board (REDPB) identifies priority infrastructure projects. Chaired by the Regional Governor, its members are the Provincial Governors of the five provinces constituting the ARMM.

List of Key Informant Interviews (KIIs) and Focus Group Discussions (FGDs)

November 14, 2016 (Cotabato City)

- FGD with a number of appointed officials and employees of the Autonomous Regional Government of Muslim Mindanao (ARGMM) from the following regional government departments: Department of Interior and Local Government (DILG), Department of Transportation and Communications (DOTC), Department of Trade and Industry (DTI), Board of Investments (BOI), Regional Planning and Development Office (RPDO), Office of the Attorney General
- KII with the Director of the Finance and Budget Management Service of the ARGMM
- KII with the former Regional Secretary of the DILG and the current Regional Secretary of the Department of Trade and Industry

November 15, 2016 (Cotabato City)

- GD with five assemblymen and assemblywomen of the Regional Legislative Assembly (RLA)
- Group interview with two officers of the regional Department of Education (DepEd)
- KII with the Assistant Regional Treasurer

November 16, 2016 (Cotabato City and Maguindanao Province)

- KII with the Chief of the Survey Design Division of the regional Department of Public Works and Highways (DPWH)
- KII with the budget officer of the regional Department of Health (DOH)
- FGD with the Provincial Administrator and other provincial government officials of Maguindanao

December 9, 2016 (Quezon City)

- FGD with Deputy Commissioner Nestor Valeroso and other key officials and employees of the Bureau of Internal Revenue (BIR)

December 13, 2016 (DBM, Manila)

- Interview with the Director Soledad Doloiras and two employees of the Budget Management Bureau-D

Annex C

Intergovernmental Mechanisms by Locus of Interaction

(Sources: BCA, 2006 and various online information)

A. Federal-state IGR mechanisms

IGR Mechanism	Purpose	Operational Mechanisms
State Council (Russia)	1. Address and discuss issues arising from a) the lack of clarity in the division of powers in the Russian Constitution, or a considerable degree of overlapping jurisdiction, and b) the divergent cultural, economic, climatic and environmental factors between the 89 constituent units of the federation. 2. Serves as an advisory body to the Russian head of state 3. Aids the President in ensuring the concerted functioning and interaction of various governmental bodies.	History and membership. President Putin set up this consultative body in 2000. The State Council consists of all the heads of the executive branches of the federation's constituent units and meets quarterly at the request of the Russian President to discuss particular issues. Management. Within the State Council, a Presidium (i.e., an executive committee) was set up, consisting of seven members drawn from the State Council on a rotating basis. 1. Various working groups prepare proposals for economic and political reform. 2. The members of the working groups are not limited to State Council members. They include 2-3 State Council Representatives, highly qualified experts, and other political representatives. 3. The working groups deal with concerns including federalism, energy production and distribution, improvement of federal administration and development of local government. Meetings. The State Council holds four (4) sessions a year. In these meetings, the President discusses the major initiatives undertaken by the federal government.

A. Federal-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
Budget Council (South Africa)	1. Set up under the Intergovernmental Fiscal Relations Act of 1997 2. The Intergovernmental Fiscal Relations Act of 1997 mandates the federal, provincial or local governments to consult the Budget Council, on issues affecting provincial finances or those relating to the management or monitoring of provincial finances	Membership. Minister for Finance as chairperson and the MECS for Finance (Members of the Provincial Executive Councils), and the chairperson of the Financial and Fiscal Commission.
Council of Education Ministers (South Africa)	Established under the National Educational Policy Act of 1996, it promotes national education policy and coordinates education matters of national interest	Membership. Minister and Deputy Minister of Education and nine (9) MECs for Education (in their capacity as political heads of provincial education); observer status for the national legislature's committee chairpersons on education
U.S. Advisory Commission on Intergovernmental Relations (United States)	1. Established in 1959 through Public Law 86-380 as a permanent, bipartisan body of 26 members, to provide continuing studies on the relationship among, local, state and national levels of government. 2. Functions a. Bring together representatives of the federal, state, and local governments to discuss common problems, and b. Serves as a forum for discussing the administration and coordination of federal grant and other programs requiring intergovernmental cooperation.	Membership. Composed of 26 individuals: 3 members of the President's Cabinet, 3 US House members, 3 US Senators, 4 Governors, 3 State legislators, 3 county commissioners, 4 mayors, and 3 private citizens. The US President directly appoints the citizen and executive branch representatives. He also appoints the representatives of state, county and municipal officials based on nominations submitted by national organizations of state and local governments.

A. Federal-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
First Ministers' Conferences (Canada)	Since 1950, this IGR mechanism serves as annual forum where the Canadian Prime Minister meets with the provincial and territorial premiers.	Importance of this IGR mechanism 1. Serves as an opportunity for provincial and territorial premiers to lobby for more transfer payments from the federal governments. Transfer payments constitute a sizable portion of provincial funding. 2. Provides a forum for provincial and territorial premiers to present a common position on various issues, to the federal government. 3. Because there is a fair amount of overlap between federal and provincial jurisdictions in Canada's federal system, this forum provides an opportunity to the federal government to secure provincial support for its programs.
Intergovernmental Conference Secretariat (Canada)	1. Established pursuant to an agreement reached at the May 1973 First Ministers' Conference, this IGR body provides organizational and secretariat services to many federal-provincial meetings in Canada. These meetings include the First Ministers' meetings, the Annual Premiers' Conference, the Eastern Canadian Premiers' Conference, the Western Premiers' Conference, and the New England Governors' Conference. 2. Core of its work is providing services to multilateral meetings of Ministers and Deputy Ministers in virtually every sector of government activity.	1. Although considered a federal department under Canada's Financial Administration Act, this IGR body is in fact an agency of the federal and provincial governments. 2. Truly intergovernmental in nature, the Secretariat is funded and staffed by both federal and provincial governments. It also has accountability to both governments. 3. The permanent Secretariat provides an 'institutional memory' which facilitates executive decision making.

A. Federal-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
Council of Australian Governments (COAG)	1. Serves as the peak intergovernmental forum in Australia. 2. Promote policy reforms that are of national significance, or which need coordinated action by all Australian governments. 3. Serves an important role in supporting COAG and allowing it to focus on national priorities. 4. Provides a forum for more defined, doable intergovernmental collaboration and decision-making. 5. Develops policy reforms and other advice for COAG consideration 6. Oversees the delivery and review of reforms agreed by COAG 7. Develops Regulation Impact Statements to assess the likely impacts of new regulations required by COAG decisions.	Membership. The Prime Minister, state and territory Premiers and Chief Ministers and the President of the Australian Local Government Association. Commonwealth and state and territory ministers with responsibility for the respective subject matters. Councils have either Commonwealth or rotating chairs Meetings 1. As needed, but usually twice a year 2. The COAG may settle issues out-of-session by correspondence. 3. Agreements reached during COAG meetings are embodied in intergovernmental agreements, including National Agreements and National Partnership Agreements. Support structures 1. The COAG is supported various ministerial-level COAG Councils that facilitate consultation and cooperation between the Commonwealth and the states and territories in specific policy areas. 2. COAG Councils pursue and monitor priority issues of national significance and take joint action to resolve issues that arise between governments. 3. Councils also develop policy reforms for consideration by COAG, and oversee the implementation of policy reforms agreed by COAG. Notable achievement On 29 November 2009, the COAG approved the Intergovernmental Agreement on Federal Financial Relations, which serves as a new framework governing the Commonwealth's financial relations with states and territories.

A. Federal-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
Council of Australian Governments (COAG), CONT.		Eight COAG Councils 1. Federal Financial Relations Council 2. Disability Reform Council 3. Transport and Infrastructure Council 4. Energy Council 5. Industry and Skills Council 6. Law, Crime and Community Safety Council 7. Education Council 8. Health Council Management 1. Councils have either Commonwealth or rotating chairs (from provinces, territories) 2. Supported by a secretariat, senior officials and/or working groups 3. Terms of reference and work plans help to govern the operations of management of COAG councils
Inter-State Council (India)	1. Established under Article 263 of the Constitution of India, the Inter-State Council was convened by the President in 1990 to perform the following functions: a. inquires into and advises upon disputes which may have arisen between States b. investigates and discusses subjects in which some or all the States, or the Union and one or more of the States, have a common interest c. make recommendations upon any such subject and, in particular, recommendations for the better co-ordination of policy and action with respect to that subject 2. Serves as a mechanism for effecting consultations between the central and state governments.	Membership. Prime Minister as Chairman and with the following as members: Chief Ministers of all States, Chief Ministers of Union Territories, Six Ministers of Cabinet rank in the Union Council of Ministers to be nominated by the Prime Minister

IGR Mechanism	Purpose	Operational Mechanisms
Conference on European Affairs (Spain)	1. Triggered by Spain's entry into the European Union. 2. In a 1994 agreement, the National Government and the Autonomous Communities set up this IGR mechanism to coordinate Spain's position on European affairs	Meetings. The Conference on European Affairs holds several meetings a year. These meetings are usually preceded by self-coordinating meetings among the Autonomous Communities (joint positions are decided on the basis of one vote per Community which are then communicated to the national government).
Bundesrat (Federal Council of Germany)	1. The constitutionally mandated upper house of Germany's national legislature serves as a primary IGR mechanism 2. Represents the interests of the elected governments of Germany's 16 <i>Landers</i> or federal states. 3. Participates in national legislation alongside the Bundestag, the directly elected representative body, particular on laws affecting state competences and constitutional changes.	Membership. Bundesrat members are not elected, but are appointed by the respective state governments. Members from the same Lander/state vote as a bloc to legislative proposals. The President of the Bundesrat is fourth in the order of succession after the Federal President, the President of the Bundestag, the Chancellor and before the President of the Federal Constitutional Court. Meetings. The President of the Bundesrat convenes and chairs plenary sessions of the body and is formally responsible for representing Germany in matters of the Bundesrat. Importance 1. While the legislative authority of the Bundesrat is subordinate to that of the Bundestag, it plays a critical legislative role: The German federal government must present all its legislative initiatives first to the Bundesrat before these proposals can be passed to Bundestag. 2. The Bundesrat must also approve all legislation affecting policy areas for which the federal Constitution grants the Lander concurrent powers and for which the Lander must administer federal regulations. 3. Constitutional changes require 2/3 of all votes in Bundestag and Bundesrat, giving this body an absolute veto against constitutional change

B. Inter-state IGR mechanisms

IGR Mechanism	Purpose	Operational Mechanisms
Council of the Federation (Canada)	Established in 2003 by the heads of provincial and territorial governments so that the provinces and territories could play a leadership role in revitalizing the Canadian federation and to build a more constructive and cooperative federal system. 1. Promote interprovincial-territorial cooperation and closer ties between members of the Council, to ultimately strengthen Canada. 2. Foster meaningful relations between governments based on respect for the Constitution and recognition of the diversity within the federation. 3. Show leadership on issues important to all Canadians.	Membership. The governments of the 10 provinces and of the three territories of Canada, as represented by their premiers, are members of the Council Chairperson. The premiers of the provinces take turns chairing the Council of Federation according to the rotation established by the Annual Premiers' Conference. The term of office of the chair is one year. The chair acts on behalf of the Council according to the mandates received from it. Meetings. The founding agreement of the Council of Federation provides that there will be an annual meeting of the Council each summer in the province of the incoming chair. From time to time, the Council may hold special meetings to which it may invite the federal government. Decisionmaking. The decisions of the Council are reached by consensus. The Council may decide, from time to time to hold special meetings to which it may invite the Federal Government. Management. There is a Steering Committee, composed of the deputy ministers responsible for intergovernmental relations or such other representative designated by a member. The Steering Committee is chaired by the deputy minister of the province chairing the Council. It prepares the meetings of the Council and carries out research. The Steering Committee sets up and supervises the Secretariat, which reports to the Steering Committee, which serves as the board of directors of the Secretariat. The head of the Secretariat is appointed by and reports to the board of directors. Secretariat. A small Secretariat located in Ottawa reports to the Council of the Federation Steering Committee, which is comprised of provincial and territorial deputy ministers of intergovernmental relations.

B. Inter-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
National Governors' Association (United States)	1. Founded in 1908, the National Governors' Association serves as the collective bipartisan voice of the nation's governors. 2. Speaks with a collective voice on national policy and develops innovative solutions that improve state government and supports the principles of federalism 3. Provides governors and their senior staff members with services that range from representing states on Capitol Hill and before the Administration on key federal issues 4. Identifies priority issues and deals collectively with matters of public policy and governance at the state and national levels	Membership. The Governors of the 55 states, territories, and commonwealths of the United States. Support structures 1. A nine-person Executive Committee elected annually that supervises the association's operations. This committee has general authority over all policy issues and primary jurisdiction over issues involving federalism, homeland security, the federal budget, and federal tax policy 2. Permanent Secretariat that provide administrative, research and policy support and facilitate communication between members and the organization 3. Other standing committees: Health and Human Services Committee, Economic Development and Commerce Committee, Education and Workforce Committee, Homeland Security and Public Safety Committee, Natural Resources Committee
National Conference of State Legislatures (United States)	Since 1975, the National Conference of State Legislatures (NSCL) has served as the champion of state legislatures. The mission of the NSCL is to: 1. Improve the quality and effectiveness of state legislatures. 2. Promote policy innovation and communication among state legislatures. 3. Ensure state legislatures have a strong, cohesive voice in the federal system.	Membership. Speakers and members of state legislatures.

B. Inter-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
Zonal Councils (India)	Created under the States Re-Organization Act of 1956 which mandates that there shall be a Zonal Council for each of the following five zones of the country: 1. Northern Zonal Council, comprising the States of Haryana, Himachal Pradesh, Jammu & Kashmir, Punjab, Rajasthan, National Capital Territory of Delhi and Union Territory of Chandigarh. 2. Central Zonal Council, comprising the States of Chhattisgarh, Uttarakhand, Uttar Pradesh and Madhya Pradesh. 3. Eastern Zonal Council, comprising the States of Bihar, Jharkhand, Odisha and West Bengal; 4. Western Zonal Council, comprising the States of Goa, Gujarat, Maharashtra and the Union Territories of Daman & Diu and Dadra & Nagar Haveli. 5. Southern Zonal Council, comprising the States of Andhra Pradesh, Karnataka, Kerala, Tamil Nadu, Telangana and the Union Territory of Puducherry.	Membership. Section 16 (1) of the States Reorganisation Act 1956 provides that the Zonal Councils shall consist of the following members: 1. A Union Minister to be nominated by the President. 2. The Chief Minister of each of the States included in the zone and two other Ministers of each such State to be nominated by the Governor and if there is no Council of Ministers in any such State, three members from that State to be nominated by the President. 3. Where any Union Territory is included in the zone, not more than two members from each such territory to be nominated by the President. The Zonal Council for each zone shall have the following persons as Advisers to assist the Council in the performance of its duties, namely: 1. one person nominated by the Planning Commission 2. the Chief Secretary to the Government of each of the States included in the Zone, and 3. the Development Commissioner or any other officer nominated by the Government of each of the States included in the Zone.

B. Inter-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
Zonal Councils (India), CONT.	Functions of the Zonal Councils: 1. Each Zonal Council shall be an advisory body and may discuss any matter in which some or all of the States represented in that Council, or the Union and one or more of the States represented in that Council, have a common interest and advise the Central Government and the Government of each State concerned as to the action to be taken on any such matter. 2. In particular, and without prejudice to the generality of the above provisions, a Zonal Council may discuss, and make recommendations with regard to any matter of common interest in the field of economic and social planning, any matter concerning border disputes, linguistic minorities or inter-State transport, and any matter connected with, or arising out of, the reorganization of the States under this Act.	

B. Inter-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
Council of Atlantic Premiers (Canada)	1. Established in May 2000, with the signing of the Memorandum of Understanding on Regional Collaboration, the Council of Atlantic Premiers' mission is to promote collaboration among the four Atlantic provinces. 2. Mission a. Promote Atlantic Canadian interests on national issues by seeking to establish common views and positions and working to ensure that Atlantic Canadians and their interests are well represented in national debates, b. Strive to provide a climate in which Atlantic Canadians can fully participate and be competitive in the global economy, benefit from quality social services, and continue to enjoy the quality of life and environment that is unique to Atlantic Canada, and c. Work with all their partners to foster and promote a sustainable and prosperous future for Atlantic Canada within a strong and united Canada that respects the diversity and equality of all its regions.	Mandates 1. Development of common Atlantic Canada positions for the Council of the Federation Meetings and First Ministers' Meetings 2. Development of common Atlantic Canada positions on national issues 3. Joint promotion of the interests of Atlantic Canadians; 4. Coordination of joint activity in areas of mutual agreement, including but not limited to, trade promotion, federal-provincial fiscal arrangements, and economic and social cooperation 5. Coordination of joint analysis and review of economic, fiscal, social, cultural, and environmental programs and policies which affect or concern the Atlantic provinces.

B. Inter-state IGR mechanisms, CONT.

IGR Mechanism	Purpose	Operational Mechanisms
The Council of Atlantic Ministers of Education and Training (Canada)	The Council of Atlantic Ministers of Education and Training (CAMET) has a broad mandate to improve education systems in the four provinces and provide a framework for regional cooperation and initiatives which transcend provincial boundaries.	The Council was created by interprovincial agreement in 2004. It replaced the Atlantic Provinces Education Foundation (APEF) and Maritime Provinces Education Foundation (MPEF), which had operated since 1982.
The Standing Conference of the Ministers of Education and Cultural Affairs (Germany)	The oldest conference of ministers of education in German Landers founded in 1948, this IGR body plays a significant role in the coordination and development of education in the country. Tasks: 1. To address “educational, higher education, research and cultural policy issues of supraregional significance with the aim of forming a joint view and intention and of providing representation for common objectives” 2. Ensure the necessary measure of commonality in educational, research and cultural issues of cross-state significance. 3. Use consensus and cooperation as a vehicle for securing the highest achievable level of mobility for learners, students, teachers and those involved in academic research. 4. Serve as an instrument for asserting the joint interests of the federal states vis-a-vis the Federal Government, the European Union, the Council of Europe, the OECD, and the United Nations. 5. Present and advocate the common positions of the federal states in the fields of education, research and culture	Membership. Ministers of Education of the Landers of Germany Support Structures: 1. President - chairs the plenary sessions and acts as the external representative of the Conference. 2. Presidium - executive committee composed of the President, three Vice Presidents and up two members. It may make decisions on behalf of the Standing Conference of the Ministers of Education and Cultural Affairs by adopting unanimous resolutions. 3. Committees - School Committee and Sub-committee for Vocational Education and Training and Continuing Education and Training, Higher Education Committee, Cultural Affairs Committee, Federal Government-Federal States Committee for Schools Abroad 4. Standing Commissions - Chiefs of Staff Commission for Quality Assurance in Schools, Chiefs of Staff Commission for Quality Assurance at Institutes of Higher Education; Commission for European and International Affairs; Commission for Statistics; Commission for Teacher Training; Sports Commission 5. Secretariat - carries out the day-to-day work of this IGR body. It focuses on preparations for the meetings held by the Plenum, the committees and the commissions and deals with the evaluation and implementation of the results of the deliberations conducted by these bodies.

C. Regional-local IGR mechanisms

IGR Mechanism	Purpose	Operational Mechanisms
Advisory Commission on Intergovernmental Relations (Connecticut)	Many of the states in America have their own Advisory Commissions on Intergovernmental Relations that are also set up under statutes and are permanent intergovernmental bodies. ACIR's role pursuant to Section 2-79a of the Connecticut General Statutes: 1. Serve as a forum for consultation between state and local officials 2. Conduct research on intergovernmental issues Encourage and coordinate studies on intergovernmental issues by universities and others 3. Initiate policy development and make recommendations to all levels of government.	1. The Advisory Commission on Intergovernmental Relations (ACIR) of Connecticut is a 24-member agency created in 1985 to study system issues between the state and local governments and to recommend solutions as appropriate. 2. The membership is designed to represent the state legislative and executive branches, municipalities and other local interests, and the general public. 3. ACIR has permanent officers and staff to support its work.