

Manasan, Rosario G.

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Designing the Fiscal Features of a Federal Form of Government: Autonomy, Accountability, and Equity Considerations

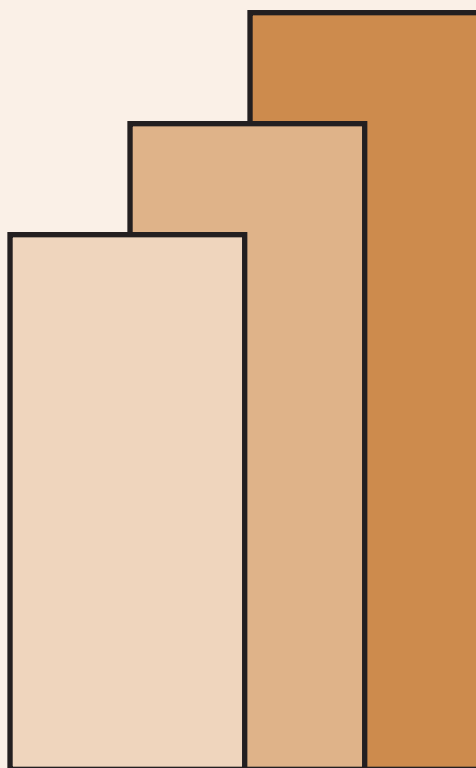
Rosario G. Manasan

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For comments, suggestions or further inquiries please contact:

The **Research Information Department**, Philippine Institute for Development Studies

18th Floor, Three Cyberpod Centris – North Tower, EDSA corner Quezon Avenue, 1100 Quezon City, Philippines

Tel Nos: (63-2) 3721291 and 3721292; E-mail: publications@mail.pids.gov.ph

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**DESIGNING THE FISCAL FEATURES OF A
FEDERAL FORM OF GOVERNMENT:
AUTONOMY, ACCOUNTABILITY AND EQUITY
CONSIDERATIONS**

Rosario G. Manasan

Philippine Institute for Development Studies

December 2017

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ABSTRACT

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

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

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

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

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

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

DESIGNING THE FISCAL FEATURES OF A FEDERAL FORM OF GOVERNMENT: AUTONOMY, ACCOUNTABILITY AND EQUITY CONSIDERATIONS

Rosario G. Manasan

1. INTRODUCTION

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

The federalism discourse in the public arena is oftentimes framed along two strands. First, the adoption of a federal form of government is seen as a means to reverse the "unequal allocation of resources between what critics call 'imperial Manila' and the rest of the country"² that has, in turn, resulted in the persistence of wide regional disparities in per capita household incomes, per capita Gross Regional Domestic Product (GRDP) and poverty incidence. Proponents of the federal movement point out that the share of NCR in the national government budget is disproportionately large, accounting for over 14% of total appropriations under the 2016 General Appropriations Act (GAA), for instance, compared to the combined share of the remaining 7 regions in Luzon (21%), the aggregate share of the 3 regions in the Visayas (10%), and the share of the 6 regions in Mindanao taken together (13%).³ The cumulative effect of such disproportionately favorable treatment of NCR and its periphery over the years, they note, is reflected in the highly uneven level of economic development across the region and the persistence of poverty with the "rich regions becoming richer and the poor regions, much poorer"⁴ (**Table 1**). They then argue that a federal form of government will address this problem by allowing regional or state governments to "retain more of their income" and "channel their own funds toward their own development instead of the bulk of the money going to the national government."⁵ However, simply allowing subnational units to keep most of their income may not be enough to undo the huge imbalance in economic and human development across regions at present; nay, it may even worsen the situation given the current wide disparity in the tax base across the different regions (**Table 1**). This discussion highlights the fact that there is no single federal model, and

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

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

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

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

⁵ <http://www.philstar.com/headlines/2016/05/31/1588742/federalism-what-filipinos-need-know> accessed 15 July 2016; <http://www.rappler.com/nation/politics/elections/2016/12/0166-federalism-pros-cons-explainer> accessed 15 July 2016

that the federal model may (or may not) work in the Philippine context depending on the specific design features of the particular model that is proposed. To use a cliché, the devil is in the details.

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

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

Second, advocates view the shift to a federal form of government as key to attaining sustainable peace in Mindanao given its potential in securing national unity while protecting regional diversity arising from religious, linguistic, ethnic, or cultural differences.⁶ However, while Bangsamoro experts continue to support federalism as a solution to the Mindanao conflict, they also recognize that “there are potential pitfalls [from federalism] that may bring more harm than good in our search for [a] sustainable formula for peace in Mindanao. ... In pushing for a shift to the federal system which is necessarily national in scope, the majority [of] Filipinos must guard against imposing their will on the minority and in the process violate their [the latter’s] right to self-determination. The Moro people and other indigenous groups must always be considered *sui generis* – a class on their own. Thus, a symmetric federal system that fails to recognize the distinctiveness of the minority may not catalyze peace but more conflicts in the future” (Bacani 2009⁷). Again, this discussion underscores the importance of paying close attention to the design of the federal model in ensuring its success.

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

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

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

This paper then puts forward a design option for each of the four pillars of intergovernmental fiscal relations. These design options generally respond to the call for greater local autonomy while paying close attention to accountability and equity concerns. It should be emphasized though that the design options offered in this paper are for the most part illustrative and best characterized as “work in progress.” They highlight the challenging task of establishing coherence and internal consistency among the different components of the intergovernmental fiscal relations based on available data on central government and local government unit (LGU) revenues and expenditures as well as indicators of possible tax bases and expenditure needs across the regions.

2. OVERVIEW OF THE FISCAL FEDERALISM FRAMEWORK

The literature on fiscal federalism posits that a federal system of government is likely to yield potential benefits in the form of (i) increased efficiency and, consequently increased societal welfare, (ii) enhanced local accountability, and (iii) stronger national unity in the face of regional diversity. First, under a federal system, optimal provision of public services is likely to be achieved if the jurisdiction of the level of government responsible for the financing and delivery of a given public service coincides with the geographic area where benefits of said public service are confined (Olson 1969; Oates 1972). Otherwise, government will tend to under-provide services which have positive benefit spillovers to other jurisdictions while over-provision may result if lower level governments are able to secure funding from higher level governments for projects that only benefit the local jurisdiction; i.e., they will tend to ask for more projects relative to a situation when they have to finance said projects themselves. Also, greater decentralization under a federal form of government will tend to lead to increased efficiency and welfare to the extent that it brings government closer to the people, thereby allowing lower level governments to respond to the local needs and preferences of their constituents (Oates 1972). This tendency is further reinforced through interjurisdictional competition when the population can to “vote with their feet” to get the “public services-tax package” that they prefer (Tiebout 1956), thereby, dampening the rent-seeking tendency of local politicians (Brennan and Buchanan 1977). Second, the federal system enhances local accountability to the extent that lower level governments have some degree of revenue autonomy (i.e., if they raise a significant amount of revenues from local taxes and user charges). Increased local accountability also results from greater citizen participation in local governance under a more decentralized setting (Slack 2006; Ivanyna and Shah 2010). Third, the federal system is also seen to have the advantage of addressing ethnocultural conflict as it accommodates regional diversity – religious, linguistic, ethnic, or cultural.

The first two of these potential gains are largely a function of the extent of decentralization. Said gains may be secured through greater fiscal decentralization with or without shifting to a federal form of government. Also, countries with a federal form of government are not necessarily decentralized to the same degree and some of them may even be less decentralized than those with a unitary form of government. (**Box 1** summarizes the distinction between a multi-tiered unitary government and one with a federal form.) For instance, Germany, which is federal, is more centralized than Canada, which is also federal. Moreover, Australia and India, which are federal, are more centralized than Sweden, Norway and Denmark, which are unitary (Shah 2007a).

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

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

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

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

The fiscal federalism literature (e.g., Shah 1991; Litvack et al. 1999; Bahl 1999; Shah 2007a) also provides some guidance in answering the basic questions that are key in crafting the country’s fiscal constitution i.e., the body of rules and regulations that frames intergovernmental fiscal relations and which are enshrined in the constitution and/ or the basic laws of federal governments and multi-tiered unitary governments (Blöchliger and Kim 2016):

- (i) Which level of government should have the power to define and implement policies in the delivery of public service in specific policy areas? Or the question of expenditure assignment.
- (ii) Which level of government should levy different types of taxes? Or the question of tax assignment.
- (iii) What policy instruments and mechanisms should be used to address the gap in expenditure responsibilities and revenue powers assigned to subnational governments and regional imbalances in the fiscal capacity of subnational governments? Or the question of intergovernmental transfers.
- (iv) What rules should be put in place with respect to subnational borrowing to enforce hard budget constraints on all levels of government and ensure the fiscal sustainability of the government as a whole? Or the question of subnational government access to credit and capital markets.

These design principles are aimed at ensuring that the federal government and subnational governments face the right incentives for an efficient and equitable delivery of public services and at enhancing the downward accountability of subnational governments to their constituents. These principles are discussed in greater detail below, together with the design option for each of the four pillars of intergovernmental relations for a federal form of government for the Philippines.

Some caveats. The four pillars of intergovernmental fiscal relations (i.e., functional or expenditure assignment, (ii) tax assignment, (iii) intergovernmental transfers, and (iv) subnational borrowing and debt management) are best considered as parts of one system in which “all the pieces must fit together” (Bahl 1999). In this sense, the coherence among these four components of the intergovernmental fiscal arrangements is just as important as the details of the specific functions and taxes assigned to subnational governments, the particular configuration of intergovernmental transfers and the specific form and character of the rules that govern subnational government borrowing. Said coherence may be defined in terms of “giving states similar degrees of autonomy in various budget items (taxation, spending, borrowing etc.),” or in terms of the balance between “a certain level of autonomy with a matching level of responsibility” (Blöchliger and Kim 2016). Put another way, the design of specific aspects of this system cannot be done in isolation. “If not assessed and designed as part of a comprehensive framework, these isolated changes may eventually create inconsistencies and imbalances across government levels and undermine the effectiveness of fiscal policy” (Fedelino and Ter-Minassian 2010).

Also, the guidance from the fiscal federalism literature in designing the four pillars of intergovernmental relations should not to be taken as rigid, one-size-fits-all prescriptions. No one single federalism model may be considered the best in a vacuum. Some aspects of the design principles may, at times, conflict with one another depending on the relative importance one assigns to the various objectives of fiscal federalism (i.e., efficiency, equity and stabilization) given the specific political and economic circumstances of country (Bird and Vaillancourt 2006).

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

The design options for the critical fiscal elements of a federal form of government offered below do not only take the guiding principles available from the fiscal federalism framework but are likewise informed by the lessons from the Philippines’ past experience with fiscal decentralization since the enactment of the 1991 Local Government Code. In addition, they are also informed by a review of the extent to which existing federal governments have incorporated the principles from the fiscal federalism literature in their constitutions.

3.1. Expenditure Assignment

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

The basic principle that guides what functional or expenditure responsibilities should be assigned to the different levels of government is attributable to Oates (1972): “each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision.” Following this principle, functions and competencies whose benefits are national in scope should be assigned to the federal government. Thus, national defense, foreign affairs, functions related to economic stabilization and macroeconomic management (i.e., monetary policy, currency, and banking; fiscal policy), and functions related to the preservation of internal common market (e.g., regulation of international and interstate trade/ commerce) are best assigned to the federal government. At the same time, the economic literature also suggests that functions related to the redistributive role of government be assigned to the federal government (Musgrave 1997). It is argued that generous redistribution programs carried out by subnational jurisdictions are not likely to be sustainable because such programs will tend to

result in the in-migration of the poor from other areas which may prompt them to increase tax rates in response to the pressure to expand said programs, a move that will likely drive away their richer, more mobile residents (Martinez-Vazquez 1999).

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

Provisions related to expenditure assignment in federal constitutions. Constitutions of countries with a federal form of government typically enumerate (i) the exclusive powers that are assigned to the federal government, (ii) the exclusive powers assigned to the states, provinces or regions, and (iii) the level of government which is assigned residual powers (i.e., powers which are not explicitly assigned to either the federal government or the subnational governments in the constitution). Some federal constitutions also specify the concurrent and/ or shared powers. In particular, the constitutions of India and Malaysia literally include "lists" of (i) exclusive powers of the federal governments, (ii) exclusive powers of the states, and (iii) concurrent powers of the federal government and the states.

Also, the level of detail with respect to the division of powers between the federal government and the states vary. In some countries with a federal form of government, the constitution does not only specify the distribution of powers in terms of policy or service areas but also in terms of legislative-executive powers. For instance, the constitution of Austria differentiates the policy or service areas in which (i) the federation has powers of legislation and execution; (ii) legislation is the business of the Federation, execution that of the; and (iii) legislation as regards principles and uniform regulations is the business of the Federation, the issue of implementing laws and execution the business of the *Laender*.

In principle, assigning powers exclusively to one level of government bolsters the autonomy of said level of government by giving said level of government the right to define and implement their own policies in the specified area/s of competency. It also provides clarity as to which level of government is accountable is responsible to their citizens for the said function/s (Watts 1996).

The grant of concurrent powers over a given policy or service area to both the federal government and the state governments "establishes parallel competencies" and, by implication, the possibility of parallel legislation and parallel public service delivery systems. In case both levels of government chooses to "act based on the concurrent competency," rules have to be put in place to delineate which legislation and/ or delivery system will prevail if there is some conflict between them (Iff and Topperwien 2017). Otherwise, coordination issues between the two levels of government would tend to be magnified.

In a number of federal countries, the constitution provides that the legislation of the federal government related to areas of concurrency takes precedence over state legislation, e.g., Australia, Brazil, India, Mexico, and Nigeria (Boadway and Shah 2009). In others, state legislation is paramount, e.g., provincial legislation prevails over federal legislation in Canada in the area of old-age pensions.

As with concurrent powers, shared powers also give both the federal government and the state governments the authority to exercise legislative and/ or administrative powers over some broad policy areas/ fields. However, in the case of shared powers, each policy area/ function is broken down, to the extent possible, into distinct tasks/ sub-competencies which, in turn, are assigned exclusively to either the federal government or the state governments.

Concurrent/ shared powers may be deemed desirable from the perspective of balancing the potential efficiency gains from the decentralized delivery of a given public service against the attainment of national objectives like ensuring uniformity and equal access to certain merit goods or compensating for interjurisdictional spillovers (Boadway and Shah 2009). The use of concurrent powers, instead of shared powers, tends to minimize the need to enumerate in detail the various tasks/ sub-competencies that constitute any given shared policy area/ field. On the other hand, clearer lines of accountability are more forthcoming with the use of shared powers.

However, there are alternatives to enumerating every subcomponent of each shared policy or service area. First, instead of listing every subcomponent of each shared policy area, the constitution may simply include a provision which defines how the subcomponents of any given policy area will be determined and how they will be assigned to the different levels of governments. Such an approach is especially suitable in the case where the sharing of powers may be defined along national - local dimensions of a broader policy area/ field, e.g., national highways versus state highways and provincial roads. Still another way of providing greater clarity when the power over specific policy/ service areas are shared by the federal government and the state governments is by giving the federal government the power to legislate national standards (or framework legislation) while assigning to the state governments the power to enact more detailed legislation and to administer the same in a manner that is responsive to the demand of their respective constituencies (Watts 1996). This is the case in Switzerland, for example (Iff and Topperwien 2017).

The system of administrative federalism practiced in Germany, South Africa and, to a lesser extent, Austria and Malaysia may be viewed as an extreme form of shared powers (Iff and Topperwien 2017). In these federal countries, the power to legislate in certain policy areas/ fields is assigned to the federal level while the administration (i.e., power to implement and execute) of the federal legislation is constitutionally assigned to state governments (Watts 1996).

There is also considerable variation in the distribution of functional/ expenditure responsibilities between the federal government and the state governments as specified in federal constitutions not only in terms of exhaustiveness of the list of exclusive and concurrent powers but also in terms of the level of government to which residual powers are assigned. The assignment of significant residual powers to state governments would highlight their autonomy and the limited nature of powers assigned to the federal government and vice versa. At the same time, the significance of residual powers depends on the comprehensiveness of the enumerated list of exclusive, concurrent/ shared powers. Conversely, the assignment of residual powers becomes less important the more exhaustive the lists of exclusive and concurrent powers are.

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

Deficiencies in expenditure assignment under the 1991 LGC

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

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

Possible design option for expenditure assignment for the proposed federal government

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

The indicative costs of the assigned functions presented in **Table 3** are estimated based on the actual allocation for these functions in the 2016 General Appropriations Act (**Table 4**). The exclusive powers of the federal government enumerated in **Table 3** correspond to the functions of some 18 agencies, including the Constitutional Commissions, under the present government structure. On the other hand, the shared powers enumerated in **Table 3** correspond to the functions of some 25 agencies. For any given policy area/ function (e.g., road infrastructure) that falls under the shared powers category, the estimate of the respective shares of the federal government and regional governments in its total cost is arrived at by sorting the various components of said policy area/ function into those whose benefits are national in scope and those whose benefits are regional/ local in scope.

Table 2. Functional assignment under the 1991 Local Government Code

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

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

Source: Section 17 (b) of 1991 LGC

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

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

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

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

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

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

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

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

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

3.2. Tax/ Revenue Assignment

Expenditure assignment and tax assignment are interrelated. Tax assignment is central to helping ensure that subnational governments have access to revenues that they need to finance the expenditures assigned to them. Thus, finance should follow function is a well-established principle in fiscal federalism.

In the fiscal federalism literature, the assignment of taxing/ revenue powers to different levels of government is guided by the following considerations: (i) economic efficiency, (ii) equity, (iii) administrative feasibility, and (iv) revenue autonomy (Shah 2007a). The economic efficiency criterion is largely anchored on the benefit principle of taxation which states that, to the extent feasible, subnational taxes should be related to the benefits that local taxpayers receive from local services. As a corollary, user charges and fees should finance the services that subnational governments provide. Conversely, this implies that subnational governments should not be assigned taxes which may be exported to residents of other jurisdictions or those that distort the location decisions of firms and households (McLure 1999). From this perspective, taxes on immobile factors (e.g., real property tax) are appropriately assigned to subnational governments while taxes on international and inter-jurisdictional trade and those on mobile factors are best assigned to the federal government. To the extent that subnational governments are assigned functions that provide “generalized benefits” (or “benefits that cannot be closely related to taxes on their beneficiaries”) and to the extent that there is a need for additional financing from local taxes, “residence-based income taxes are probably superior to employment-based payroll taxes, and destination (consumption)-based sales taxes are better than origin (production)-based ones” ((Martinez-Vazquez *et al.* 2006).

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

Finally, from the perspective of securing incentives for local accountability to local constituents, the public choice strand of the fiscal federalism literature (e.g., McLure 1999) emphasizes the need to provide subnational units some degree of revenue autonomy. The revenue autonomy criterion requires that each level of government must be assigned sources of “own” revenues whose level they have the power to control at the margin (McLure 1999).⁸ The link between revenue autonomy and accountability is articulated succinctly by Bird (1999): “If subnational governments are expected to act responsibly, such governments must be able to increase or decrease their revenues by means that make them *publicly responsible* for the consequences of their actions.” A similar sentiment is expressed by Bahl (1999): “Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes, as opposed to the case where financing is primarily by central government transfers. The tax must be visible to local voters, large enough to impose a noticeable burden, and the burden must not be easily exported to residents outside the jurisdiction.” On the other hand, Shah (2007a) argues that revenue autonomy also provides subnational governments incentives to allocate their resources more efficiently and effectively: “If subnational governments are not responsible for raising at least some level of their own revenues, they may have too little incentive to provide local public services in a cost-effective way.”

Provisions related to tax assignment in federal constitutions. Constitutions of existing federal countries vary relative to the manner by which the taxes assigned to the different levels of government are specified.

⁸ It should be emphasized that while revenue sharing with the central government (e.g., through the IRA) may provide LGUs with “own” revenues, this scheme does not provide revenue autonomy because subnational governments do not have the power to affect the amount of shared revenues they receive. On the other hand, subnational governments are said to have control over their own revenues when they are able to (i) determine the tax rate/s, (ii) define the tax base/s, or (iii) administer tax collection.

“Some constitutions are very precise about how and which taxing powers are assigned to different levels of government. Others, by contrast, are vague or simply silent. ... In some countries, constitutional voids are filled by legal interpretation” (Blöchliger and Kim 2016). For instance, constitution of Germany sets out detailed provisions on the assignment of exclusive and shared taxes to the federal government and the *Länders*. In like manner, the constitution of Switzerland contains provisions that delineate the taxing powers of the federal government and the canton in some detail. The same is also largely true of the constitution of India.

In contrast, the only taxing power that is specified in the constitutions of Australia and the United States refers to the exclusive power of the federal government to impose custom duties and excises. Aside from this, these constitutions assign the federal government unspecified taxing powers while providing that provinces/ states will retain all the taxing powers they enjoyed prior to the formation of their respective federation. The constitution of Mexico, on the other hand, specifies the taxing powers of the federal government but is quiet with regards to the taxing powers of the state. Meanwhile, the constitution of Belgium provides both the federal government and the communities/ regions open-ended taxing authorities; thus the authority to impose a tax on most subject matters may be considered as a concurrent power.

Related to this, Martinez-Vazquez et al. (2006) cautions: “Excessive [subnational] latitude in the choice of tax bases and in tax administration can create unacceptable complexity and administrative burdens, as well as inequities and distortions in the allocation of resources.” For instance, in the US, the Courts have had to perform the task of reconciling alternative interpretation of the various constitutional provisions related to taxation.

The constitutions of some federal countries (e.g., Argentina and Germany) contain provisions governing the sharing of the revenues from certain specified taxes between the different levels of government. In contrast, in other countries (e.g., Australia), tax sharing is provided in ordinary law. In some countries (e.g., South Africa and Spain), their constitutions provide for the creation of an independent body tasked to set and adjust tax shares (Blöchliger and Kim 2016).

It is also notable that some constitutions include provisions that state certain important principles of taxation. Such provisions have the potential of providing some clarity in areas where there is lack thereof. For example, Article 127 of the Swiss constitution says: “Principles of taxation. (1) The main structural features of any tax, in particular those liable to pay tax, the object of the tax and its assessment, are regulated by law. (2) Provided the nature of the tax permits it, the principles of universality and uniformity of taxation as well as the principle of taxation according to ability to pay are applied. (3) Intercantonal double taxation⁹ is prohibited.”

In sum. As with the assignment of expenditure responsibilities, there is no single best assignment of taxing powers in the sense of which particular taxes are assigned to the different levels of government. Oftentimes, the guidance provided by economic efficiency, equity, and administrative feasibility considerations are not consistent with each other. However, the revenue autonomy criterion appears to be of primordial importance in creating the right incentives for local accountability. Again, as with the assignment of expenditure responsibilities, greater clarity in the distribution of taxing powers between the central government and subnational governments is critical.

⁹ “Double taxation results from the overlapping of different taxation authorities. Consequently, the taxpayer is simultaneously subject to the same or similar taxes on the same tax object by different tax jurisdictions and for the same tax period” (Swiss Federal Tax Administration 20016).

Deficiencies in revenue/ tax assignment under the 1991 LGC

Philippine fiscal decentralization to date is characterized by weak revenue autonomy. The low local tax-to-GDP ratio and OSR¹⁰-to-GDP ratio of all LGUs in the aggregate as well as their heavy reliance on fiscal transfers, particularly the IRA, is indicative of the low degree of revenue autonomy of the LGU sector in the country during the post-LGC period. As a result, accountability at the local level is likely to continue to be rather weak. Given this, it is not surprising that the Philippine Development Plan 2016-2020 has reiterated the call for the strengthening of local accountability.

The improvement in the OSR effort of LGUs under the 1991 LGC is fairly modest, with own-source revenues for all LGU in the aggregate rising by only a slim margin from 0.7% of GDP in 1985-1991 to 1.2% of GDP in 1992-2016 (**Table 5**). The increase in LGU own-source revenues is also more limited when compared to the expansion in the IRA and other external sources of LGU income. Consequently, LGUs in the aggregate have become less self-reliant (and, therefore, less revenue autonomous) with LGU OSR accounting for a smaller proportion of total LGU income in the post-LGC period (34%) relative to the pre-LGC period (50%) (**Table 5**). Because of this, many analysts (e.g., Manasan 2007, Llanto 2012) give the 1991 LGC a low score in terms of the revenue autonomy criterion so that downward accountability at the local level is likely to be deficient.

Table 5. OSR^{a/} and local tax revenues for all LGUs combined in pre- 1991 LGC and post- 1991 LGC period, by level of local government

	1985-1991				1992-2016			
	Prov	Cities	Munis	All LGUs	Prov	Cities	Munis	All LGUs
% of GDP								
LGU OSR	0.14	0.30	0.26	0.70	0.14	0.77	0.24	1.15
Local tax	0.07	0.22	0.17	0.47	0.07	0.62	0.15	0.84
RPT	0.06	0.12	0.10	0.28	0.05	0.26	0.06	0.37
Local business tax		0.07	0.06	0.13		0.30	0.07	0.36
% of total LGU tax								
RPT	80.7	56.7	57.8	60.9	73.8	41.1	43.3	44.4
Local business tax	0.0	32.1	33.8	27.9		48.2	44.0	42.3
% of P/C/M to all LGUs								
LGU OSR	20.3	43.1	36.6	100.0	12.2	66.7	21.1	100.0
Local tax	15.8	47.0	37.3	100.0	8.7	73.7	17.6	100.0
RPT	20.9	43.7	35.4	100.0	14.5	68.3	17.2	100.0
Local business tax		54.5	45.5	100.0		82.1	17.9	100.0
OSR-to-total LGU income ratio	16.2	62.9	47.4	49.5	16.4	54.1	21.8	33.6

Author's estimates based on COA AFR data

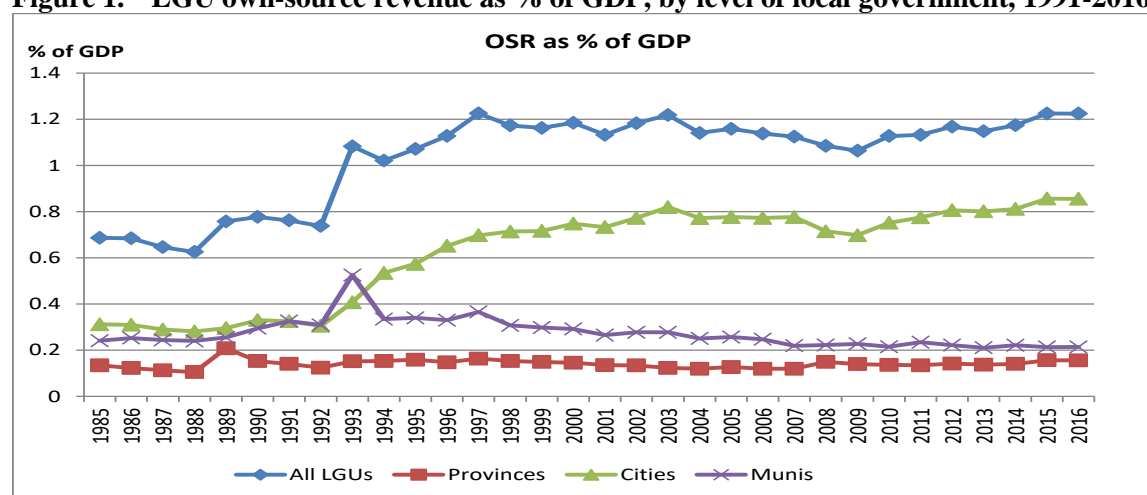
Weak local revenue autonomy and high IRA dependency is manifested by all levels of local governments but is more muted in the case of cities. Moreover, local revenue autonomy has deteriorated with the implementation of the 1991 LGC in the case of both cities and municipalities. To wit, the share of OSR in total LGU income of cities and municipalities declined from 63% and 47%, respectively, in 1985-1991 to 54% and 22%, respectively, in 1992-2016. While the revenue autonomy of provinces has remained

¹⁰ OSR refers to own-source revenue of local government units (LGUs).

practically unchanged before and after the enactment of the LGC, provinces are the least self-reliant, with their OSR accounting for only 16% of their total LGU income (**Table 5**).

After the initial up swell in the early years of LGC implementation, LGU OSR, in general, and local taxes, in particular, have started to show signs of stagnation if not deterioration in 2000-2013, with exception of some slight improvement in 2014-2016. In particular, after increasing almost imperceptibly from 0.14% of GDP in 1991 to 0.15% of GDP in 1993-2000, the OSR of all provinces in the aggregate deteriorated to an average of 0.14% of GDP in 2001-2013 (back to pre-LGC level) before rising to 0.16% of GDP in 2014-2016 (**Figure 1**). In like manner, the OSR of all municipalities in the aggregate increased from 0.33% of GDP in 1991 to an average of 0.38% in 1993-2000 but dipped to an average of 0.23% of GDP in 2001-2016, a level even lower than the average in pre-LGC period. In contrast, the OSR of all cities as a group increased steadily in the post-LGC period. To wit, it went up from 0.20% of GDP in 1991 to a peak of 0.61% of GDP in 1992-2013 and subsequently to 0.67% of GDP in 2014-2016.

Figure 1. LGU own-source revenue as % of GDP, by level of local government, 1991-2016



Low local revenue autonomy may be attributed to (i) limited local taxing authority particularly with respect to rate setting, (ii) limited revenue productivity of assigned local tax bases, and (iii) less than optimal utilization of local taxing powers by LGU officials.

First, LGU tax authority under the 1991 LGC is limited with respect to their power to set tax rates. The Local Government Code (LGC or the Code) explicitly enumerates 11 taxes that LGUs may impose (Table 6). In addition to these 11 taxes, Section 186 of the Code also gives LGUs the power to levy other taxes, fees or charges “on any base or subject not otherwise specifically enumerated herein or taxed under the provisions of the National Internal Revenue Code.” In contrast, Section 133 of the LGC contains the common limitations on the taxing powers of the LGUs, i.e., the taxes, fees, and charges that all LGUs are specifically not allowed to levy.

The low score of the 1991 LGC in terms of the revenue autonomy criterion have been primarily ascribed to the limited power of LGUs to set local tax rates (Manasan 2005, Diokno 2012, ADB 2012). One, the Code fixes the tax rate of some of the taxes that are assigned to LGUs (like the SEF real property tax and the community tax). Two, while LGUs do have some discretion in setting tax rates in the case of other local taxes, the Code sets limits (i.e., floors and ceilings) on the tax rates that LGUs may impose. Moreover, the maximum allowable rates appear to be low. For instance, although the Local Government Code raised the ceiling rate for real property taxation at the provincial level from 0.5% to 1%, it withdrew the power of

municipalities¹¹ to impose such tax, thus maintaining the effective real property tax rate in provincial municipalities at the pre-LGC level (Manasan, 1992). In terms of real property assessment levels, the LGC set maximum assessment rates for different classes of property whereas the levels themselves were fixed in the pre-LGC period. The maximum assessment rates set under the LGC are no higher and often significantly lower than the fixed assessment rates in the pre-LGC period¹², thereby resulting in the reduction in the effective assessment levels of residential land, all types of buildings and all types of machinery, leading to a potentially substantial reduction in real property tax revenues. Three, the Code mandates that tax rates can only be adjusted once in 5 years and by no more than 10%. This provision is particularly restrictive in the case of taxes (like the professional tax and the tax on delivery vans and trucks) whose rates are specified in nominal peso terms. Clearly, the resulting adjustments will not allow LGUs to maintain the real value of their revenues.

Table 6. Taxes assigned to provinces, cities, municipalities and barangays under the 1991 LGC

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

a/ Shares in proceeds of levy of province.

b/ Shares in proceeds of levy of municipalities/ cities

Source: Manasan (2007)

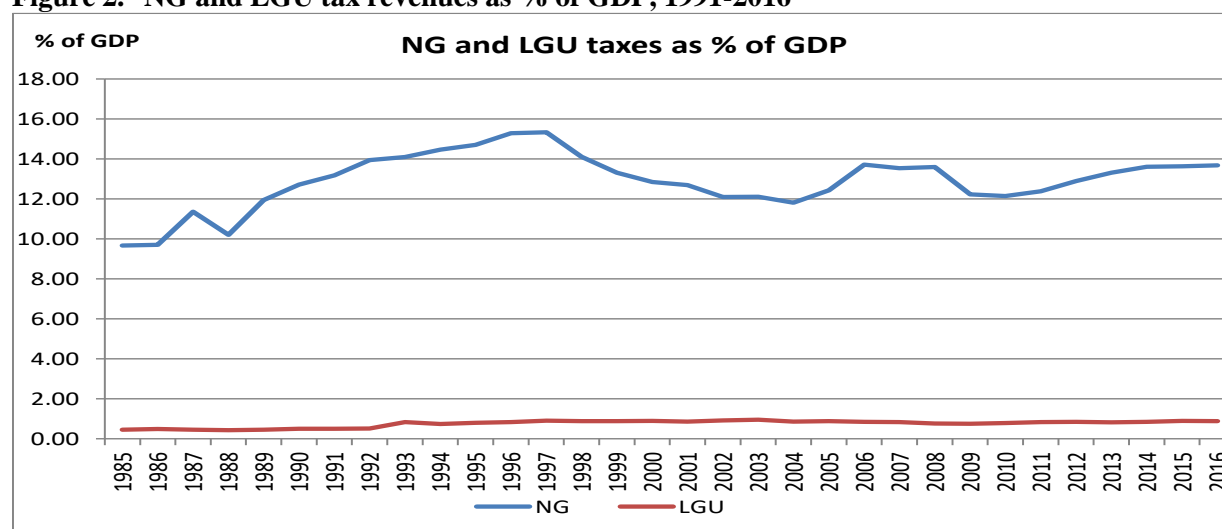
Second, the revenue productivity of the local tax bases assigned to LGUs under the 1991 LGC is likewise limited. The 1991 LGC authorizes LGUs to levy local taxes on a good number of tax bases (including some which were not allowed under Presidential Decree (PD) 231 and PD 464 during the pre-LGC period like banks and other financial institutions, and printing/publication). However, despite these changes, the size of the tax base outside of the real property tax and the local business tax is not significant as the bulk of the productive tax bases still rests with the central government. This point is illustrated starkly in **Figure 2** which shows how small LGU tax revenues (which never breached 1% of GDP in 1991-2016) are relative to national government tax revenues (which ranged from 12%-15% of GDP during the same period) when measured in terms of GDP. Thus, the increase in the share of LGUs in total tax revenues of the general government between the pre-LGC and the post LGC period is modest, from 4.0% in 1985-1991 to an average of 6.0% in 1992-2016.

Only two of the taxes that are assigned to LGUs are actually important in terms of revenue yield. In 1985-1991, prior to the implementation of the LGC, the RPT contributed the bulk (61%) of total local tax revenues of all LGUs in the aggregate, followed by the local business tax (28%) while other taxes accounted for the remainder (11%). In 1992-2016, the local business tax gained more importance with the share of local business tax and RPT in total local tax revenues about equal at 44% and 42%, respectively, while the share of other taxes went up to 13%.

¹¹ Municipalities in Metro Manila are still allowed to impose real property taxes.

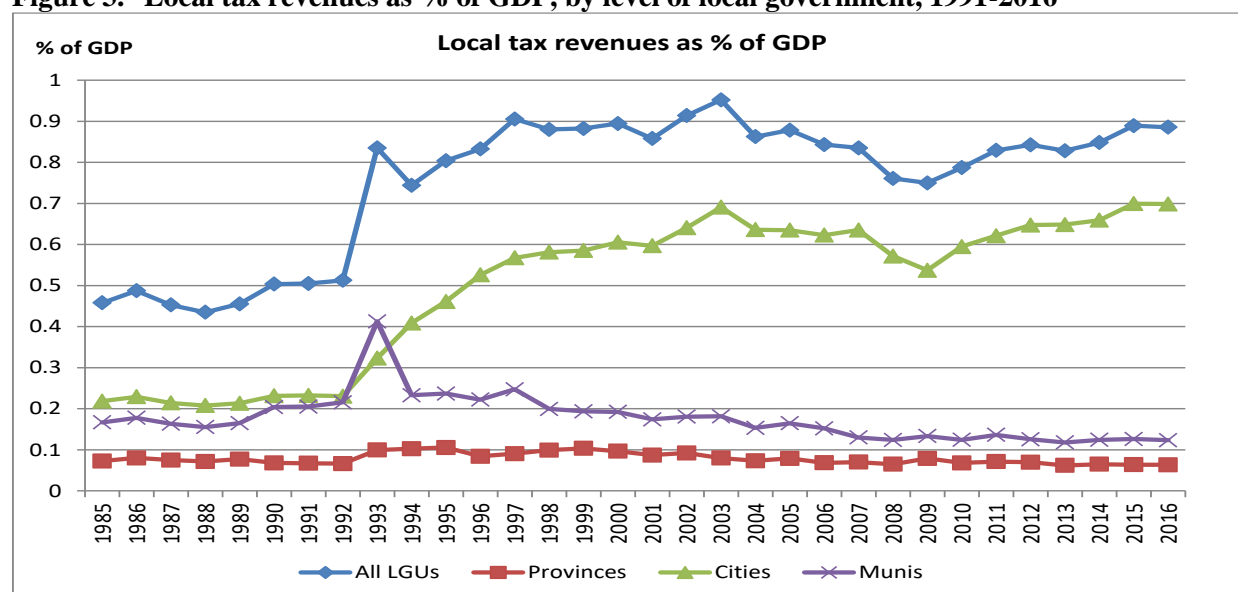
¹² The LGC also provided for the exemption of residential buildings with market value below P175,000 from real property taxation.

Figure 2. NG and LGU tax revenues as % of GDP, 1991-2016



The inadequacy of the tax bases assigned to LGUs is most pronounced in the case of provinces and municipalities. The local tax-to-GDP ratio of provinces is not only the lowest among that of provinces, cities and municipalities, it has also shown a declining trend in more recent years. To wit, after increasing from 0.07% of GDP in 1991 to an average of 0.10% of GDP in 1992-2000, local tax revenue of all provinces in the aggregate gradually dipped to 0.06% of GDP in 2014-2016, a level that is even slightly lower than its 1991 level (**Figure 3**). In like manner, after increasing sharply from 0.21% of GDP in 1991 to 0.41% of GDP in 1993, local tax revenue of all municipalities combined persistently declined to 0.12% of GDP in 2016. On the other hand, local tax revenue of cities has exhibited an upward trend from a low of 0.23% of GDP in 1991 to an average of 0.69% of GDP in 2014-2016. It appears that the LGC has redistributed local tax bases away from provinces and municipalities in favor of cities. Thus, the share of cities in local tax revenues of all LGUs combined increased from 47% in 1985-1991 to 74% in 1992-2016 while the share of provinces in local tax revenues of all LGUs combined decreased from 16% to an average of 9% in 2009-2013 and that of municipalities contracted from 37% to 18% (**Table 5**).

Figure 3. Local tax revenues as % of GDP, by level of local government, 1991-2016



It is also notable that there are significant differences in the degree of self-reliance of LGUs across regions (see last column of **Table 7**), a reflection perhaps of the varying level of economic development across the regions. When all LGUs in a region are taken as a group, LGUs in the NCR, Region IVA and Region III are found to be the most self-reliant in 2015, posting OSR-to-total-LGU-income ratios of 78%, 41% and 33%, respectively. In contrast, LGUs in ARMM, Region IVB, Region VIII and Region II are ranked poorly in this regard, with OSR-to-total-LGU-income ratios of 1.8%, 12.3%, 14.5%, and 14.7%, respectively.

Table 7. LGU OSR performance, by region, 2016

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

The differences in the revenue performance of provinces, cities and municipalities may partly be explained by differences in their tax bases as well as differences in their taxing powers. Being more urbanized and having economies that are more market-based, the tax base of cities tends to be more buoyant when compared to those of municipalities and provinces. However, the changes in the OSR effort of cities may also be explained by the reclassification (i.e., the conversion) of a significant number of municipalities into cities in more recent years. Manasan (2007) compared the revenue effort of the original 60 cities at the time the Code was enacted with the revenue effort of all cities (including those that have been converted from municipalities into cities following the implementation of the Code) and found that almost all of improvement in the revenue effort of all cities in the aggregate in the last half of the 1990s and early 2000s is due to the latter factor.

Third, earlier studies have pointed out that LGUs have not fully maximized the utilization of the local taxing powers that have been assigned to them under the LGC (Manasan 2003, 2007; Talierco 2003). First, many of the personnel assigned to the tax division are not technically well-equipped for their tasks. Very few of these units have certified public accountants in their rolls, thereby impairing their audit capability. Also, not many LGUs have computerized the assessment and collection functions of their Local Treasurers Office. Two, the LGC prescribes different tax rate schedule for different categories of firms. This situation tends to increase administrative and compliance costs and further strains the capacity of an already weak

local tax administration (Taliercio 2003). Three, many LGU officials tend not to fully utilize the tax powers assigned to them. For instance, as of the end of 2015, the schedule of fair market values of real properties was up-to-date in only a small number of LGUs, 22% of all provinces and 7% of cities.¹³ Also, few LGUs have revised their local tax codes since 1992 despite the fact that the rates of some taxes are not indexed to inflation. This development is reportedly due to resistance on the part of either the local chief executive or the local Sanggunian (or both) to increase the tax rates for fear of a backlash from their constituents during election. It may also be due to the disincentive effect of the IRA distribution formula on local tax effort (Manasan 2007).¹⁴

Thus, reform in the area of revenue assignment needs to be focused on enhancing LGUs' revenue autonomy by assigning them more taxes whose rates and bases they can control. In this manner, LGUs will have the incentive to allocate public funds and deliver services in an effective and efficient manner. Greater downward accountability of subnational governments will also be enhanced. Related to this, a number of specific amendments to the 1991 LGC have been proposed including: (i) transferring the authority to approve the schedule of market value (SMV) of real properties (which is used as the basis of real property taxation) from the local Sanggunians to the Department of Finance while still retaining the autonomy of provinces and cities to set tax rates and assessment levels so as to depoliticize the needed adjustments in the RPT tax base; if the SMVs of all provinces and cities were to be fully updated; (ii) simplifying the differentiated and graduated local business tax structure that currently applies to different types of business enterprises to a single flat tax rate not exceeding 1.5% of their gross receipts/ sales, a recommendation that is justified on the grounds that the different graduated local business tax rate schedule for different types of businesses complicates local tax administration and provides a venue for tax evasion, (iii) finding a pragmatic solution to the *situs* issue in the local business tax,¹⁵ and (iv) expanding the taxing powers of provinces by allowing them to impose a surcharge on the national personal income tax (Manasan 2014).

Local taxation and the cost of doing business. More recently, the business sector has called for greater clarity on the taxing powers of LGUs. Section 18 of the 1991 LGC gives LGUs the power and authority to create their own sources of revenues and to levy taxes, fees, and charges provided they do not impose a specified list of taxes levied by the central government. Perhaps because of their desire to raise revenues on their own, some LGUs have decided to raise permit fees and licenses that are at times deemed to be excessive by the business sector and to impose taxes on bases that are otherwise reserved for the central government. This practice has led to numerous disagreements between the LGUs and the business sector that have oftentimes ended in court and added to the cost of doing business and introduced greater uncertainty in the local business environment.

¹³ The Code mandates that LGUs conduct a general revision of market values once every three years with the first one taking effect in 1994.

¹⁴ This finding is based on a regression analysis of per capita local tax revenue on per capita household income (as a proxy for the local tax base) and per capita IRA (as a way to check whether intergovernmental grants stimulate or substitute for local government revenue effort) using panel data for provinces, cities and municipalities for 1995-2000.

¹⁵ While the LGC authorizes all cities and municipalities to levy the local business tax on the gross receipts of all businesses that operate in their jurisdiction, many firms, especially those whose operations are vertically integrated, choose to pay the local business tax on the basis of their consolidated financial statement in the city/ municipality where their head office is located. As result, LGUs which host the plants, branches, warehouses, sales offices, etc. of said vertically integrated businesses find it difficult to secure their rightful share in the local business tax paid by the head office of said businesses. It has also magnified the inequality in the distribution of own-source revenues of LGUs across regions.

Possible design option for tax assignment for the proposed federal government

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

- (i) a residence-based surtax on personal income tax, say, 1% of taxable personal income of residents; this measure is estimated to yield PhP 19 billion a year in 2016 prices, and
- (ii) the motor vehicle user charge (i.e., motor vehicle user charge) and drivers' license fees which are assigned to the central government at present;¹⁶ this measure is estimated to generate PhP 13 billion a year in 2016 prices (**Table 8**).

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

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

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

¹⁶ The transfer of the MVUC from the central government to regional governments may be justified from the perspective of benefit taxation since proceeds from the tax are conceivably used to finance the maintenance of regional and local roads.

Table 8 also presents the likely distribution of revenues from these taxes across the different regional or state governments, assuming for the moment that their jurisdictions will coincide with the existing administrative regions. Ideally, this table should reflect fiscal capacity which may be measured in terms of potential revenue, not actual collections as it does right now.¹⁷

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

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

3.3. Intergovernmental Fiscal Transfers

Intergovernmental transfers of one form or the other¹⁸ are ubiquitous in all federal and decentralized unitary states, generally serving as the primary instrument in the attainment of the following objectives:

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

Because intergovernmental transfers create incentives that affect the efficiency and effectiveness of local public service provision and the accountability of subnational governments, the importance of the design of intergovernmental transfers cannot be overemphasized. In this regard, the fiscal federalism literature indicates the need to use the type of transfer that is consistent with the objective that it is meant to achieve. Conversely, the use of a single type of grant to address multiple objectives will likely result in failing to achieve most of said objectives (Shah 2007a).

¹⁷ For **Table 8**, actual collections of MVUC at the national level are distributed across regions on the basis of the number of registered motor vehicles in the regions. On the other hand, the revenues from the proposed surtax on personal income tax are estimated based on personal household income from the Family Income and Expenditure Survey (FIES) in the regions.

¹⁸ Intergovernmental transfers may take various forms: (i) unconditional or general-purpose grants, (ii) conditional matching grants which delimit the use of the grant to pre-specified activities and which require counterpart financing on the part of subnational governments, and (iii) conditional non-matching grants which delimit the use of the grant to pre-specified activities and which do not require counterpart financing on the part of subnational governments. Differences in the form that intergovernmental transfers takes result in differences in the way they affect the behavior of subnational units.

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

Two, horizontal fiscal gaps, or disparities in fiscal capacity, across regions are largely driven by variations in the economic base available to the regions as a result of the uneven level of economic development across regional jurisdictions (**Table 1**). However, the fiscal capacity of regional governments may also diverge because of differences in their ability to collect taxes as a result of difference in the structure of their local economy (Martinez-Vazquez 2000). More urbanized jurisdictions whose economies are more market-based and dependent on the formal sector may find it easier to collect the business tax than more rural jurisdictions whose economies are less market-based and more dependent on the informal sector. On the other hand, variations in fiscal needs across regions may result from cost differentials due to differences in geographic conditions, poverty incidence, and demographic composition.

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

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

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

- (i) The transfers should take the form of unconditional lump-sum grants because "the objective of equalization is best served by providing subnational governments with the equivalent of their own-revenues, which in principle they can use without any limitations or constraints."
- (ii) The transfer should "not create negative incentives for revenue mobilization by subnational governments, neither should they induce inefficient expenditure choices. ... In order to avoid these negative incentives it is critically important that the formulas do not try to equalize actual revenues and expenditures but instead fiscal capacity and expenditure needs"¹⁹

¹⁹ Expenditure needs refer to the amount of funding necessary to cover the costs of providing all the responsibilities assigned to the subnational government at a standard level of service provisions taking into account "differences in needs arising from different demographic profiles (percent of the population of school age or retired), geographical and climatological conditions, incidence of poverty and unemployment, and so on" (Martinez-Vazquez 2000).

- (iii) The equalization formula should be simple and transparent so that it is easily understood by all stakeholders and “not be subject to political manipulation or negotiation in any of its aspects.”
- (iv) Introduction of equalization transfers should include “hold harmless” or grandfathering provisions to ensure that there is no diminution in the amount of unconditional transfers received by all subnational units relative to the pre-reform period.

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

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

Provisions related to intergovernmental transfers in federal constitutions. Intergovernmental transfers is not a subject matter that is found in the constitutions of all countries with a federal form of government despite the prevalence of vertical and horizontal fiscal gaps. For instance, the US constitution is absolutely silent about intergovernmental transfers of any kind despite the widespread use of the federal government’s power of the purse or spending power to influence state-level governments’ spending priorities (Shah 1991). The same is true in Mexico.

The constitutional provisions related to intergovernmental transfers in federal countries also differ with respect to the purpose of said transfers. For example, the provision on intergovernmental transfers in the Australian constitution is rather open-ended with the federal-level parliament being given the power to grant financial assistance to any State on such terms and conditions as the former sees fit.²⁰

In contrast, the Swiss and German constitutions contain provisions that differentiate intergovernmental transfers with respect to the objectives these grants are meant to support. For instance, the German constitution contains a provision which enables the federal government to extend capital grants to

²⁰ Australia’s fiscal equalization transfers, one of few such transfers in the world that considers both revenue capacity and expenditure needs, is not constitutionally guaranteed but is instead enacted under ordinary legislation.

subnational governments for economic stabilization purposes.²¹ On the other hand, both the German and the Swiss constitutions have provisions that allow their federal governments to use transfers in the pursuit of national level objectives.²² Finally, the constitutions of both countries provide for equalization transfers. In the case of Germany, equalization transfers are intended to be distributed in a manner that “will establish a fair balance, avoid excessive burdens on taxpayers, and *ensure uniformity of living standards throughout the federal territory*.” In comparison, equalization transfer under the Swiss constitution are intended to: “(i) reduce the differences in financial capacity among the cantons; (ii) guarantee the cantons a minimum level of financial resources; (iii) compensate for excessive financial burdens on individual cantons due to geotopographical or socio-demographic factors; (iv) encourage intercantonal cooperation on burden equalization; (v) maintain the tax competitiveness of the cantons by national and international comparison” (Article 135). In both cases, the scheme may be considered fraternal in nature in the sense that the transfer payments are financed partly from the contributions of the richer *Länders*/ cantons and partly by the federal government.

Equalization transfers are also guaranteed in the constitutions of Canada and South Africa. The constitution of Canada states this guarantee in unequivocal terms: “Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that *provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation*.”²³ On the other hand, the constitution of South Africa requires an independent council for the crafting and implementation of its equalization policy (Blöchliger and Kim 2016).²⁴

Meanwhile, the constitution of Argentina includes a provision which allows its National Treasury to grant subsidies to provinces whose incomes fall short of their ordinary expenses. This is perhaps one of the surest ways to dis-incentivize sound fiscal management.

Deficiencies in intergovernmental transfer arrangements under the 1991 LGC

The internal revenue allotment (IRA), a formula-based block grant, accounts for the bulk (94%-99%) of all national government transfers to LGUs in 1994-2014. Most of the remaining transfers come in the form of derivation-based special share of LGUs in other taxes like the excise tax on tobacco products and the VAT and origin-based LGU share in national government income from the exploitation of natural resources. In addition, LGUs also receive sector-specific categorical/ matching grants that are administered by a number of sectoral national government agencies and the Department of Interior and Local Government (DILG).

The 1991 LGC increased the aggregate IRA from a maximum of 20% of total collections from national internal revenue taxes three years prior to the current year as mandated under PD 144 to 40% of collections of national internal revenue taxes.²⁵ As such, under the 1991 LGC, the IRA has not only increased but has

²¹ Article 104b of the German constitution provides that the federal government may give capital grants to the *Länder* and municipalities for the purpose of averting a disturbance of the overall economic equilibrium or for promoting economic growth.

²² Article 104a of the German constitution provides that when the *Länders* act on federal commission (i.e., when the *Länders* implement functions that are inherently the responsibility of the federal government), the federal government is responsible for financing of the resulting expenditures. On the other hand, Article 46(2) of the Swiss Constitution provides that the cantons may implement programs that receive financial support from the Confederation when there is agreement between the Confederation and the cantons that said programs are needed to fulfill specific goals.

²³ This definition is perhaps the closest to the economic definition of equalization transfers.

²⁴ The Commonwealth Grants Commission was established on 1933 under the Commonwealth Grants Commission Act to recommend how the revenues raised from the Goods and Services Tax (GST) should be distributed to the States and Territories to achieve horizontal fiscal equalization (HFE).

²⁵ The amount of IRA that was actually appropriated in the pre-Code era was 13% of net BIR tax receipts on the average in 1987-1990.

also become a more predictable and secure source of funding for LGUs that allows them wide discretion in terms of spending allocation.²⁶

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

Because of the higher LGU share in national internal revenue taxes under the 1991 LGC, the IRA rose from 0.5% of GDP in 1985-1991 to 2.2% of GDP in 1992-2016 and the contribution of the IRA to total LGU income of all LGUs combined went up from 35% to 64% (**Table 9**). However, because of the assignment of greater taxing powers to cities and municipalities and the more buoyant local tax base in cities, plus the smaller share of provinces in the aggregate IRA compared to that of municipalities, provinces are more IRA-dependent than cities and municipalities in the post-1991 LGC period.

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

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

Another weakness of the IRA design pertains to its inability to sufficiently equalize the *net* fiscal capacity of LGUs in the sense of providing more resources to LGUs with lower revenue capacity relative to their needs and less to LGUs with greater revenue capacity relative to their needs. This follows from the fact that the IRA distribution formula only takes into account indicators of expenditure needs like population and land area and does not explicitly consider the revenue raising capacity of LGUs. Note that the IRA is distributed to specific LGUs within each level according to a pre-determined formula that is based on

²⁶ Despite a provision in the 1991 LGC that calls for the automatic release of the 40% IRA share of LGUs in national internal revenue taxes, the national government failed to either appropriate or release the designated IRA amount in 1998-2004 because of fiscal difficulties faced by the national government. However, after two Supreme Court rulings, that supported the LGU position, one in 2000 and another one in 2004, a law was passed in 2006 stating that henceforth the IRA will be automatically appropriated.

population (50 percent), land area (25 percent) and equal sharing (25 percent).²⁷ There is also some evidence that the IRA distribution formula was counter-equalizing in the case of provinces and municipalities but was weakly equalizing in the case of cities (Manasan 2003). This finding is still generally supported by analysis done for this study using more recent data.²⁸

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

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

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

If the proposed design option for the assignment of expenditure functions are as outlined in **Section 3.1** and if the proposed design option for the assignment of taxing powers are as discussed in **Section 3.2**, then the vertical fiscal gap is estimated to be about PhP 1,086 billion, 84% of the total expenditure needs of subnational governments or 57% of total revenues from national government internal revenue taxes in the current year or 7.5% of GDP (**Table 10**). It should be emphasized that this figure is inclusive of the amount that is currently distributed to LGUs in the form of the IRA.

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

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

a/ refers to LGU expd responsibilities under the LGC

b/ inclusive of the amount that is now distributed in the form of IRA

²⁷ In contrast, the weights used under PD 144 were: population (70%), land area (20%) and equal sharing (10%).

²⁸ When 2012 data is used, the distribution of the IRA across individual cities and across individual municipalities was found to be counter-equalizing. On the other hand, the same data set shows that the distribution of the IRA across provinces is weakly equalizing.

The estimates of the expenditure needs in **Table 10** refer to actual expenditures of LGUs in the case of old SG expenditure functions. In the case of new SG expenditure functions which are proposed to be re-assigned to regional governments under a federal set-up, the estimates are based on actual aggregate spending of the central government at present which is distributed to the different regions using some allocation factor like population, etc. Admittedly, this approach is far from ideal and should be treated as indicative only.

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

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

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

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

^{a/} refers to LGU expd responsibilities under the LGC

3.4. Subnational Government Borrowing

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

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

In principle, fiscally unsustainable behavior of subnational governments can be avoided if they face hard budget constraints. If the credit market is functioning properly, the risk of excessive borrowing by subnational government is averted even if subnational governments have full borrowing autonomy. This occurs as the credit market ensures that only creditworthy subnational governments will be able to borrow and only to the extent that they have the capacity to service their debt. However, when the market players perceive a lack of credible commitment on the part of the central government not to bail out subnational governments in fiscal distress, then market discipline breaks down. On the one hand, financial institutions do not have the incentive to diligently apply prudent creditworthiness tests when they evaluate subnational government loan applications. On the other hand, subnational governments will have the incentive to spend beyond their means and borrow excessively.

The credit market's bailout expectations are driven by (i) previous history of actual central government bailouts, and/ or (ii) the extent of the revenue autonomy of subnational governments. The first point is obvious. If the central government has a history of assuming the debt of fiscally weak subnational governments in the past, then the market will come to expect that they will behave in the same manner in the future. Second, the political economy fiscal federalism literature suggest that bail expectations are strong when subnational governments rely on revenue sharing and intergovernmental transfers rather than on local taxes in financing local spending. Rodden (2006) expounds on this point further: "When a highly transfer-dependent government faces default and must close schools and fire stations or fail to deliver health or welfare benefits that are viewed as national entitlements, the eyes of voters and creditors turn quickly to the center for a solution, even if the fiscal crisis was actually precipitated by bad decisions at the local level.

If local governments believe that the center's role in financing them will cause the political pain of default to be deflected upward, this affects not only their beliefs about the probability of a bailout, but also reduces their own disutility of default." Thus, "intergovernmental grants are at the heart of the commitment problem." ... "When the link between taxes and benefits is distorted or broken, as is the case with intergovernmental grants, voters are less likely to sanction overspending by politicians. Intergovernmental grants create the appearance that local public expenditures are funded by non-residents."

Given this perspective, the guidance from the fiscal federalism literature on subnational government access to the credit and capital market may be summarized as follows:

- (i) The first best approach to the issue is to increase the revenue autonomy of subnational governments giving them more independent taxing authority. In this manner, the efficiency and accountability gains from more decentralized spending and more autonomous subnational borrowing will be more forthcoming.
- (ii) A strong commitment on the part of the central/ federal government not to bail out fiscally distressed subnational governments and not to guarantee subnational government borrowing is needed to help ensure fiscal discipline in all levels of government. The no bailout rule may be reinforced by the institution of insolvency frameworks that will specify the policies and mechanisms that will apply in the event of subnational government bankruptcy.
- (iii) Perhaps in response to the subnational debt crises in a number of countries (e.g., Brazil, Mexico, India, and Russia during the 1990s, multilateral agencies (e.g., World Bank, IMF) have advised decentralized governments, particularly those where taxation is not, or only weakly, decentralized, to strengthen the regulatory frameworks for subnational government debt financing. These frameworks generally include fiscal rules or *ex ante* borrowing regulations which "may take the form of quantitative ceilings on borrowing, debt, or debt service of subnational governments (often specified in relation to these government revenues, as in Brazil and Colombia); or of procedural rules relating to subnational governments' budget processes. These rules may be embodied in national legislation (e.g., Brazil and Spain) or in subnational government constitutions or laws (e.g., some states of the US and some Canadian provinces). The effectiveness of such rules depends on their specificity, comprehensiveness of coverage, and most important, the degree of political commitment to their observance and enforcement. The design of the rules also matters, particularly clear specification of appropriate escape clauses (that is, legal provisions that would waive the application of the fiscal rules under well-specified circumstances, such a national disaster or similar) and of credible sanctions for noncompliance" (Fedelino and Ter-Minassian 2000).

Related to this, Boadway and Shah (2009) argue that "fiscal rules are neither necessary nor sufficient for fiscal discipline. However, fiscal rules accompanied by "gatekeeper" intergovernmental councils or committees provide a useful framework for fiscal discipline and fiscal policy coordination for countries with fragmented political regimes." On the other hand, Blöchliger and Kim (2016) point out that "constitutional fiscal rules are more difficult to amend and may entail high reputation costs for the government if breached."

- (iv) One of the fiscal rules related to subnational government budget processes mandates balanced budgets net of public investment or, alternatively, that borrowing is allowed only for long-term public capital investments.²⁹ Many countries (e.g., Germany, Brazil, India, and Russia) have enacted laws to this effect. On the other hand, the South African constitution prohibits borrowing for consumption expenditure (South Africa National Treasury 2001: 192 as cited in Liu 2010).

²⁹ This is sometimes referred to as the "golden rule."

Provisions related to subnational government borrowing in federal constitutions. The adherence to the golden rule (i.e., borrowing for the sole purpose of making capital investments) is specified in the constitutions of some federal countries. This is true, for example, of Mexico (Article 117-viii, paragraph 2), Brazil, except when authorized otherwise by supplemental or special appropriations for a precise purpose and approved by an absolute majority of the Legislature (Article 167-iii) and South Africa as noted above.

With regards to provisions related to federal government bail-out of the subnational governments debt, “the Brazilian and Spanish constitutions forbid them, while those of Argentina and Germany enable them, ... And, although, some fiscal constitutions do not contain explicit bail-out provisions, they offer alternatives such as federal borrowing guarantees which are akin to an implicit bailout” (e.g. Pakistan) (Blöchliger and Kim 2016).

The treatment of subnational government access to borrowing in federal constitutions varies from country to country. For instance, the constitution of Mexico does not allow the states to borrow directly or indirectly from foreign sources or in foreign currency (Article 117-viii, paragraph 1). In contrast, the constitution of Pakistan allows provinces to borrow from domestic and international sources within such limits as may be fixed by provincial legislation (Article 167-1&4). Meanwhile, the constitution of Malaysia provides that states may borrow only from the federation or from a bank or other financial source approved by the federal government and subject to such conditions as may be specified by the federal government and only under the authority of a state law (Article 111). In like manner, in Spain, the state and the self-governing communities must be authorized by law before they can issue bonds or contract loans (Section 135-3).

The constitutions of a good number of federal countries include references to balanced budget rules or the like. For example, the constitution of Germany provides that the budgets of the Federation and the *Länder* shall in principle be balanced without revenue from credits (Art. 109-3 and Article 115-2). Similarly, the constitution of Switzerland states that the Confederation shall maintain its income and expenditure in balance over time (Article 126-1). The constitution of Austria includes a somewhat less prescriptive, more aspirational provision: “The Federation, the *Laender*, and the municipalities must aim at the securement of an overall balance and sustainable balanced budgets in the conduct of their economic affairs” (Article 13-2).

Finally, Constitutional provisions that call for the enactment of legislation that would set debt/ deficit limits and other types of fiscal rules are also evident in the constitutions of some federal countries. This is the case in Mexico (Article 73-3), Brazil (Article 52) and Spain (Article 135).

Deficiencies in subnational government borrowing framework under the 1991 LGC

The 1991 Local Government Code liberalized LGUs’ access to the credit and capital markets. More specifically, the 1991 LGC gives LGUs the power to borrow from government banks, domestic private banks and other lending institutions for the purpose of financing the construction, installation, improvement, expansion, operation, or maintenance of public facilities, infrastructure facilities, housing projects, the acquisition of real property, and the implementation of other capital investment projects (Section 297).³⁰ Provinces, cities and municipalities are also allowed to issue bonds, debentures, securities and other obligations to finance self-liquidating, income-producing development or livelihood projects (Section 299).³¹ Moreover, the 1991 LGC incorporated relevant provisions of Republic Act 6957 (Build-Operate-Transfer Law) and authorized LGUs to enter into public-private partnership (PPP) arrangements

³⁰ Under Presidential Decree 752 of 1975 (which governed LGU credit finance in the pre-1991 period), LGUs were only allowed to borrow from government financial institutions (Presidential Decree 752 of 1975).

³¹ Under PD 752, only provinces and cities were given this power.

for the financing, construction, operation, and maintenance of any financially viable infrastructure facilities (Section 302).

The regulatory framework governing sub-national debt in the Philippines is largely oriented toward the enforcement of *ex ante* rules and procedures that apply before LGUs are actually able to access the credit market. However, it does not include *ex-post* remedies, i.e. procedures to work out cases of fiscal distress and insolvency. Thus, the system may be described as one that is focused solely on the prevention of borrowing default and fiscal distress but one that is extremely weak in mitigating their *ex-post* impact (Manasan 2015).

Statutory ex ante rules. The regulation of LGU debt in the Philippines operates largely through *ex ante* fiscal rules for LGUs that are defined in the 1991 LGC and take two forms: (i) balanced budget constraint and (ii) cap on debt service capacity.

Local governments in the Philippines are subject to some form of the balanced budget constraint (golden rule), albeit somewhat weaker relative to those in other countries. One of the fundamental principles of local fiscal administration set forth in Section 305 of the Local Government Code (LGC) says: “The local government unit shall endeavor to have a balanced budget in each fiscal year of operation” (Section 305 - m).

The LGC also provides that the aggregate amount appropriated in the budgets of LGUs for any given fiscal year shall not exceed the estimates of income (Section 324). Taken together, these two provisions of the Code have generally been interpreted to mean that proposed and approved budget appropriations for current operating expenditures during any given fiscal year shall not exceed current revenues in that year. In other words, the operating fiscal balance or current fiscal balance (i.e., current revenues less current expenditures) is not allowed to be in deficit.

For many, these provisions have also meant that LGU borrowing can only be undertaken to finance investment expenditure. This view is further reinforced by the Updated Budget Operation Manual (UBOM) which includes borrowings as one of the income sources that has to be estimated as part of budget preparation and which specifies that the proceeds from borrowings are to be used to finance the development of capital projects (DBM 2005 p. 53).

However, Section 296 (b) of the Local Government Code (General Policy on Credit Financing) says: “A local government unit may avail of credit lines from government or private banks and lending institutions for the purpose of stabilizing local finances.”³² This provision implies that LGUs may also borrow to bridge short-term cash flow shortfalls that may result in an actual current operating fiscal deficit.

On the other hand, Section 324(b) of the 1991 LGC provides that appropriations for debt service shall not exceed 20% of LGUs’ regular income.³³ Enforcing this provision is at the core of central government control of LGU borrowing in the Philippines as can be seen below.

Central government administrative and procedural controls. The current regulatory system in the country also employs a number of additional central control mechanisms which cut across five central agencies namely, the Bureau of Local Government Finance (BLGF), Bangko Sentral ng Pilipinas (BSP), Department

³² Unlike the 1991 LGC which poses no restrictions on LGU borrowing for the purpose of stabilizing LGU finances, PD 752 limited the size of such borrowing to not more than 15% of their regular income (or roughly equivalent to two-months’ worth of regular LGU income) and required that the same be paid in full in the first quarter of the year immediately following the year when the loan was secured.

³³ This is translated into a ceiling for borrowing capacity by the Bureau of Local Government Finance.

of the Interior and Local Government (DILG), Commission on Audit (COA), and the Department of Finance (DOF). Changes in the procedural and documentary requirements put in place to enforce the *ex ante* fiscal and monetary rules outlined in the Local Government Code and the New Central Bank Act³⁴ that were instituted in 2012 have made the regulatory regime governing LGU borrowing more complicated and burdensome. Prior to 2012, central government controls over LGU access to the credit market were limited solely by the BLGF's issuance of the Certificate of Debt Service Capacity and the Certificate of Borrowing Capacity. In April 2012, new central government regulations on LGU access to loans were put in place which involve more documentary requirements from more central government agencies.

For instance, starting in 2012, after securing the Certificate of Debt Service Capacity and Certificate of Borrowing Capacity from the BLGF, LGUs are required to obtain a Monetary Board opinion before their loans can be released by the lending institution. Furthermore, the BLGF requires LGUs to have a Seal of Good Housekeeping from the DILG, Audit Certificates from the COA showing no adverse findings in the last three years, and a certification from lenders that it will not require LGU deposits as compensating balance for the loan. This shift towards a more restrictive regulatory regime apparently came about because of concerns with poor governance on the part of both LGUs and lending institutions (World Bank 2014).

Trends in LGU borrowing. Concomitant with the enhancements in LGU access to the credit and capital market under the 1991 LGC, LGU borrowing for all LGUs combined rose more than ten-fold from a miniscule 0.01% of GDP in 1985-1991 to an average of 0.14% of GDP in 1992-2013 (**Table 12**). Also, the contribution of borrowing to the financing of capital investments rose from 5% in 1985-1991 to 24% in 1992-2013 for all LGUs in the aggregate.

Although borrowings of all levels of government increased markedly in the post-1991 LGC period, the growth in the borrowings of cities was more pronounced compared to that of provinces and municipalities (**Figure 4**). Thus, the share of cities and municipalities in total LGU borrowing expanded from 38% and 11%, respectively, in 1985-1991 to 49% and 24% in 1992-2016 while that of provinces contracted from 51% to 27% (**Table 12**).

However, the overall level of LGU indebtedness in the Philippines at 0.6% of GDP in 2002-2016 (**Table 13**) remains low not only when viewed relative to that of other countries³⁵ but also relative to the high unmet need for LGU capital spending that is suggested by the low levels of LGU capital spending. This is worrisome considering the close association between capital spending and LGU borrowing (**Figure 5**). The low demand for LGU debt in the Philippines has been attributed by Liu, Llanto and Petersen (2013) to a number of factors that includes among others: (i) the major role that national government agencies continue to play in the delivery and finance of devolved services, (ii) the dependence of many LGUs on “pork barrel” of legislators to finance local projects, (iii) the low fiscal capacity of poorer LGUs to leverage borrowings, and (iv) the weak technical capacity to develop projects suitable for credit financing. Moreover, the stringent procedural requirements that LGUs have to comply with to access the credit market that were put in place in 2012 appear to have contributed to further muting of the demand for LGU borrowing (**Table 12**). On the supply side, the LGU credit market is also constrained by the limited participation of private

³⁴ Section 123 of the New Central Bank Act (Republic Act No. 7653) provides that “whenever the Government (including all its political subdivisions and instrumentalities) contemplates borrowing from within or outside the Philippines, the prior opinion of the Monetary Board shall be sought with regard to the probable effects of the proposed operation on monetary aggregates, price levels, and the balance of payments.” While the law has been in effect since 1993, the *Bangko Sentral ng Pilipinas* (BSP) did not enforce this requirement with respect to LGU loans until 2012, when it issued a circular requiring all LGU borrowings to secure a Monetary Board opinion before loan transactions can be processed (Bangko Sentral Circular No. 769, Series of 2012).

³⁵ Subnational debt outstanding was estimated to be equal to 5.0% of GDP on the average for a sample of 20 developing and transitioning countries in 2006 (Petersen and Soriano, 2008 as cited in Liu, Llanto, and Petersen, 2013).

financial institutions (PFIs) as a result of the undue advantage that government financial institutions have in effectively being able to intercept the IRA arising from their role as primary LGU depository bank. This lack of competition in the LGU debt market has increased the cost of LGU borrowing which further compresses LGU demand for debt.

Table 12. LGU borrowing and LGU capital expenditures, 1985-2016

	1985-1991	1992-2000	2001-2010	2011-2016	1992-2016		1985-1991	1992-2000	2001-2010	2011-2016	1992-2016
Borrowings as % of GDP						Capital expd as % of GDP					
All LGUs	0.01	0.13	0.15	0.11	0.13	All LGUs	0.23	0.62	0.57	0.59	0.59
Provinces	0.01	0.02	0.04	0.03	0.04	Provinces	0.08	0.13	0.12	0.14	0.13
Cities	0.00	0.08	0.08	0.05	0.06	Cities	0.07	0.32	0.29	0.28	0.29
Munis	0.00	0.02	0.03	0.03	0.03	Munis	0.08	0.16	0.16	0.18	0.17
Share in borrowings of all LGUs						Share in capex of all LGUs					
All LGUs	100.0	100.0	100.0	100.0	100.0	All LGUs	100.0	100.0	100.0	100.0	100.0
Provinces	51.4	19.0	26.1	31.0	27.1	Provinces	33.5	20.8	21.4	23.4	22.2
Cities	37.5	62.1	51.1	42.7	49.3	Cities	31.6	52.7	50.7	46.4	49.0
Munis	11.1	18.8	22.8	26.2	23.6	Munis	34.9	26.5	27.9	30.3	28.8
Borrowings as % of capital expd											
All LGUs	5.0	21.1	26.5	18.8	22.1						
Provinces	7.7	19.2	32.2	24.9	26.8						
Cities	5.9	24.9	26.7	17.3	22.2						
Munis	1.6	15.0	21.7	16.3	18.1						

Author's estimates based on COA-APR data

Figure 4. LGU borrowing, by level of LGU, 1985-2016

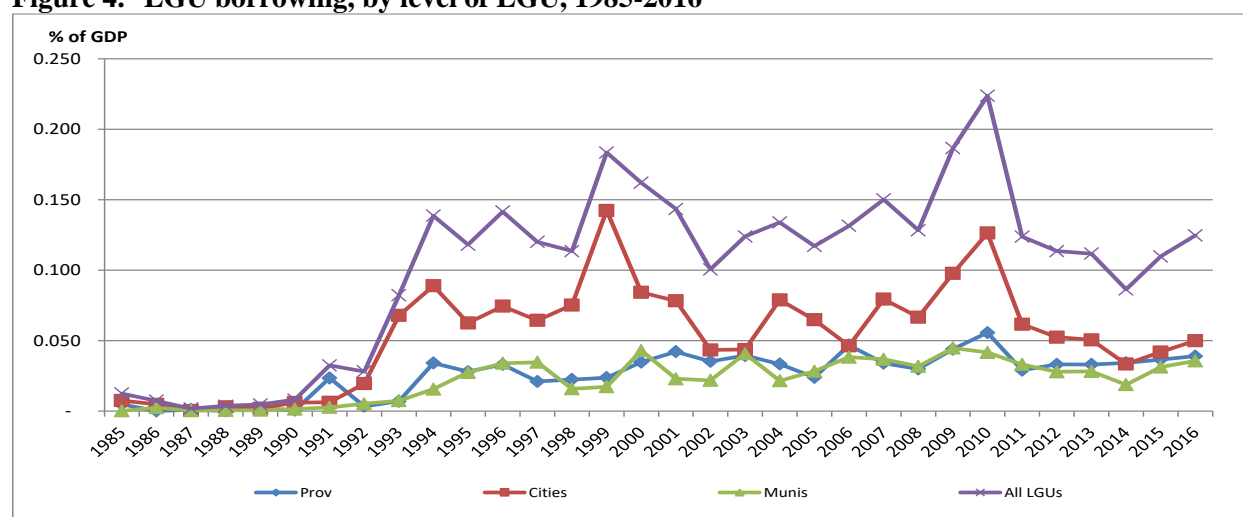
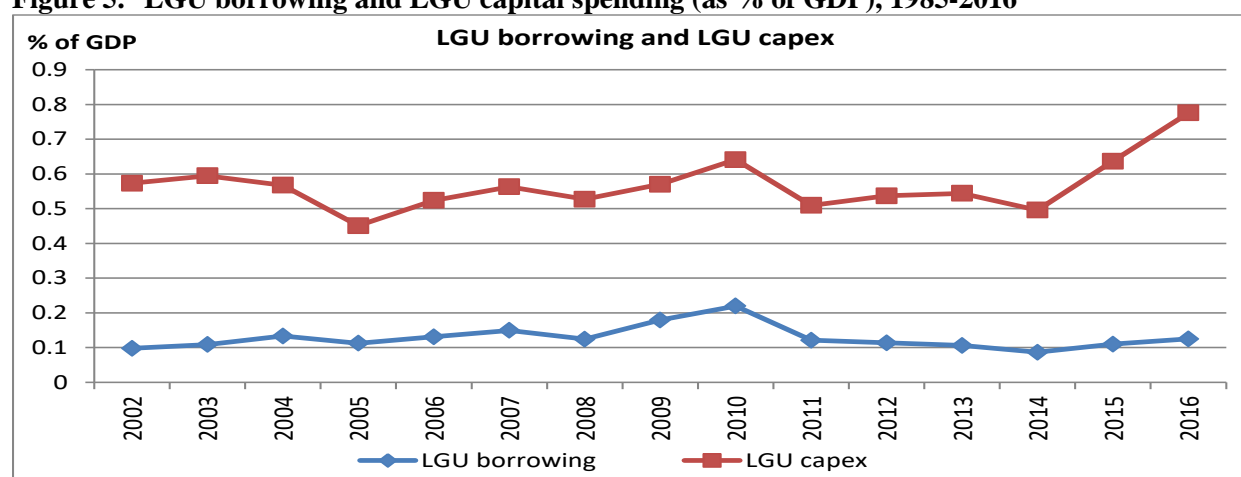


Table 13. LGU borrowings, LGU debt outstanding and LGU overall fiscal position, 2002-2016

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
LGU borrowings (in million PhP)	4,090	4,937	6,806	6,373	8,211	10,286	9,578	14,362	19,768	11,760	11,993	12,225	10,909	14,621	18,044
LGU borrowings (% of GDP)	0.10	0.11	0.13	0.11	0.13	0.15	0.12	0.18	0.22	0.12	0.11	0.11	0.09	0.11	0.12
LGU loans outstanding (in million PhP)	25,100	28,162	31,782	37,841	36,798	45,844	46,779	57,560	68,346	72,039	74,804	76,190	75,634	61,726	65,450
LGU loans outstanding (% of GDP)	0.60	0.62	0.62	0.67	0.59	0.67	0.61	0.72	0.76	0.74	0.71	0.66	0.60	0.46	0.45
LGU overall surplus/ (deficit) (in million PhP)	25,544	54,977	13,570	26,284	26,096	21,120	45,696	33,896	32,076	52,781	34,535	42,585	76,076	68,779	63,076
LGU overall surplus/ (deficit) (% of GDP)	0.61	1.21	0.27	0.46	0.42	0.31	0.59	0.42	0.36	0.54	0.33	0.37	0.60	0.52	0.44
LGU capex as % of GDP	0.57	0.59	0.57	0.45	0.52	0.56	0.53	0.57	0.64	0.51	0.54	0.54	0.50	0.64	0.78
NG Debt (% of GDP)	67.1	73.8	74.4	68.5	61.4	53.9	54.7	54.8	52.4	51.0	51.5	49.2	45.4	44.7	42.1
NG overall surplus/ (deficit) (% of GDP)	(5.0)	(4.4)	(3.7)	(2.6)	(1.0)	(0.2)	(0.9)	(3.7)	(3.5)	(2.0)	(2.3)	(1.4)	(0.6)	(0.9)	(2.4)

Source of basic data: Acquisition of loans and loans outstanding from COA, GDP from NSCB and NG debt from BTr

Figure 5. LGU borrowing and LGU capital spending (as % of GDP), 1985-2016



Direction of needed improvements in the statutory LGU borrowing framework. Although LGU debt level in the Philippines is undoubtedly low at present, it cannot be denied that sub-national government borrowing is associated with risks of fiscal distress and fiscal insolvency that may result from excessive or inappropriate local government debt accumulation. The 1991 LGC appears to fall short when viewed from the perspective of international good practice as discussed in the previous subsection. Although the 1991 LGC includes provisions that allude to a balanced budget constraint or golden rule, Section 296 (b) allows LGUs to borrow to bridge short-term cash flow shortfalls.³⁶ Moreover, the 1991 LGC, unlike PD 752 before it, does not include a provision that mandates LGUs to pay in full provisional advances in the first quarter of the year immediately following the year when the loan was secured in order to prevent the rolling over of borrowings undertaken for financing current operating deficits. Related to this, Liu, Llanto and Petersen (2013) estimated that about 80 percent of GFI lending to LGUs is for capital projects and the other 20 percent is for cash flow purposes (borrowing in anticipation of collections of taxes or aid payments).

³⁶ Liu, Llanto and Petersen (2013) estimated that about 80 percent of GFI lending to LGUs is for capital projects and the other 20 percent is for cash flow purposes (borrowing in anticipation of tax collections or aid payments).

Furthermore, the debt service cap under the 1991 LGC is expressed in relation to LGU total regular income. The Commission on Audit (COA 2009) points out that some LGUs had difficulty amortizing their indebtedness even if their actual debt service capacity was less than 20% of the debt service cap. Because of this, the COA recommended that the computation of debt service capacity should take into account not just regular revenues but also mandatory expenditures and cash flow. In like manner, the IMF (2012) recommended that the debt service cap be computed relative to LGUs' net operating surplus (NOS) on the ground that the NOS provides a better measure of LGUs' capacity to service their debt than their regular income. On the other hand, the WB (2014) further refined the IMF's advice in the context of the existing LGU budgeting practice in the Philippines and recommended that debt service capacity of LGUs be computed relative to LGUs' net operating primary surplus (i.e., total LGU recurrent revenues less current operating expenditures before interest payments) adjusted for continuing appropriations and accounts payable (or adjusted NOPS, for short) while at the same time increasing the prescribed debt service ratio from the present 20% to a number very close to 100%.³⁷

Also, the importance of revisiting the rules on LGU depository bank cannot be overemphasized, given the need to make the LGU credit and capital market more competitive by fostering greater participation of private financial institutions in the market so as reduce the cost of borrowing and increase LGU demand for financing.

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

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

4. FISCAL COST OF ADOPTION OF FEDERAL FORM OF GOVERNMENT

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

- (i) Salaries of governors and vice governors of regional governments and their staff as well as operating expense of their offices
- (ii) Salaries of Senators (second chamber) and their staff as well as operating expense of their offices – 3 to 7 senators per regional government under the original PDP-Laban model

³⁷ Manasan (2015) found that 27% of all LGUs for which data is available in 2013 either have negative adjusted NOPS or have debt service (DS) in excess of 100% of their adjusted NOPS and, thus, score low in terms of creditworthiness. At the same time, the prevalence of LGUs with less than sterling creditworthy qualities which were able to access new or additional borrowing in 2013 is not small. More specifically, 78 (or 43%) out of the 181 LGUs that accessed new or additional borrowing in 2013 either have negative adjusted NOPS or have DS in excess of 100% of their adjusted NOPS.

- (iii) Salaries of members of the judiciary at the state government level, their staff as well as operating expense of their offices³⁸
- (iv) Salaries of state legislators and their staff as well as operating expense of their offices
 - Prior to the enactment of the Organic Act of each region, Regional Consultative Assembly – 3 from each LGU comprising the regional government
 - After enactment of Organic Act of each region, Regional Assembly – 2 from each province and one from each city.³⁹

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

5. CONCLUSION

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

Moving forward, it should be stressed that even if the initial design of the federal model is coherent at the start, the likelihood is high that the initial model will be changed to reflect the particular interests of the framers of the new constitution. In this regard, a good understanding of the political economy of attempts to reform the decentralization regime in the Philippines is instructive. Matsuda (2011) pointed out that Congress as an institution is not likely to expand the resource of local governments. To wit: "Fiscally stronger LGUs depend less on individual national legislators for financial assistance and hence would result in loss of political leverage for members of the Congress [over the LGUs within their districts]. ... If more resources were made available to provinces, governors could emerge as strong political rivals, more so than

³⁸ The cost related to this has not been included in the estimates because of the lack of detail on how the judiciary will be affected by the proposed shift to the federal form.

³⁹ Federalism models other than the PDP-Laban's propose a bigger number of regional level legislators (i) 3 legislators elected by popular vote in each province/ city plus 3 sectoral representatives in each province/ city or a total of 1,428 regional level legislators under former Senator Nene Pimentel's proposal, and (ii) at least 10 legislators per legislative district (40% of whom are elected by popular vote, 50% are party representatives, and 10% are sectoral representatives) or a total of 2,380 regional legislators under the current version of the proposed Bangsamoro Basic Law (BBL).

they are already” (Matsuda 2011). From this perspective, it matters a lot whether it is the Constituent Assembly or a Constitutional Convention that is given the task to amend/ overhaul the Philippine Constitution if the potential benefits from the shift to a federal form of government are to be realized.

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

- (i) reform of the party system so as to institutionalized strong political parties with “coherent ideological programs and policy platforms and internal organizational discipline” (Matsuda 2014); related to this, government budget support of political parties is also indicated; and
- (ii) the lowering, if not the outright elimination of the high barrier to entry in the political arena, including presence of political dynasties (Pilapil 2016).

There is also a need to reverse the undue concentration of power over fiscal resources in the executive branch of the central government that currently prevails because such a situation tends to distort the incentives for more autonomous and accountable subnational units. This point may be better appreciated in the light of the discussion below.

Despite the promise of greater fiscal decentralization under the 1991 Local Government Code, resource allocation and revenue mobilization continued to be highly centralized in the post-Code period. In 2015, for instance, the central government had effective control in allocating 84% of aggregate general government spending even as it was responsible for generating 93% of total general government revenues. Beyond these aggregate numbers, the ambit of central government control over spending is manifested in the disproportionate portion of the appropriations intended for the regional operations of various departments under the General Appropriations Act (GAA) that is set aside for their central offices (**Table 14**), indicative of the wide degree of discretion that these central offices possess in allocating these amounts to the different regions during budget execution. It should be emphasized that the issue here is not so much that the NCR and its periphery (i.e., Regions III and IVA) receive a disproportionate share of national government spending relative to their contribution to the economy (as measured by GRDP share, for instance) or to their need for public services (as measured by their share in population, for example) because, in fact, this is not necessarily the case especially in recent years. Compare the share of the various regions in the budgets of various departments with their corresponding share in GRDP and population in the last two columns of **Table 14**. Rather, the issue is that, by providing the venue for legislators and local government officials to access additional budgetary resources in the common pool via transactional politics, this undue concentration of power over fiscal resources that is currently lodged with the executive branch of the central government adds an additional layer of distortions on the incentives for more accountable governance at the local level that have already been compromised by the weak structural design of the NG-LGU fiscal relations under the present decentralized set up.⁴⁰ This discussion, thus, further highlights the equal importance of the design of the details of the fiscal decentralization framework and the overall political context.

⁴⁰ For instance, weak revenue autonomy of LGUs and the unclear expenditure assignment under the 1991 LGC does not foster the right incentives for efficient, effective and accountable local governance.

Table 14. Allocation for regional operations in the 2016 GAA budgets of selected departments

Regions	DA		BFAR		DENR		DPWH ^{a/}		DTI		DSWD		DILG		DOH		DepEd		Total		GRDP share	Popn share
	PhP M	% distn	PhP M	% distn	PhP M	% distn	PhP M	% distn	PhP M	% distn	PhP M	% distn	PhP M	% distn	PhP M	% distn	PhP M	% distn	PhP M	% distn		
CO++	4,528	16.4	2964.4	53.9	2,379	19.9	15,911	18.9	261	13.9	5,843	47.7	969	9.0	17,176	17.0	20,483	5.5	70,514	11.2		
NCR		0.0		0.0	54	0.5	18,105	21.5	6	0.3	748	6.1	156	1.4	3,169	3.1	30,835	8.3	53,073	8.4	37.9	12.8
CAR	1,114	4.0	34.8	0.6	546	4.6	746	0.9	81	4.3	197	1.6	640	5.9	2,609	2.6	7,787	2.1	13,755	2.2	1.8	1.7
RI	2,023	7.3	152.3	2.8	302	2.5	2,205	2.6	90	4.8	355	2.9	444	4.1	5,576	5.5	20,893	5.6	32,041	5.1	3.1	5.0
II	2,195	8.0	148.3	2.7	501	4.2	1,762	2.1	106	5.7	274	2.2	317	2.9	3,745	3.7	13,207	3.5	22,256	3.5	1.8	3.4
III	2,243	8.1	174.3	3.2	550	4.6	4,610	5.5	140	7.5	514	4.2	383	3.5	7,463	7.4	31,326	8.4	47,404	7.5	8.9	11.1
IVA	1,754	6.4	170.9	3.1	864	7.2	5,752	6.8	160	8.6	560	4.6	469	4.3	7,441	7.4	39,600	10.6	56,772	9.0	15.5	14.4
IVB	1,311	4.8	189.4	3.4	731	6.1	1,469	1.7	86	4.6	294	2.4	557	5.2	4,062	4.0	20,040	5.4	28,740	4.6	1.5	3.0
V	1,440	5.2	218.9	4.0	521	4.4	2,711	3.2	135	7.2	417	3.4	1,142	10.6	6,717	6.6	24,425	6.5	37,728	6.0	2.1	5.7
VI	1,543	5.6	191.4	3.5	521	4.4	2,359	2.8	92	4.9	523	4.3	829	7.7	7,623	7.5	30,375	8.1	44,057	7.0	4.1	7.5
VII	1,164	4.2	294.5	5.4	586	4.9	3,817	4.5	90	4.8	451	3.7	706	6.5	7,440	7.4	28,525	7.6	43,075	6.9	6.5	7.3
VIII	1,337	4.8	250.8	4.6	631	5.3	3,886	4.6	101	5.4	366	3.0	1,159	10.7	5,121	5.1	23,808	6.4	36,660	5.8	2.0	4.3
IX	1,230	4.5	160.0	2.9	895	7.5	7,300	8.7	71	3.8	428	3.5	539	5.0	5,291	5.2	17,839	4.8	33,752	5.4	2.1	3.7
X	1,441	5.2	127.1	2.3	694	5.8	4,032	4.8	93	4.9	423	3.4	662	6.1	5,405	5.3	16,942	4.5	29,817	4.7	3.9	4.7
XI	1,426	5.2	130.3	2.4	484	4.1	4,029	4.8	99	5.3	347	2.8	680	6.3	5,011	5.0	16,471	4.4	28,678	4.6	4.2	4.9
XII	1,773	6.4	122.8	2.2	949	7.9	3,485	4.1	123	6.6	284	2.3	364	3.4	4,140	4.1	17,122	4.6	28,362	4.5	2.7	4.6
XIII	1,064	3.9	166.8	3.0	728	6.1	2,003	2.4	141	7.5	235	1.9	794	7.3	3,121	3.1	13,521	3.6	21,773	3.5	1.2	2.6
Phil	27,588	100.0	5,497	100.0	11,934	100.0	84,183	100.0	1,876	100.0	12,259	100.0	10,811	100.0	101,109	100.0	373,200	100.0	628,457	100.0		

^{a/} refers only to "various local infrastructure" and "local infrastructure"

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