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## An assessment of the fiscal features of the PDP Laban model of Philippine Federalism 1.0 and the Gonzales-De Vera Federal model

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# An Assessment of the Fiscal Features of the PDP Laban Model of Philippine Federalism 1.0 and the Gonzales-De Vera Federal Model

*Rosario G. Manasan*



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An Assessment of the Fiscal Features  
of the PDP Laban Model of Philippine Federalism 1.0  
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PHILIPPINE INSTITUTE FOR DEVELOPMENT STUDIES

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## **Abstract**

The paper highlights the importance of the design of the fiscal features of the federal system of government in ensuring that the potential benefits from its adoption are realized. The economic literature on fiscal federalism posits a framework that delineates the potential benefits that ensues from the adoption of a federal system of government and expounds on the principles that can guide the design of the elements of the fiscal architecture to support the achievement of said benefits.

This paper presents an approach on how to assess the design of the fiscal aspects of alternative federal models and illustrates its application in evaluating the the PDP Laban Model of Philippine Federalism 1.0 and the Gonzales-De Vera model. The approach that is followed in the conduct of the assessment essentially involves the benchmarking of the relevant provisions of these two models against the guiding principles emanating from the fiscal federalism literature related to the design of the fiscal features of a federal system of government. The assessment also takes into consideration current practice by reviewing the constitutions of various countries that have a federal system of government at present.

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

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# **An Assessment of the Fiscal Features of the PDP Laban Model of Philippine Federalism 1.0 and the Gonzales-De Vera Federal Model**

***Rosario G. Manasan\****

## **1. Introduction**

The shift to a federal system 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.<sup>1</sup> On the other hand, the PDP Laban headed by Senate President Aquilino Pimentel III, is actively involved in the advocacy and design of a "federalism model" for the Philippines. The PDP Laban draft Constitution, which was crafted under the auspices of the PDP Laban Federalism Institute and which proposes the adoption of a semi-presidential federal system of government, was submitted to the HOR Committee on Constitutional Amendments 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. In the meantime, a Consultative Commission, created by the President last January 24, 2018 to review the 1987 Constitution and to draft a new Constitution that it will recommend to the President before the latter delivers his SONA in July 2018.

The federalism discourse in the public arena is oftentimes framed along two strands. First, the adoption of a federal system of government is seen as a means to reverse the "unequal allocation of resources between "imperial Manila" and the rest of the country" (Taruc 2016). Proponents of federal movement argue that the dominance of "imperial Manila" has resulted in the persistence of wide regional disparities in per capita household incomes, per capita Gross Regional Domestic Product (GRDP) and poverty incidence. They 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%) [Malaya 2016]. 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" (PDP Laban Federalism Institute 2017). They then argue that a federal system 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" (Ranada and Villarete 2016; So 2016). However, closer scrutiny of the provincial level per capita household income from the Family Income and Expenditure Surveys (FIES) of 1985, 1991, 1994, 1997, 2003, 2006, 2009 and 2015 provides

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

evidence of  $\beta$ -convergence<sup>2</sup> in 1991-2015 in contrast with the period 1985-1991 prior to the implementation of the 1991 Local Government Code (LGC) (Manasan and Tolin forthcoming). Not only is estimated speed at which the per capita household incomes of the poorer provinces are catching up with that of their richer counterparts faster in the post-LGC period relative to the pre-LGC period, the convergence coefficient in latter period is found to be statistically significant while that in the earlier period is not. Moreover, 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**). Given that there is no single federal model, the adoption of a federal system of government may (or may not) work in the Philippine context depending on the specific design features of the particular model that is proposed. To use a cliché, the devil is in the details.

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

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

Second, advocates view the shift to a federal system of government as key to attaining sustainable peace in Mindanao given its potential in securing national unity while protecting regional diversity arising from religious, linguistic, ethnic, or cultural differences.<sup>3</sup> 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

<sup>2</sup>Absolute  $\beta$ -convergence is said to exist if poorer economies (regions) tend to grow faster than richer ones (Sala-i-Martin 1996). That is, it measures the speed at which poorer regions catch up with richer ones.

<sup>3</sup> No less than President Duterte articulated this thought during the first Presidential debate held in 23 February 2016 (DU30's 30 2016) and then again in a speech he delivered in 30 November 2016, five months after winning the Presidency (Ramos 2016).

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 2009<sup>4</sup>). Again, this discussion underscores the importance of paying close attention to the design of the federal model in ensuring its success.

As indicated earlier, there are two specific federal models that have already been submitted to the HOR Committee on Constitutional Amendments in the second half of 2017: (i) the Gonzales-de Vera model which was drafted by Congressmen Aurelio Gonzales Jr. and Eugene de Vera and (ii) the PDP-Laban Federal Model Version 1.0 which was crafted under by group put together by the PDP-Laban Federalism Institute.

The present paper presents an approach on how to assess the design of the fiscal aspects of alternative federal models and illustrates its application in evaluating the aforementioned two models. The approach that is followed in the conduct of the assessment essentially involves the benchmarking of the relevant provisions of these two models against the guiding principles emanating from the fiscal federalism literature related to the design of the fiscal features of a federal system of government. The assessment also takes into consideration current practice by reviewing the constitutions of various countries that have a federal system of government at present.

## **2. Overview of the Fiscal Federalism Framework<sup>5</sup>**

The literature on fiscal federalism suggests that a federal system of government is likely to yield potential benefits in the form of (i) increased efficiency and, consequently increased societal welfare, (ii) enhanced local accountability, and (iii) stronger national unity in the face of regional diversity. First, under a federal system, optimal provision of public services is likely to be achieved if the jurisdiction of the level of government responsible for the financing and delivery of a given public service coincides with the geographic area where benefits of said public service are confined (Olson 1969; Oates 1972). Otherwise, government would tend to under-provide services which have positive benefit spillovers to other jurisdictions while over-provision may result if lower level governments from higher level governments are able to secure funding for projects that only benefit the local jurisdiction, i.e., they would tend to ask for more projects relative to a situation when they have to finance said projects themselves. Also, greater decentralization under a federal system of government would 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

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<sup>4</sup> While this article was originally written in 2009, it was republished on the Institute for Autonomy and Governance website in 1 June 2016 attesting to its continued relevance to on-going federalism debate (Bacani 2016).

<sup>5</sup> This section draws heavily from Manasan (2018).



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 system of government. Also, countries with a federal system of government are not necessarily decentralized to the same degree and some of them may even be less decentralized than those with a unitary system of government. 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). **Box 1** summarizes the distinction between a multi-tiered unitary government and one with a federal system. With regards to the third potential benefit, the adoption of a federal system of government does not necessarily prevent the break-up of conflict-ridden states. For instance, pre-1971 Pakistan has split up into present-day Pakistan and Bangladesh.

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

Under a multi-tiered unitary government, subnational units exercise only the powers delegated to them by the central government and the latter can unilaterally withdraw these 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 system of government	Federal system of government
Subnational government units exercise <u>only</u> the powers that the central government (CG) chooses to delegate to them; lower levels of government can be attributed with own political institutions, decision-making powers and resources" (i.e., some degree of self-rule) [Iff and Topperwien, 2017, p. 26]	Powers are shared by "two or more constitutionally established orders of government" (i.e., federal government and constituent units); "system combines elements of shared rule (collaborative partnership) through a common government and regional self-rule (constituent unit autonomy);" "each directly elected, and each order having some autonomy in the exercise of powers assigned to it" (self-rule); [Iff and Topperwien, 2017, p. 14]
* CG can <u>unilaterally withdraw</u> powers delegated to subnational government units	* <u>Division of powers</u> and allocation of resources between federal government (FG) and constituent units (state/ regional/ provincial governments) are <u>written/ guaranteed in constitution</u>
* Constituent units are <u>not</u> represented in decision-making at the central government level	* Constituent units are "involved in the decision-making at the federal level" through representation of the constituent units in central policy-making institutions (shared rule) [Iff and Topperwien, 2017, p. 14]

Adapted from Iff and Topperwien (2017)

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 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 when the specific design elements of the de Vera-Gonzales model and the PDP Laban model are assessed design option for each of the four pillars of intergovernmental relations for a federal system 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 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. Fiscal Features of the PDP-Laban Model 1.0 and the Gonzales-De Vera Model**

The assessment of the critical fiscal elements of the Gonzales-de Vera and the PDP Laban models that follows 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 (LGC). 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. Degree of Autonomy of Regional Governments.**

The autonomy of regional governments is articulated prominently in both the PDP-Laban model (*Article II, Section 1 and Section 25, Article X, Section 2 and Section 5*) and the Gonzales-de Vera model (*Article II, Section 2, Article X, Section 2*). However, said autonomy is limited by the provisions which give the power to exercise general supervision over regional governments to the Federal Government through the Prime Minister under the PDP-Laban model (*Article X, Section 21*) and to the President under the Gonzales-de Vera model (*Article X, Section 3*).

### **3.2. Expenditure Assignment**

***Guiding principles in expenditure assignment.***<sup>6</sup> 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

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<sup>6</sup> This sub-section draws heavily from Manasan (2018).

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.***<sup>7</sup> Constitutions of countries with a federal system 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 system 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 *Laender*; 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

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<sup>7</sup> This sub-section draws heavily from Manasan (2018).

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.

***Expenditure assignment in the PDP Laban Model 1.0.*** Three sections in Article X of the PDP Laban model delineate the division of functions and expenditure responsibilities between the federal government and regional governments in explicit and definitive terms, thereby appearing to provide an unequivocal guarantee of said functional assignment in the constitution. *Section 20* enumerates a short list of exclusive legislative powers assigned to the federal government:

1. National defense
2. Police and national security
3. Foreign affairs
4. Currency and monetary policy
5. Customs and tariff
6. International trade
7. Inter-regional commerce
8. Postal service
9. Quarantine
10. Citizenship, naturalization, immigration and deportation
11. General auditing
12. National elections
13. Maritime, land and air transportation and communication<sup>8</sup>
14. Patents, trademarks, trade names and copyrights
15. Judiciary and administration of justice.

On the other hand, the first paragraph of *Section 26* enumerates an even shorter list of exclusive legislative powers assigned to the regional governments:

1. Create its own sources of regional revenues and to levy taxes, fees and charges subject to the limits of this Constitution and consistent with the basic policy of regional autonomy. Such taxes, fees and charges shall accrue exclusively to the region, provided that regional collection and the revenue measure shall be uniform, equitable and progressive;
2. Social welfare and development;
3. Tourism;
4. Irrigation, water and sewerage;
5. Waste management;
6. Fire protection;
7. Regional development planning;
8. Franchises, licenses and permits to land, sea and air transportation plying routes in the provinces or cities within the regions, and communication facilities whose frequencies are confined to and whose main offices are located within the region; and
9. Legislation to allocate and provide funds and resources from the regional government to competent local governments within each region.

Furthermore, *Section 19* assigns the residual power to the federal government, i.e., all powers, functions, and responsibilities not granted by this Constitution or by law to the regions shall remain with the federal government). (Emphasis supplied by the author.)

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<sup>8</sup> Some components of maritime, land and air transportation may be confined to subnational jurisdictions.

However, a comparison of the list of powers enumerated in *Article X, Section. 26* of the PDP-Laban model with those listed under *Section 17 (b)* of the 1991 Local Government Code (**Table 2**) indicates that (i) all of the powers in the former with the exception of items #6, #7 and a portion of # 8 are assigned to LGUs under the 1991 LGC, and (ii) there are important functions in the LGC list that are not in the PDP Laban list, e.g., agriculture extension services, health services, some natural resource management services, and local infrastructure. Thus, these three sections of the PDP Laban model when taken together imply a greater concentration of power at the center relative to what is the case under the existing unitary but decentralized set-up as provided under the 1991 LGC.

At the same time, four sections under *Article X* further qualifies the powers assigned to regional government under *Section 26*, at times, diminishing and, at other times, expanding the same but always requiring additional actions on the part of the federal government (either the executive branch or Parliament) to effect said changes. Thus, these sections weaken or, at the very least, introduce ambiguity in what initially appears to be constitutionally guaranteed powers assigned to regional governments under *Article X, Section 26*.

One, the last paragraph of *Article X, Section 26* provides that “Regional governments shall not exercise the exclusive legislative powers unless their respective regional governments have the financial and organizational capacity to implement and administer the legislation and the federal government has devolved the related functions and powers to the regional government in accordance to Constitution and the law.” (Emphasis supplied by the author.)

Two, *Article X, Section 27* states that “Within its territorial jurisdiction and subject to the provisions of this Constitution and federal laws, the regional governments shall have concurrent or shared legislative powers with[in] the federal government in the enactment of legislation not covered in *Article X, Section 20* and *Section 26* except when the Parliament has enacted legislation in the exercise of such concurrent powers. The concurrent legislative powers may be delegated as exclusive legislative powers of the regional governments as may be provided in the Organic Act for the region enacted in accordance with *Section 27 to 31* of this *Article*. Federal and regional governments shall cooperate and coordinate in the exercise of concurrent powers through mechanisms of intergovernmental relations to be defined under the Regional and Local Government Code. (Emphasis supplied by the author.)

Three, *Article X, Section 24* provides that “Powers and functions of the federal government shall be devolved and transferred to regional governments depending on the competence, capacity and resources of the regions. The Prime Minister and cabinet members in coordination with Senate and the regional governments shall determine the powers and functions that may be further devolved and transferred to the regional governments. ...” (Emphasis supplied by the author.)

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

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

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

Source: Section 17 (b) of 1991 LGC



Four, *Article X, Section 30* says: “The Organic Act<sup>9</sup> shall define the basic structure of government for the region consisting of the executive and legislative departments, both of which shall be elective and representative of the constituent political units: provided that .... The Organic Act may increase exclusive powers and functions of the regional government as provided in the Constitution and the Law. The Organic Acts may provide for special courts consistent with this Constitution and federal laws. ...” (Emphasis supplied by the author.)

Furthermore, *Section 19* and *Section 27* of *Article X* appear to be inconsistent with each other. While *Section 19* seem to imply that residual powers reside with the federal government by stating that all powers not assigned to regional governments (i.e., powers not listed in *Section 26*) shall remain with the federal government, *Section 27* appear to imply that all powers not listed in *Section 20* and *Section 26* are concurrent or shared powers.

***Expenditure assignment in the Gonzales-de Vera model.*** *Article VI, Section 28* lists of exclusive legislative powers assigned to the federal government:

1. National security and defense
2. Declaration of war
3. Foreign relations
4. Foreign trade
5. Customs and quarantine
6. Federal currency, fiscal and monetary system, taxation, budget and audit
7. Immigration, emigration and extradition
8. Inter-regional commerce and trade
9. Federal public works and infrastructure
10. Federal postal and telecommunications
11. Federal air, sea and land transportation
12. Intellectual property and copyright
13. Meteorology and standards of weights and measures
14. Grants-in-aid to regions
15. Federal census and statistics
16. Federal loans
17. Federal penal system
18. Cloning, genetic research and engineering
19. Settlement of territorial and other disputes among states
20. Offenses under the Revised Penal Code and federal laws.

While the number of policy areas that regional governments may legislate on is large under the Gonzales-de Vera model, there are no specific expenditure responsibilities that are exclusively assigned to regional governments either. More specifically, *Article X, Section 21* provides that the Regional Assembly shall have the authority to legislate areas that are not exclusively reserved to the Federal Congress such as but not limited to the following:

1. Public health, sanitation, hospitals, dispensaries, and drug rehabilitation institutions, ..
2. Agriculture, agricultural lands ...

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<sup>9</sup> *Article X, Section 29* provides that after a minimum period of five years after the organization of the Regional Commission, and upon two-thirds majority vote by the Commission and the Regional Consultative Assembly, voting separately, or by regional people's initiative as determined by law within a specific region, the Regional Commission may submit to Parliament an Organic Act more responsive to the specific needs, culture, and aspirations of the people within the region.

3. Land use and development ...
4. Cadastral and land surveys
5. Taxes and duties, except those that are reserved to the Federal Congress, on all kinds of agricultural income, businesses of all types, the general, consumption and distribution of electricity, oil, gas and other energy products, luxuries, entertainment and amusements
6. Fisheries, aqua or marine culture, swamps or marshlands .....
7. Public works and infra, airports, ship ports, wharves, levees, drainage systems and the like excepting those initiated by the federal government
8. State public corporations and quasi-public corporations
9. Trade, industry and tourism
10. Trade relations that Regions may establish with other countries, ...
11. Bankruptcy and insolvency
12. Trust and trustees
13. Compelling the attendance of Region, its Regional and local government officials or persons doing business in the Region and their giving testimony .... before the Regional Assembly or any of its committees.
14. Payment of share of the Region in the national public debt that was used to fund projects or programs for the development of the nation as determined by the federal government
15. Courts for the governance according to the customs and traditions of the indigenous populations of the Regions
16. Salaries, emoluments, allowances ... of all officials and employees of the Regions
17. Penalizing offenses against matters that are lodged within the jurisdictions of the Regions
18. Police with jurisdictions over crimes or offenses committed within the boundaries of the individual regions
19. Total ban or regulation on gambling activities
20. Local prisons, reformatories and the like
21. Transfer from one Region to another of persons under investigation, accused of crimes or detention or convicted prisoners
22. Wild animals, birds and other endangered species
23. Mines, mineral resources, gas, gas-works excepting those located within ancestral domains  
....
24. Water, water supplies, irrigation and canals and water power ...
25. Economic and social planning
26. Social security and social insurance, employment, pension plans, social welfare including  
....
27. Cooperatives, microfinance or micro-credit and money- lending activities
28. Weight and measures
29. Price control
30. Labor and employment
31. Science and technology
32. Free education from pre-school, primary and elementary up to secondary schools, and subsidized colleges and universities
33. Libraries, museums, ancient and historical monuments, and ....
34. Charities and charitable institutions
35. Registration of marriages, births and deaths
36. Pilgrimages to places outside of the Federal State

37. Totally prohibiting or regulating the production, manufacture, transport and sale of tobacco, cigarettes or other tobacco products, beer, wine or alcoholic beverages or intoxicating liquor ....
38. General welfare of the people of the Regions subject only to the prohibitions provided for under the Constitution or by federal laws.

In other words, *Article X, Section 21* implies that all functions not included in list of exclusive functions of the federal government are shared functions, i.e., shared by the federal and the regional governments. At the same time, because the draft Gonzales-de Vera constitution is silent on principles that will govern such of sharing of expenditure responsibilities, the resulting functional assignment is not only highly ambiguous but also has a higher potential for duplication than under the present set-up.

### 3.3. Tax/ Revenue Assignment

***Guiding principles in tax assignment.***<sup>10</sup> Expenditure assignment and tax assignment are interrelated with the expenditure assignment. 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 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). On the other hand, 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

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<sup>10</sup> This sub-section draws heavily from Manasan (2018).

accountability to local constituents, the public choice strand of the fiscal federalism literature (e.g., McLure 1999) emphasizes the need to provide subnational units some degree of revenue autonomy. The revenue autonomy criterion requires that each level of government must be assigned sources of “own” revenues whose level they have the power to control at the margin (McLure 1999).<sup>11</sup> 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.***<sup>12</sup> Constitutions of existing federal countries vary relative to the manner by which the taxes assigned to the different levels of government are specified. “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. In contrast, 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.

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<sup>11</sup> 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.

<sup>12</sup> This sub-section draws heavily from Manasan (2018).

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 taxation<sup>13</sup> 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.

***Tax assignment in the PDP Laban Model 1.0.*** The provisions of PDP Laban Model related to the allocation of taxing powers to regional governments are vague and non-specific to make it appear that the both the federal government and regional governments will be allowed to levy taxes on all conceivable tax bases at the same time. In particular, *Article X, Section 26*<sup>14</sup> is so vague and non-specific with respect to the taxes that regional and local governments may impose and contrasts sharply with the guidance against too much latitude in the subnational government choice of tax bases because of the negative unintended consequences it entails (Martinez-Vazquez *et al.* 2006).

Also, many of the provisions related to the assignment of taxing power to regional and local governments (e.g., *Article X, Section 12 (1)*,<sup>15</sup> *Section (2)*<sup>16</sup> and *Section 15*<sup>17</sup>) are focused on revenue sharing, and, thus, not supportive of revenue autonomy. On the other hand, *Article X,*

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<sup>13</sup> “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 2016).

<sup>14</sup> *Article X, Section 26.* (1) Each region shall have exclusive legislative powers applicable within the territorial jurisdiction of the regions to create its own sources of regional revenues and to levy taxes, fees and charges subject to the limits of this Constitution and consistent with the basic policy of regional autonomy. Such taxes, fees and charges shall accrue exclusively to the region, provided that regional collection and the revenue measure shall be uniform, equitable and progressive.

<sup>15</sup> *Article X, Section 12.* (1) The regional governments shall have a just share, as determined by federal law, in national federal taxes and revenues which shall be automatically released to them provided that the share of RGs shall not be less than   ?   percent of all national taxes and revenues.

<sup>16</sup> *Article X, Section 12.* (2) In addition, specific national taxes collected within the territorial jurisdiction of each region shall be retained by and shall accrue exclusively to the regional government.

<sup>17</sup> *Article X, Section 15.* In addition to the equalization grant, regional governments shall be entitled to at least 50% share in the proceeds of the utilization and development of national wealth such as mining, hydro and geothermal, forestry, fisheries, pasture leases within their respective areas, in the manner provided by law....

*Section 12 (2)* raises a number of questions: Does it refer to revenue sharing on a derivation basis? What are the taxes that will be shared on a derivation basis?

The PDP Laban Model 1.0 does contain two provisions which articulate clearly the taxing powers that will be assigned to LGUs, namely *Article X, Section 36*<sup>18</sup> and *Section 38*<sup>19</sup>. However, their applicability is limited timewise, thereby introducing a good deal of uncertainty not only in terms of the taxing powers of LGUs but also in the appropriate size of their revenue share in federal level taxes in the case of *Article X, Section 38*.

***Tax assignment in the Gonzales-de Vera model.*** While *Article X, Section 4*<sup>20</sup> gives regional governments broad and wide-ranging taxing powers, it also bestows on the Federal Congress the power to limit the power of regional government to create their own sources of revenues, thereby negating the whatever constitutional guarantee there is on the revenue autonomy of the former. On the other hand, while *Article X, Section 21*<sup>21</sup> does specify some of the tax bases assigned to regional governments (e.g., all kinds of agricultural income, businesses of all types, the general [?], consumption and distribution of electricity, oil, gas and other energy products, luxuries, entertainment and amusements), many ambiguities remain as to the kind of taxes that regional government may impose. In particular, *Article X, Section 21* provides that the taxes that regional governments may levy on the said tax bases shall not include the “taxes and duties that are reserved to the Federal Congress.” However, the lack of clarity on the taxes assigned to regional governments remains because the Gonzales-de Vera draft constitution is silent on “the taxes and duties that are reserved to the Federal Congress” (see *Article VI, Section 28 (f)*<sup>22</sup>). Such vagueness in tax assignment is likely to result in inequities and distortions in allocation of resources and to create complexity in tax administration and compliance (Martinez-Vazquez et al. 2006).

In contrast with the PDP-Laban model, the provision in the Gonzales-de Vera model related to revenue sharing between the federal government, on the one hand, and the regional governments and LGUs, on the other hand, is more specific as to their respective shares in all taxes imposed by the federal government (i.e., 20%-80% in favor of the federal government), at least in the interim before the federal Congress amends the 1991 Local Government Code (*Article X, Section 22 (2)*<sup>23</sup>).

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<sup>18</sup> *Article X, Section 36*. Until a Regional and Local Government Code is enacted in accordance with the Constitution, powers, functions, rights, and obligations under the Local Government Code of 1991 shall remain applicable to local governments unless the contrary is provided in the Constitution.

<sup>19</sup> *Article X, Section 38*. Local Governments shall have a just share, as determined by federal law, in federal taxes and revenues which shall be automatically released to them provided that the share of local governments shall not be less than 2 percent of all national taxes and revenues. The share of local governments shall be separate from the share of the regional governments in Sec. 12 of this *Article*. .....

<sup>20</sup> *Article X, Section 4*. Each Region and LGU shall have the power to create their own sources of revenues, and to levy taxes, fees and charges subject to such guidelines and limitations as the Federal Congress may provide, consistent with the basic policy of autonomy, equality and limited sovereignty for Regions and local autonomy for LGUs. Such taxes, fees, and charges shall accrue exclusively to the Regions and LGUs.

<sup>21</sup> *Article X, Section 21*. The Regional Assembly shall have the authority to legislate on areas that are not exclusively reserved to the Federal Government, such as but not limited to: ... (g) Taxes and duties, except those that are reserved to the Federal Congress, on all kinds of agricultural income, businesses of all types, the general, consumption and distribution of electricity, oil, gas and other energy products, luxuries, entertainment and amusements.

<sup>22</sup> *Article VI, Section 28*. The Federal Congress shall have exclusive jurisdiction and authority to legislate on the following areas: ... (f) Federal currency, fiscal and monetary system, taxation, budget, and audit; ....

<sup>23</sup> *Article X, Section 22. (2)* Until the Federal Congress provides otherwise, the sharing of taxes between the National Government (now Federal Government) and the LGUs as stated in the Local Government Code of 1991 is hereby amended, as follows:

(a) The taxes mentioned in the Local Government Code of 1991 shall include all revenues and taxes imposed or collected by the Federal Government;

However, this provision is problematic for a number of reasons. One, *Article X, Section 22 (2)(a)* is unclear because it fails to mention which specific section of the 1991 LGC it is referring to when it says “the taxes mentioned in the Local Government Code of 1991 shall include all revenues and taxes imposed or collected by the Federal Government.” Presumably, the taxes referred to here are the national government taxes that are shared with LGUs in the form of the Internal Revenue Allotment (IRA). Two, *Article X, Section 22 (2)(b)* is confusing because it is not apparent what it means when it talks about the revenues and taxes “collected by agencies of the federal government are collected in accordance with 1991 LGC.” Note that under the tax regime based on which the 1991 LGC operates, all the revenues and taxes that are collected by agencies of the national government are levied and collected not in accordance with the 1991 LGC but in accordance with, *inter alia*, the National Internal Revenue Code, and the Tariff Code and other special laws. Three, *Article X, Section 22 (2)(b)* and *Article X, Section 25*<sup>24</sup> are inconsistent with each other. On the one hand, *Article X, Section 22 (2)(b)* says that “all revenues and taxes collected by the LGUs or by the agencies of the Federal Government ... shall be divided” 20%-80% in favor of the federal government. On the other hand, *Article X, Section 25* says that the taxes, fees and charges that LGUs may choose to levy and collect “shall accrue exclusively to the LGU concerned.”

### 3.4. Intergovernmental Fiscal Transfers

***Guiding principles on intergovernmental fiscal transfers.***<sup>25</sup> Intergovernmental transfers of one form or the other<sup>26</sup> 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

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(b) All revenues and taxes collected by the LGUs or by the agencies of the Federal Government in accordance with the Local Government Code of 1991 shall be divided in the following manner; 20% shall accrue to the Federal Government and 80% shall accrue to the Regions;

(c) Of the share accruing to the Regions, 30% shall pertain to the Region concerned and 70% shall be apportioned among the provinces, cities, municipalities and barangays according to the formula stated in the Local Government Code of 1991.

<sup>24</sup> *Article X, Section 25.* Every province, city, municipality and barangay shall have the power to create its own sources of revenues and to levy taxes, fees and charges as provided by law subject to such limitations as the Federal Congress may provide, consistent with the basic policy of local autonomy. Such taxes, fees and charges shall accrue exclusively to the LGU concerned.

<sup>25</sup> This sub-section draws heavily from Manasan (2018).

<sup>26</sup> 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.

the objective that it is meant to achieve. Conversely, the literature cautions that 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).

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”<sup>27</sup>
- (iii) The equalization formula should be simple and transparent so that it is easily understood by all stakeholders and “not be subject to political manipulation or negotiation in any of its aspects.”
- (iv) Introduction of equalization transfers should include “hold harmless” or grandfathering provisions 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 under-provide merit goods. On the other hand, conditional capital grants with matching rates that vary inversely

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<sup>27</sup> Expenditure needs refer to the amount of funding necessary to cover the costs of providing all the responsibilities assigned to the subnational government at a standard level of service provisions taking into account “differences in needs arising from different demographic profiles (percent of the population of school age or retired), geographical and climatological conditions, incidence of poverty and unemployment, and so on” (Martinez-Vazquez 2000).

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 fiscal transfers in federal constitutions.***<sup>28</sup>

Intergovernmental transfers is not a subject matter that is found in the constitutions of all countries with a federal system 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.<sup>29</sup>

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 subnational governments for economic stabilization purposes.<sup>30</sup> 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.<sup>31</sup> 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 geo-topographical 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, South Africa, and Argentina. 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.” This definition is perhaps

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<sup>28</sup> This sub-section draws heavily from Manasan (2018).

<sup>29</sup> 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.

<sup>30</sup> 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.

<sup>31</sup> 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.

the closest to the economic definition of equalization transfers. 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).<sup>32</sup> In contrast, 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 disincentivize sound fiscal management.

***Intergovernmental transfers in the PDP Laban Model 1.0.*** It is creditable that the equalization features highly in the PDP Laban Model 1.0 given the wide disparity in the level of economic and human development across the regions. In particular, *Article X, Section 12 (3)*<sup>33</sup> and *Section 38*<sup>34</sup> capture fairly well the essence of what an equalization grant is meant to achieve.

However, *Article X, Section 14 (paragraph 2)*<sup>35</sup> and its two explanatory footnotes<sup>36</sup> are rather confused and confusing. On the one hand, *Sec. 14 (paragraph 2)* seems to imply that the equalization fund is intended to provide regional governments an incentive to pursue federal priorities. There is no mention at all here of the equalization objective in its true sense. On the other hand, *Section 14 (paragraph 2)* also appears to say that two types of grants (i.e., unconditional general purpose block grant and conditional and matching grant) will be used to incentivize regional governments to pursue federal priorities. This stands in sharp contrast against one of the important lessons from the fiscal federalism theory and practice which advises governments to use conditional matching grants, not unconditional block grants, to influence subnational government spending decisions. Moreover, the logic of footnote 85 in the PDP Laban Model 1.0 is flawed. An equalization fund will not necessarily ensure fiscal equivalence, meaningful autonomy and good governance. Revenue autonomy and clarity in expenditure assignment are just as important as ensuring that finance follows function in promoting fiscal equivalence, meaningful autonomy, good governance and greater accountability. Finally, the kind of thinking that appears to underpin footnote 86 of the PDP-Laban Model 1.0 (i.e., that the equalization fund may be funded by the federal government possibly through borrowing from donors and international bond markets) is dangerous from the perspective of fiscal sustainability.

On the other hand, *Article X, Section 12 (1)* does not specify the share of regional governments in all national taxes perhaps because it is impossible to do so in a manner that will ensure that “finance follows function” unless there is greater clarity in the assignment of expenditure responsibilities as well as taxing power across the different levels of government.

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<sup>32</sup> 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).

<sup>33</sup> *Article X, Section 12. (3)* As determined by law, the Parliament shall, by law, institute a fair and equitable system of sharing and equalization between regions, provided that the share of regional governments shall be adjusted in accordance with the needs and capacity of a region.

<sup>34</sup> *Article X, Section 38.* .... The Parliament shall, by law, institute a fair and equitable sharing and equalization between local governments, provided that the share of local governments shall be adjusted in accordance with the needs and capacity of local governments.

<sup>35</sup> *Article X, Section 14. (paragraph 2)* The Regional and Local Government Code shall provide for an equalization fund and the creation of a National Finance Commission. The Fund shall comprise of an unconditional general purpose block grant as well conditional and matching grants as incentive for regional governments to pursue federal priorities.

<sup>36</sup> Footnote 85 to *Article X, Section 14. (paragraph 2)* The Equalization Fund shall be the main mechanism to ensure that the principle of fiscal equivalence, meaningful autonomy and good governance will be realized. This will replace the IRA.

Footnote 86 to *Article X, Section 14. (paragraph 2)* ... The federal government as a sovereign power has a much bigger fiscal space through borrowing from donors and international bond markets. The main mechanism for financing the regional governments will be via the equalization fund and for city governments mainly from property taxes. ...

***Intergovernmental transfers in the Gonzales-de Vera model.*** Does not contain a provision on equalization transfer –

As is the case with the PDP-Laban model, it is difficult to judge whether the proposed 20%-80% sharing of all revenues and taxes collected by LGUs or the federal government under the Gonzales-de Vera model appropriately reflects the balance between the resources allocated to subnational governments and cost of the expenditure responsibilities that are assigned to them because of the lack of clarity in the assignment of expenditure responsibilities as well as taxing power across the different levels of government.

### ***3.5. Subnational Government Borrowing and Debt Management***

#### ***Guiding principles related to subnational government borrowing and debt management.***<sup>37</sup>

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

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<sup>37</sup> This sub-section draws heavily from Manasan (2018).

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 (2006b) 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.<sup>38</sup> 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).

***Provisions related to subnational government borrowing in federal constitutions.***<sup>39</sup> 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-

<sup>38</sup> This is sometimes referred to as the "golden rule."

<sup>39</sup> This sub-section draws heavily from Manasan (2018).

1&4). On the other hand, 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).

***Subnational government borrowing and debt management in the PDP Laban Model 1.0 and the Gonzales-de Vera model.*** The PDP Laban Model 1.0 has no provision related to subnational government borrowing and debt management except for a tangential one in *Article X, Section 34*.<sup>40</sup> On the other hand, there is absolutely no reference at all to subnational government borrowing and debt management in the Gonzales-de Vera model. This is a major gap in proposed model considering the fiscal risks that are associated with excessive subnational government borrowing and experienced by such countries as Brazil, Mexico, India, and Russia during the 1990s.

The following provisions related to subnational government borrowing may be included in the constitution in support of fiscal discipline and fiscal sustainability 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 of the latter default on their debt.
- (ii) Regional and local government may borrow for the purpose of financing capital investments only. (Golden Rule)
- (iii) Legislature shall enact Fiscal Responsibility Law that shall specify quantitative ceilings on borrowing, debt, debt service, or fiscal deficits of subnational government.

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<sup>40</sup> *Article X, Section 34*. Regional governments shall be held accountable by, among others, the Federal Commission on Audit, Ombudsman, CSC, and the Courts. The COA shall see to it that the regions have adequate mechanisms to ensure credible fiscal controls such as budgetary balance, taxation and spending, and credible penalties for enforcement as well as effective fiscal coordination mechanisms. ...

- (iv) Legislature shall enact law addressing bankruptcy policy and insolvency mechanisms for regional and local governments.

#### 4. Fiscal Cost of Adopting A Federal System of Government

The adoption of a federal system of government involves additional bureaucratic cost in the operation of government. 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 at the federal government level and their staff as well as operating expense of their offices
  - Under the PDP-Laban model - 3 senators per region or a total of 54 senators (*Article VI, Section 5*);
  - Under the Gonzales-de Vera model – at least 2 up to a maximum of 6 senators per region or a total of 108 senators at the maximum (*Article VI, Section 2*)
- (iii) Salaries of state legislators (i.e., members of the Regional Assembly) and their staff as well as operating expense of their offices<sup>41</sup>
  - Under the PDP-Laban model, Regional Consultative Assembly and Regional Assembly
    - Prior to the enactment of Organic Act of each region, Regional Consultative Assembly - 3 representatives from each province, highly urbanized city and independent component city in the region or a total of 357 members of the Regional Consultative Assemblies in all regions (*Article X, Section 28 (E)*);
    - After the enactment of the Organic Act, Regional Assembly - 2 representatives from each province and 1 from each highly urbanized city and independent component city in the region or a total of 200 members of Regional Assemblies in all regions (*Article X, Section 31*);
  - Under the Gonzales-de Vera model, Regional Assembly – 3 representatives from each province, highly urbanized city and independent component city in the region plus at least 3 sectoral representatives in each region or at least 405 members of the Regional Assemblies in all regions (*Article X, Section 18 (1) and Section 18 (2)*);
- (iv) Salaries of members of the judiciary at the state government level, their staff as well as operating expense of their offices.<sup>42</sup>

Assuming there are 18 regions, the estimates of the incremental fiscal cost of setting up a federal system of government amount to Php 50 billion for the PDP-Laban model and Php 62 billion for the Gonzales-de Vera model.

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<sup>41</sup> 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).

<sup>42</sup> 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.



## 5. Conclusion

The discussion in **Section 3** has focused on the design of the fiscal features of a federal system of government guided largely by the welfare economic strand of the literature on fiscal federalism which assumes that political leaders are benevolent rulers who aim to maximize the welfare of their constituents. It emphasized the importance of getting the design of the fiscal aspects of the federal system if its potential benefits are to be realized. It recognized that there is no single best expenditure assignment in a federal set-up. The same is true of tax assignment. However, it is critical that the expenditure assignment, the tax assignment and intergovernmental transfers are designed in an internally consistent and coherent manner that provides the subnational governments the right incentives to deliver the services assigned to them in 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), (ii) securing greater revenue autonomy for subnational governments, otherwise, local accountability may weaken; and (iii) ensuring clarity in expenditure assignment otherwise underprovision of public services or duplication of efforts in the delivery of the same and lack may result. 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.

In contrast, the political economy strand of the fiscal federalism literature<sup>43</sup> (highlights some risks attendant to the proposed shift to a federal system of government. One, 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 they are already" (Matsuda 2011, p. 23). 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 system of government are to be realized.

Two, acknowledging importance of political incentive structures on behavior of elected public officials, the political economy literature likewise suggests suggest that the presence of strong, inclusive democratic institutions is a precondition for success of federal system (e.g., Watts 1996, Simeon 2007, Weingast 2008, Koeppinger 2016).<sup>44</sup> In particular, two items are key:

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<sup>43</sup> The political economy strand of the fiscal federalism literature assumes that "public officials are motivated by electoral goals" and which "places much greater emphasis on political incentive structures like parties, legislative organization, and electoral rules." assumes that "politicians are primarily interested in maintaining and enhancing their political careers" [Rodden 2006a, p 376].

<sup>44</sup> This point of view is echoed by Dr. Jose V. Abueva in forum on federalism organized by Center for Strategic Planning and Policy Studies of the College of Public Affairs, UPLB and SEARCA. Accessed May 13 2017, <https://cpaf.uplb.edu.ph/index.php/2012-09-07-06-09-58/cpaf-updates/cpaf-news/331-former-up-president-speaks-about-federalism>

- (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, p. 242); 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).

Absent the pre-conditions, the likelihood of elite capture is large. Moreover, “pre-condition” should be understood here in the sense of “occurring prior to event *x*” in a sequential manner. This is so because while formal rules can be changed quickly, informal rules take a significantly longer time to adjust to the changes in the formal rules. The warning that Croissant and Merkel (2004, p. 15) about the pitfalls of shifting from a presidential to a parliamentary form of government are just relevant to the shift from a unitary to a federal system at hand sans strong political parties. To wit: “a switch from presidential governments to parliamentary systems in order to “engineer” programmatic and non-clientelistic parties run the risk of a “constitutional fallacy” and the trap of “hyperrationality”. Such a constitutional reform does not take into account the un-simultaneous time horizons: the consolidation of a party system takes much longer than the establishment of the constitutional structures. Once the new parliamentary government has been introduced, it has to cope – at least for a certain period of time – with the old, fragmented, clientelistic, and irresponsible parties.” For instance, the PDP-Laban model assigns the tasks of drafting the regional and local government code which will define the powers, structures, functions and responsibilities of the regional governments to Parliament within a period of 18 months from the ratification of the Constitution [*Article X, Section 6 (3) (B)*]. However, it is likely that Parliament will be dominated by members of the very political dynasties that are now in power even if the provisions on the regulation of political dynasties (*Article II, Section 26; Article IX-C, Section 16*), strengthening of political parties (*Article IX-C, Sections 12*), limitations on changing political party affiliation of elective officials (*Article IX-C, Sections 13*) and state subsidy to political parties (*Article IX-C, Sections 14*) are included in new constitution as proposed in the PDP-Laban model.

In the final analysis, one’s decision on whether or not to adopt federal system of government depends on one’s assessment of (i) the value of the potential benefits from such a shift, (ii) the associated fiscal cost, and (iii) the likelihood that the net benefits are realized.

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