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Fiscal sustainability, equity, and allocative efficiency in the light of the 2019 supreme court ruling on the LGUs' share in national taxes

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DISCUSSION PAPER SERIES NO. 2020-18

Fiscal Sustainability, Equity, and Allocative Efficiency in the Light of the 2019 Supreme Court Ruling on the LGUs' Share in National Taxes

Rosario G. Manasan



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Fiscal Sustainability, Equity, and Allocative Efficiency
in the Light of the 2019 Supreme Court Ruling
on the LGUs' Share in National Taxes

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PHILIPPINE INSTITUTE FOR DEVELOPMENT STUDIES

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Abstract:

The Supreme Court (SC) ruled with finality in April 10, 2019 on the motions for reconsideration of its initial decision promulgated in July 3, 2018 on the petitions filed by separately by Mandanas *et al.* and Garcia regarding what petitioners perceived to be errors in the computation of the Internal Revenue Allotment (IRA) or the LGUs' share in national internal revenue taxes (NIRTs) as mandated under Section 284 of the 1991 Local Government Code (LGC). As a result, the IRA in 2022 will increase by P225.3 billion relative to what it would have been prior to promulgation of the said ruling to reach PhP 1,102.7 billion. This study proposes that said increase in the IRA be sourced by unfunding PAPs in the budgets of some national government agencies that are actually intended to deliver functions that are assigned to LGUs under the LGC with the end in view of ensuring sustainability of the national government's fiscal position. It then proceeds to these PAPs on the basis of the 2020 General Appropriations Act. It also evaluates the impact that this manner of financing the increase in the IRA has on the vertical fiscal balance across different levels of local government and horizontal fiscal balance across individual LGUs within each level of local government.

Keywords: Fiscal federalism, Fiscal Decentralization, Fiscal Sustainability, Local Government, Local Expenditure, Gross Regional Product, Revenue Collection, Fiscal Capacity

Acronyms

ARMM	- Autonomous Region in Muslim Mindanao
BIR	- Bureau of Internal Revenue
BOCs	- Bureau of Customs
COA	- Commission on Audit
DBCC	- Development Budget Coordination Committee
DOF	- Department of Finance
DOH	- Department of Health
DPWH	- Department of Public Works and Highways
DST	- Documentary Stamp Taxes
FY	- Fiscal Year
GAA	- General Appropriation Act
GDP	- Gross Domestic Product
HFEP	- Health Facilities Enhancement Program
IRA	- Internal Revenue Allotment
LGC	- Local Government Code
LGSF	- Local Government Support Fund
LGUs	- Local Government Units
LSR	- Local Source Revenue
NEP	- National Expenditure Program
NG	- National Government
NGAs	- National Government Agencies
NIRC	- National Internal Revenue Code
NIRTs	- National Internal Revenue Taxes
OSG	- Office of the Solicitor General
PAPs	- Programs, Activities and Projects
PD	- Presidential Decree
RA	- Republic Act
SC	- Supreme Court
TRAIN	- Tax Reform for Acceleration and Inclusion Act
TVET	- Technical and Vocational Education and Training
VAT	- Value Added Taxes
VIIPs	- Various Infrastructure Including Projects

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Fiscal sustainability, equity, and allocative efficiency in the light of the 2019 Supreme Court ruling on the LGUs' share in national taxes

Rosario G. Manasan*

1. Introduction

In April 10, 2019, the Supreme Court (SC) ruled with finality on the motions for reconsideration of its initial decision promulgated in July 3, 2018 on the petitions filed by Mandanas *et al.* (G.R. No. 199802) and Garcia (G.R. No. 208488) regarding what petitioners perceived to be errors in the manner by which the Internal Revenue Allotment (IRA) or the LGUs' share in national internal revenue taxes (NIRTs) is actually computed as mandated under Section 284 of the 1991 Local Government Code (LGC).¹ In particular, Hermilando Mandanas *et al.* contends that certain collections of national internal revenue taxes by the Bureau of Customs, (namely, excise taxes, value added taxes or VAT, and documentary stamp taxes or DSTs) have not been included in the base amounts for the computation of the IRA but that said taxes even if collected by the BOC are in reality NIRTs and should therefore rightfully form part of the base amount for the computation of the IRA. On the other hand, Enrique Garcia Jr. argues that the use of the term national internal revenue taxes in Section 284 of the 1991 LGC results in a diminution of the base for determining the just share of LGUs in all national taxes as provided in Section 6, Article X of the 1987 Constitution and should be declared unconstitutional. Moreover, Garcia pleads that the exclusion of certain taxes and accounts pursuant to or in accordance with special laws was likewise unconstitutional. At the same time, both petitioners pleaded for the payment of NG arrears of the LGUs' just share in all national taxes should the SC agree with their contention that computation of the base amount for the IRA is unconstitutional (SC En Banc Decision promulgated July 3, 2018 on G.R. No. 199802 and G.R. No. 208488).²

In its July 3, 2018 decision on G.R. No. 199802 and G.R. No. 208488, the SC ruled that these petitions are "partly meritorious." First, it agrees with Garcia that the present articulation of Section 284 of the 1991 LGC deprives LGUs of their just share in other national taxes not considered as national internal revenue taxes under Section 21 of the National Internal Revenue

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¹ Section 284. Allotment of Internal Revenue Taxes – Local government units (LGUs) shall have a share in the national internal revenue taxes based on the collection of the third fiscal year preceding the current fiscal year as follows:

- a) On the first year of the effectivity of this Code, thirty percent (30%);
- b) On the second year, thirty-five percent (35%); and
- c) On the third year and thereafter, forty percent (40%).

Provided, that in the event that the national government incurs an unmanageable public sector deficit, the President of the Philippines is hereby authorized, upon recommendation of the Secretary of Finance, Secretary of Interior and Local Government, and Secretary of the Budget and Management, and subject to consultation with the presiding officers of both Houses of Congress and the presidents of the "liga", to make the necessary adjustments to the IRA of LGUs but in no case shall the allotment be less than 30% the collection of NIRT in the third fiscal year preceding the current fiscal year."

² The exclusions from the base used in computing the IRA share of LGUs that Garcia is referring to include:

- a) The share of the affected LGUs in the proceeds of the sale and conversion of former military bases in accordance with Republic Act (RA) No. 7227;
- b) The share of different LGUs in the excise taxes imposed on locally manufactured Virginia tobacco products as provided for in Section 3, RA 7171, and as now provided in Section 289 of the NIRC;
- c) The share of the different LGUs in incremental revenue from Burley and native tobacco under Section 8 of RA 8240 and as now provided for in Section 288 of the NIRC;
- d) The share of the Commission on Audit (COA) in the NIRTs as provided in Section 24 (3) of Presidential Decree (PD) No. 1445 in relation to Section 284 of the NIRC;
- e) The share of the different LGUs in the excise taxes on mineral products as provided in Section 287 of the NIRC in relation to Section 290 of the 1991 LGC;
- f) The NIRTs collected by the cities and provinces and divided exclusively among the LGUs of the ARMM, the regional government and the central government, pursuant to Section 9 and Section 9 of Article IX of RA No. 9054; and
- g) The shares of the relevant LGUs in the franchise taxes paid by the Manila Jockey Club, Inc., and the Philippine Racing Club, Inc. (SC En Banc Decision promulgated July 3, 2018 on G.R. No. 199802 and G.R. No. 208488).

Code (NIRC), including customs duties. It also ruled that the national taxes to be included in the base for the computation of the IRA should include:

- (i) The NIRTs enumerated in Section 21 of the NIRC, as amended, to be inclusive of the VAT, excise taxes, and documentary stamp taxes collected by the BIR and the BOC, and their deputized agents;
- (ii) Tariffs and customs duties collected by the BOC;
- (iii) 50% of the VAT collected in the ARMM, and 30% of all other national taxes collected in the ARMM; the remaining 50% of the VAT and 70% of the collections of the other national taxes in the ARMM shall be the exclusive share of the ARMM pursuant to Section 9 and Section 15 of Article IX of RA 9054;
- (iv) 60% of the national taxes collected from the exploitation and development of the national wealth; the remaining 40% will exclusively accrue to the host LGUs pursuant to Section 290 of the 1991 LGC;
- (v) 85% of the excise taxes collected from locally manufactured Virginia and other tobacco products; the remaining 15% shall accrue to the special purpose funds pursuant created in RA 7171 and RA 7227;
- (vi) The entire 50% of the national taxes collected under Sections 106, 108 and 116 (i.e., VATs) of the NIRC in excess of the increase in collections for the immediately preceding year; and
- (vii) 5% of the franchise taxes in favor of the national government paid by franchise holders (Manila Jockey Club, Inc. and Philippine Racing Club, Inc.) in accordance with Section 6 of RA 6631 and Section 8 of RA 6632, respectively.

Third, the SC mandates the prospective application of its ruling on the basis of the “operative fact” doctrine. Fourth, the SC likewise mandates the automatic release of the LGUs’ just share in national taxes.

The SC ruling on the motion for reconsideration of its July 3, 2018 decision filed by the Office of the Solicitor General (OSG) basically reiterated the four basic elements of its original decision. In addition, it provides that the adjusted LGUs’ share in national taxes will be given to LGUs starting with the FY 2022 Budget.

The Development Budget Coordination Committee (DBCC) projects that the FY 2022 IRA will have to be equal to PhP 1,102.7 billion if the SC decision on the Garcia-Mandanas IRA petitions were to be implemented.³ This means that the IRA will increase by PhP 225.3 billion (or 0.9% of GDP) relative to what the IRA would have been in 2022 prior to the said SC ruling (i.e., PhP 877.4 billion). Given this background, this study aims to find answers to the following questions:

- (i) What are the options available to government that will allow it to allocate PhP 1,102.7 billion for the IRA in FY 2022 while keeping within the bounds of its medium-term fiscal program, i.e., while ensuring fiscal sustainability?
- (ii) What is the impact, if any, of the manner by which the increase in the IRA resulting from the SC ruling on the Mandanas-Garcia IRA petitions on vertical and horizontal fiscal balance across the different levels of LGUs and across individual LGUs within each level?

³ This estimate refers to the one presented by the DOF during the December 11, 2019 DBCC meeting.

- (iii) How does one minimize the fiscal disparities across LGUs so as to provide all LGUs the ability to “provide comparable levels of public services at comparable rates of taxation” (Boadway 2007)?
- (iv) What policy instruments are available to government to ensure that national objectives are met given that an increasing proportion of total general government spending will be made by LGUs with significant funding coming from their IRA, a block grant?

2. Options for Ensuring Fiscal Sustainability While Complying with the SC Ruling on the Mandanas-Garcia IRA Petitions

In principle, three options are available to the national government that will allow it to increase the LGUs’ share in all national taxes in accordance with the April 2019 SC decision on this matter while at the same time being mindful of fiscal sustainability concerns. One, the national government may look for new revenue measures that will increase national government revenue by another 0.9% of GDP in 2022 (plus an additional 0.35% of GDP in 2025, an additional 0.14% of GDP in 2028, an additional 0.05% of GDP in 2031, etc.) over and above its programmed level inclusive of the new revenue measures under the administration’s tax reform program that have already been legislated to date. In this manner, the national government will be able to fully fund the increase in the IRA while maintaining both its current expenditure program and its fiscal deficit target at their original levels in its medium-term fiscal program. Such a scenario is difficult to realize given that the phase one of the administration’s tax reform program (as embodied in the Tax Reform for Acceleration and Inclusion Act or TRAIN) has only yielded an increase in tax revenue equal to 0.5% of GDP yearly in 2018-2019 (**Table 1**). Two, the national government may increase its fiscal deficit target by 0.9% of GDP yearly. While a 0.9% of GDP increase in the fiscal deficit target in the short-term will most likely be fiscally sustainable given that the country’s NG debt-to-GDP ratio is significantly lower than international benchmark, implementing a more expansionary fiscal stance long term will be risky from a fiscal perspective (**Table 1**). Third, the national government may cut back on national government spending on its own account in order to create fiscal space for the additional PhP 225.3 billion LGU share in national taxes that is required under the final SC ruling on the Mandanas-Garcia IRA petitions. This approach implies that NG will have PhP 225.3 billion less budgetary resources with which to fund public services that it has been providing the public prior to the said SC decision. While this is perhaps the most prudent option from a purely fiscal point of view, it begs the following question: How can NG ensure no corresponding diminution in the delivery of public services even as its spending on its own account is reduced?

One way to address this issue is for the national government to unfund some of the programs/activities and projects (PAPs) that are currently being funded under the budgets of some national government agencies from the General Appropriation Act (GAA) but which represent functions that have been devolved to LGUs under the 1991 LGC. Note that while a “ cursory reading of the LGC suggests that Section 17 (b) provides an explicit and clear delineation of functions across

Table 1. National Government cash operations and outstanding debt, 2000-2019

Particulars	2000	2002	2004	2005	2006	2008	2009	2010	2011	2013	2015	2016	2017	2018	2019
Revenues	514,762	578,406	706,718	816,159	979,638	1,202,905	1,123,211	1,207,926	1,359,942	1,716,093	2,108,956	2,195,914	2,473,132	2,850,184	3,137,498
Revenue Effort	14.4%	13.8%	13.8%	14.4%	15.6%	15.6%	14.0%	13.4%	14.0%	14.9%	15.8%	15.2%	15.6%	16.4%	16.9%
Tax Revenues	460,034	507,637	604,964	705,615	859,857	1,049,189	981,631	1,093,643	1,202,066	1,535,698	1,815,475	1,980,390	2,250,678	2,565,812	2,827,841
Tax Effort	12.8%	12.1%	11.8%	12.4%	13.7%	13.6%	12.2%	12.1%	12.4%	13.3%	13.6%	13.7%	14.2%	14.7%	15.2%
Expenditures, of which:	648,974	789,147	893,775	962,937	1,044,429	1,271,022	1,421,743	1,522,384	1,557,696	1,880,155	2,230,645	2,549,336	2,823,769	3,408,443	3,797,734
Expenditure Effort	18.1%	18.8%	17.5%	17.0%	16.7%	16.5%	17.7%	16.9%	16.0%	16.3%	16.7%	17.6%	17.9%	19.6%	20.4%
Interest Payments	140,894	185,861	260,901	299,807	310,108	272,218	278,866	294,244	278,996	323,434	309,364	304,454	310,541	349,215	360,874
IP to GDP ratio	3.9%	4.4%	5.1%	5.3%	4.9%	3.5%	3.5%	3.3%	2.9%	2.8%	2.3%	2.1%	2.0%	2.0%	1.9%
Surplus/(-)Deficit	-134,212	-210,741	-187,057	-146,778	-64,791	-68,117	-298,532	-314,458	-197,754	-164,062	-121,689	-353,422	-350,637	-558,259	-660,236
Surplus/(-)Deficit to GDP ratio	-3.7%	-5.0%	-3.7%	-2.6%	-1.0%	-0.9%	-3.7%	-3.5%	-2.0%	-1.4%	-0.9%	-2.4%	-2.2%	-3.2%	-3.5%
NG outstanding debt	2,166,710	2,815,468	3,811,954	3,888,231	3,851,506	4,220,903	4,396,640	4,718,171	4,951,188	5,681,153	5,954,537	6,090,262	6,652,430	7,292,500	7,731,290
NG debt as % of GDP	60.5%	67.1%	74.4%	68.5%	61.4%	54.7%	54.8%	52.4%	51.0%	49.2%	44.7%	42.1%	42.1%	41.8%	41.5%
External	1,098,510	1,344,266	1,810,734	1,723,938	1,697,428	1,806,475	1,926,599	1,999,969	2,077,831	1,947,731	2,070,157	2,156,165	2,211,170	2,515,641	2,603,390
% share to total NG debt	50.7%	47.7%	47.5%	44.3%	44.1%	42.8%	43.8%	42.4%	42.0%	34.3%	34.8%	35.4%	33.2%	34.5%	33.7%
Domestic	1,068,200	1,471,202	2,001,220	2,164,293	2,154,078	2,414,428	2,470,040	2,718,202	2,873,357	3,733,422	3,884,380	3,934,097	4,441,260	4,776,859	5,127,600
% share to total NG debt	49.3%	52.3%	52.5%	55.7%	55.9%	57.2%	56.2%	57.6%	58.0%	65.7%	65.2%	64.6%	66.8%	65.5%	66.3%

Source: Bureau of Treasury

the different levels of governments except perhaps in the area of environment and natural resource management ... Section 17 (c) allows central government agencies to continue to implement devolved public works and infrastructure projects and other facilities, programs and services provided these are “*funded by the national government under the annual General Appropriations Act, other special laws, pertinent executive orders, and those wholly or partially funded from foreign sources.*” At the same time, Section 17 (f) allows the national government or the next higher level of local government unit to “provide or *augment* the basic services and facilities assigned to a lower level of local government unit when such services or facilities are not made available or, if made available, are inadequate to meet the requirements of its inhabitants”. ... In effect, Section 17 (c) and (f) obfuscate what initially appears to be a clear-cut assignment of expenditure responsibilities” (Manasan 2005). Gonzalez (1996) goes even further to say that the prevailing regulatory framework effectively permits the existence of a two-track delivery system, where both NGAs and LGUs can initiate devolved activities.

Thus, the first step in creating fiscal space for the anticipated increase in the IRA in 2022 is to check which of the PAPs that are currently funded under the GAA budgets of various national government agencies are found in the list of functions that have been devolved to LGUs under the 1991 LGC (**Table 2**). In this regard, it should be emphasized that the functions assigned or devolved to LGUs under Section 17 (b) are for the most part stated in broad sectoral terms. As such, while some of these functions may not appropriately be assigned exclusively to LGUs when considered in their entirety, some component/s of said functions may well be assigned exclusively to either the central government or to LGUs. The second step then in identifying the PAPs (or components thereof) which are good candidates for unfunding in FY 2022 involves the unbundling/ deconstruction of the broadly defined functions in **Table 2** so as to be able to determine which of their components are best assigned to LGUs and which are best assigned to the central government in accordance with the basic principles in the assignment of expenditure/ functional responsibilities across the different levels of governments. These principles are summarized in Manasan (2018, p. 6-7):

“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 central 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 central government. At the same time, the economic literature also suggests that functions related to the redistributive role of government be assigned to the central 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).

Table 2. Expenditure assignment under 1991 Local Government Code (Section 17)

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

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

Source: Author's summary of Section 17 (b) of the 1991 LGC

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 is typically assigned to subnational governments because the benefits of these goods/ services generally accrue to residents of subnational jurisdictions, the central government is often involved in setting uniform standards of service that will apply across all jurisdictions (Shah 1991). Also, provision/ production of public goods/ services that involve economies of scale (i.e., those whose average cost of production declines as output increases) are best assigned to higher level governments.”

On the other hand, broad sectoral/ functional assignments may be unbundled using alternative ways of decomposing said wide-ranging and expansive statements of functions assigned to either levels of government. One, broadly defined sectors/ functions may be decomposed along national - local dimensions of a broader policy area/ field, e.g., national highways versus provincial roads and city/ municipal roads on the basis of whether the benefits of the services provided are national or local in scope. Two, broadly defined sectors/ functions may also be unbundled along management functions, i.e., policy, regulation, planning, budgeting, staffing, implementation and reporting (GTZ 2009). Three, broadly defined sectors/ functions may also be decomposed in terms of their sub-competencies, e.g., education may be broken down into elementary, secondary, TVET, and tertiary sub-sectors.

Whichever approach is utilized to deconstruct broadly defined sectors/ functions, it is important to remember that “the purpose of unbundling is not to dissect a service to its most granular form” (GTZ 2009, p. 16). Rather, “the intent should be to only unbundle to the *degree that is necessary* to apportion the components of broad functions between the stakeholders involved in service provision/production” in an exclusive manner (GTZ 2009).

Given this perspective, a review of the PAPs of the various government agencies in the 2020 GAA yielded a number of PAPs that (i) have been devolved to LGUs under the 1991 LGC and (ii) that are appropriately assigned exclusively to LGUs in accordance to the basic principles of expenditure assignment in the fiscal decentralization literature. These PAPs with their corresponding appropriations in the 2020 GAA and the pertinent provisions of the 1991 Local Government Code with regards to the duties and functions that are vested to the different levels of local government are presented in **Table 3**.

Of all the PAPs included in **Table 3**, the one with the biggest appropriation in the 2020 GAA (Php 164.8 billion) is found in the budget of Department of Public Works and Highways (DPWH) and refers to the “construction/ repair/ rehabilitation/ improvement of various infrastructure including local projects (VIILP).”⁴ The VIILP-type PAPs found in **Table 3** do not include those that are expressly intended for national buildings, national roads, national bridges, and for non-local flood control structures and facilities. Notwithstanding this, the unfunding of VIILPs in the GAA is likely to be met with resistance from legislators given that many of these type of projects have been pre-identified by legislators during the preparation of the DPWH budget prior to the President’s submission of the National Expenditure Program (NEP) to Congress.

The second most important item in the list of PAPs in **Table 3** is the Local Government Support Fund (LGSF) that provides national government assistance to various levels of local governments with a combined appropriation of Php 31.2 billion in the 2020 GAA. On the other hand, **Table 3** also include three PAPs in the budget of the Department of Health (DOH),

⁴ VIILP includes multipurpose facilities, flood control structures and facilities, drainage protection works, roads, bridges, and water management facilities.

namely: (i) the human resources for health deployment, (ii) the health facilities enhancement program (HFEP), and (iii) the assistance to indigent patients. The appropriations for these three PAPs in the 2020 GAA amount to PhP 28.9 billion.

The total combined appropriation in the 2020 GAA for all the PAPs included in **Table 3** is equal to PhP 247.6 billion, higher than the projected increase in the IRA as a result of the SC ruling on the Mandanas-Garcia petitions by PhP 22.3 billion. Related to this, the question that begs to be asked: Should the national government reallocate to other national government functions (e.g., build, build, build program) the PhP 22.3 billion that is in excess of the amount required to fund the increase in the IRA as a result of the SC ruling on the Mandanas-Garcia IRA petitions? The paper will return to this point later.

Table 3. List of devolved PAPs in budgets of National Government Agencies (NGAs) that may be re-devolved to LGUs in 2022

Agency	PAP	TOTAL APPROPRIATIONS - 2020 GAA LEVEL (in million pesos)	RELEVANT 1991 LOCAL GOVERNMENT CODE PROVISION	RESPONSIBLE LEVEL OF LGU
DA-OSEC	Agricultural machinery, equipment, facilities and infrastructures program - provision of agricultural equipment and facilities	2,039	Book I, Title I, Chapter II, Section 17 (b) (3) (i) Agricultural extension and on-site research services and facilities which include assistance in the organization of farmers and fishermen's cooperatives, and other collective organizations, as well as the transfer of appropriate technology;	Provinces
DA-OSEC	Irrigation network services (CO)	1,186	Book I, Title I, Chapter II, Section 17 (b) (3) (viii) 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, irrigation systems;	Provinces
DA-OSEC	Farm to market roads (FMR)	9,959	Book I, Title I, Chapter II, Section 17 (b) (1) (v) Maintenance of barangay roads and bridges and water supply systems; (vi) Infrastructure facilities such as multi-purpose hall, multipurpose pavement, plaza, sports center, and other similar facilities;	Barangays
DOH-OSEC	Human resources for health deployment	9,954	Book I, Title I, Chapter II, Section 17 (b) (2) (iii) Subject to the provisions of Title Five, Book I of this Code, 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,;	Provinces/ Cities/ Municipalities
DOH-OSEC	Health Facilities Enhancement Program	8,484	Book I, Title I, Chapter II, Section 17 (b) (3) (iii) Subject to the provisions of Title Five, Book I of this Code, health services which include hospitals and other tertiary health services;	Provinces/ Cities/ Municipalities
DOH-OSEC	Social health protection program - assistance to indigent patients	10,483		Cities/ Municipalities
DSWD-OSEC	Supplementary feeding program	3,700	Book I, Title I, Chapter II, Section 17 (b) (2) (iv) Social welfare services which include programs and projects on child and youth welfare, ... nutrition services, ...	Cities/ Municipalities
DSWD-OSEC	Services for residential and center-based clients	1,869	Book I, Title I, Chapter II, Section 17 (b) (2) (iv) Social welfare services which include programs and projects on child and youth welfare, family and community welfare, women's welfare, welfare of the elderly and disabled persons; community-based rehabilitation programs for vagrants, beggars, street children, scavengers, juvenile delinquents, and victims of drug abuse; livelihood and other pro-poor projects; ...	Provinces

Con't. of Table 3.

Agency	PAP	TOTAL APPROPRIATIONS - 2020 GAA LEVEL (in million pesos)	RELEVANT 1991 LOCAL GOVERNMENT CODE PROVISION	RESPONSIBLE LEVEL OF LGU
DPWH	Construction/ repair/ rehabilitaion of various infrastructure including local infrastructure projects (VIILP)	164,784	Book I, Title I, Chapter II, Section 17 (b) (2) (viii) Infrastructure facilities intended primarily to service the needs of the residents of the municipality and	Provinces
			Book I, Title I, Chapter II, Section 17 (b) (2) (vii) Infrastructure facilities intended to service the needs of the residence of the province and which are funded	Cities/ Municipalities
LGSF	Provision for Potable Water Supply (SALINTUBIG)	1,550	Book I, Title I, Chapter II, Section 17 (b) (2) (viii) 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; ... artesian wells, spring development, rainwater collectors and water supply systems;	Municipalities
MMDA	Solid Waste Management Program	2,345	RA 9003 (Solid Waste Management Act) Section 10. Role of LGUs in Solid Waste Management. -- Pursuant to ther elevant provisions of R.A. No. 7160, otherwise known as the Local Government Code, the LGUs shall be primarily responsible for the implementation and enforcement of this Act in their respective jurisdictions. Section 44. Establishment of Common Waste Treatment and Disposal Facilities. -- Pursuant to Sec. 33 of R.A. 7160, otherwise known as the Local Government Code, all provinces cities, municipalities and barangays, through appropriate ordinances, are	
ALGU	Barangay officials death benefits	50		Barangay
LGSF	Assistance to Municipalities	11,714		Municipalities
LGSF	Assistance to Cities	2,490		Cities
LGSF	Conditional Matching Grant to Provinces (CMGP) for Road Repair, Rehabilitation and Improvement	8,224		Provinces
LGSF	Other Financial Assistance to LGUs	8,753		Provinces/ Cities/ Municipalities
TOTAL		247,583		

Source: 2020 General Appropriations Act (GAA) for list of PAPs of various NGAs that may be re-devolved to LGUs; Section 17 of the 1991 Local Government Code

3. Vertical and Horizontal Fiscal Imbalance Across Different Levels of LGUs and the SC Ruling on the Mandanas-Garcia IRA Petitions

If one assumes that the national government is not only omniscient but also benevolent in funding the PAPs found in **Table 3** in the sense that its budget allocation decisions are aimed at maximizing the welfare of its citizenry, then the importance of ensuring that LGUs continue to provide the services associated with these PAPs when the funding is transferred to them in the form of an increase in their IRA share cannot be overemphasized. In this regard, three conditions have to be satisfied. First, the increase in LGUs' IRA should be enough for them to deliver the same level of services that were made available to their constituents prior to the effectivity of the April 2019 SC ruling on the IRA. Second, LGUs should prioritize the services associated with the unfunded PAPs when they allocate their budget. Satisfying the first condition does not automatically assure that the second condition will be met because the IRA is a block grant. As such, LGUs have full discretion as to its utilization. Third, local constituents should be informed that starting in 2022 LGUs, not the national government, will be responsible for the provision of the services associated with the PAPs found in **Table 3**. In other words, local constituents will have to demand said services from their local governments in order for their LGUs to prioritize the funding for the same.

In this section, this study assessed the implications of paying for the increase in the IRA share of LGUs in 2022 by “re-devolving” to LGUs the PAPs identified in **Table 3** while withdrawing the funding for the said PAPs in NGAs' budgets on the ability of LGUs to fund the same level of services that used to be provided by the NGAs previously (i) across different levels of local government in the aggregate, and (ii) for individual LGUs within each level of local government.

3.1. Vertical fiscal balance across different levels of LGUs

When the 2020 GAA appropriations for the PAPs that are proposed to be re-devolved to LGUs in 2022 are assigned notionally to provinces, cities, municipalities, and barangays in a manner that is consistent with how the responsibilities for the delivery of those PAPs are assigned to provinces, cities, municipalities and barangays under Section 17 of the 1991 LGC, a vertical fiscal imbalance across different levels of LGUs becomes evident (**Table 4**). In particular, the combined amount of the appropriations for the re-devolved PAPs that are assigned to provinces is equal to 37.9% of the incremental IRA due to the SC ruling on the Mandanas – Garcia IRA petitions, almost 14.9 percentage points higher than the 23% share of all provinces in the IRA as mandated under Section 285 of the 1991 LGC. This means that the increase in the IRA of all provinces in the aggregate will not be enough to provide the services that used to be provided by the NGAs prior to the unfunding of the re-devolved PAPs to provinces. In contrast, the combined amount of the appropriations for the re-devolved PAPs that are assigned to municipalities are significantly lower than their mandated codal share in the IRA. This means that the increase in the IRA of all municipalities in the aggregate is more than enough to provide the services that used to be provided by the NGAs prior to the unfunding of the re-devolved PAPs to municipalities. The same holds true for all cities combined and all barangays as a group. These results arise because of the inconsistency between the IRA distribution formula and the nature of the PAPs that are proposed for re-devolution.

Table 4. Allocation to different level of LGUs of the amount of appropriations for PAPs that will be re-devolved

	All LGUs	Provinces	Cities	Munis	Barangays
Agri machinery, equipmet, facilities	2,038.9	2,038.9			
Irrigation network services	1,185.8	1,185.8			
Farm-to-market roads	9,958.5				9,958.5
Health HR deployment ^{a/}	4,880.8	2,048.3	811.1	2,021.4	
HFEP ^{a/}	13,557.1	3,327.5	1,786.0	8,443.5	
Soc health assistance	10,483.5		8,209.1	2,274.4	
Feeding program	3,700.4		2,897.6	802.8	
SW residential care	1,869.2	1,869.2			
DPWH VIILP	138,629.3	74,979.6	27,783.0	35,866.8	
Salintubig	1,549.6			1,549.6	
MMDA-SWMP	2,345.3		2,345.3		
Death benefits of barangay officials	50.0				50.0
Total	190,248.5	85,449.3	43,832.1	50,958.6	10,008.5
Share of PCMB in total increase in IRA (PhP 225.3 billion)		37.9	19.5	22.6	4.4
LGU share in IRA as provided in Section 285 of the 1991 LGC		23.0	23.0	34.0	20.0

a/ The combined total amount for health HR deployment and HFEP that is shown in this table is equal to the combined appropriations for these PAPs in Table 3

3.2. Horizontal fiscal imbalance within each level of local government

In this sub-section, the study also evaluates whether individual LGUs (at least for the provincial, city and municipal level) will have the fiscal capacity (as measured by the incremental IRA they will receive as a result of the April 2019 SC ruling on the IRA) that will allow each one of them to provide comparable level of services related to the PAPs that are proposed to be re-devolved in **Table 3**. A three-step procedure was followed to do this. Step 1, the appropriations for the said PAPs are distributed first to the different levels of LGUs as shown in **Table 4**. Step 2, the amounts thus assigned to the different levels of LGUs are allocated notionally to individual LGUs within each level on the basis of some objective measure of need at the subnational level that are relevant to these PAPs (**Table 5**). Step 3, the sum of the estimated amounts of budgetary resources needed for the delivery of comparable level of services for the PAPs under consideration in step 2 is subtracted from the incremental IRA for each individual LGU to arrive at a measure of the net incremental resource transfer due to the SC ruling on the Mandanas-Garcia IRA petitions. This exercise found that the incremental IRA due to the April 2019 SC IRA ruling 66 out of 81 provinces (or 81.5%), 43 out of 145 cities (or 29.7%) and 161 out of 1,489 municipalities (or 10.8%) will not be enough to allow them to provide comparable levels of re-devolved PAP services (**Table 6**). In comparison, Manasan (2005) reports that the net resource transfer in 1999 (defined as the 1999 IRA less 1992 less inflation adjusted cost of functions devolved in 1992) was negative in 50 out of 79 of provinces (or 63.1%), 28 out of 83 of cities (or 33.7%), and 893 out of 1,525 municipalities (or 58.6%). The difference in the proportion of LGUs which suffered net resource transfer in 1999 and the estimate for 2022 indicates a need to have a more comprehensive assessment of the horizontal imbalance by matching the incremental IRA between 1992 and 2022 against the entirety of the all functions assigned to LGUs under the 1991 LGC.

On the other hand, the **Table 7** presents the top 10 and bottom 10 LGUs within each level of local government when individual LGUs are ranked in terms of the per capita difference between the IRA increase and the amount needed for them to provide comparable level of re-devolved services (or per capita net resource transfer). This table further highlights the horizontal imbalance among individual LGUs within each level of local government and suggest the need for equalization grants to address the horizontal imbalance problem.

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. Martinez-Vazquez and Boex (2000, p. 19-20) 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.”⁵
- (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.

⁵ 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 and Boex 2000, p. 21).

Table 5. Basis for the allocation to individual LGUs of the amounts appropriated in the 2020 GAA for the PAPs that are proposed to be re-devolved to fund the increase in the IRA.

	Provinces	Cities	Munis	Barangays	Basis for distn across individual LGUs within each level
Agri machinery, equipmet, facilities	x				number of farmers in region + number of poor popn within each region
Irrigation network services	x				number of farmers in region + number of poor popn within each region
Farm-to-market roads				x	length of barangay road in province + number of poor popn within each
Health HR deployment ^{a/}	x	x	x		number of health facilities (hospital beds/ RHU/ BHS) needed to reach specified targets + associated staffing required + unit cost of the same
HFEP ^{a/}	x	x	x		
Soc health assistance		x	x		number of poor popn
Feeding program		x	x		number of poor popn
SW residential care	x				number of poor popn
DPWH VIILP	x	x	x		length of local roads + cost of preventive maintenance
Salintubig			x		number of poor popn
MMDA-SWMP		x			number of LGU population
Death benefits of barangay officials				x	

Table 6. Number of LGUs whose IRA increase is less than what they would need if they were to provide comparable level of re-devolved PAPs services.

	Number	% of total no. of LGUs
Provinces	66 out of 81	81.5
Cities	43 out of 145	29.7
Municipalities	161 out of 1,489	10.8

Table 7. Provinces, cities, and municipalities ranked in terms of the per capita difference between IRA increase and amount needed to provide comparable of re-devolved services

	in pesos		in pesos
Top 10 among provinces		Bottom 10 among provinces	
Batanes	4,577	Mountain Province	-3,229
Dinagat Islands	1,135	Abra	-2,752
Biliran	697	Palawan	-2,346
Northern Samar	306	Misamis Oriental	-1,993
Aurora	278	Siquijor	-1,950
Rizal	234	Quirino	-1,905
Laguna	143	Compostela Valley	-1,890
Bulacan	107	Apayao	-1,854
Quezon	70	Ilocos Norte	-1,490
Pampanga	61	Oriental Mindoro	-1,444
Top 10 among cities		Bottom 10 among cities	
Santiago	3,274	Kabankalan	-2,523
Ilagan	3,129	Sipalay	-2,488
Tabuk	2,820	Bislig	-2,251
Bayugan	2,230	Pagadian	-1,749
Palayan	2,207	San Carlos, Negros Occ	-1,475
Puerto Princesa	1,955	Island Garden City of Samal	-1,416
Candon	1,869	Gen. Santos	-1,190
Dapitan	1,793	Ligao	-1,167
Mati	1,708	Tandag	-1,088
Bais	1,683	Baybay	-1,086
Top 10 among municipalities		Bottom 10 among municipalities	
Kalayaan, Palawan	125,150	Botolan, Zambales	-2942
Uyugan, Batanes	5,673	Candelaria, Zambales	-2626
Daguioman, Abra	5,596	Palauig, Zambales	-2137
Ivana, Batanes	5,501	San Marcelino, Zambales	-2117
Barlig, Mt. Province	4,927	Nueva Era, Ilocos Norte	-2113
Mahatao, Batanes	4,705	Santa Cruz, Zambales	-2042
Bucloc, Abra	4,362	Masinloc, Zambales	-1897
Calanasan (Bayag), Apayao	4,082	Cabangan, Zambales	-1721
Dinapigue, Isabela	4,058	Mabini, Pangasinan	-1539
Lacub, Abra	3,898	San Antonio, Zambales	-1509

While there is agreement in the literature that, in principle, equalization transfers should equalize net fiscal capacity of subnational governments, the design of equalization transfers actually used by different countries show some variation with respect to the inclusion of the two components of net fiscal capacity in the equalization formula. Some countries like Australia and Switzerland incorporate fiscal capacity and expenditure need in the design of their equalization transfers. In contrast, other countries like Canada and Germany do not include compensation for differences in expenditure need in the design of their equalization

transfers. Related to this, Shah (2007) 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.

However, the need for equalization transfers require further study given the differences in relative size of the disparity in per capita IRA and per capita LSR among provinces vis-à-vis that among cities. Likewise, the difference in the direction of the relationship between per capita IRA and per capita LSR for provinces and that for cities is unexpected and requires further study.

4. Policy Instruments for Ensuring that National Objectives are Met

The substantial of the reduction in the spending of national government agencies that will likely result from the SC ruling on the Garcia-Mandanas IRA petitions suggests that there may be a need for intergovernmental transfers that are designed for the purpose of support 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 with local fiscal capacity are considered most suitable to address local infrastructure deficiencies that affect the functioning of the internal common market.

5. Conclusion

Given the findings on horizontal fiscal imbalance and the need for equalization grants raised in Section 3 and the argument for conditional matching grants that is put forward in Section 4, we go back to the answer question raised at the end of Section 2 above:

“Should the national government reallocate to other national government functions (e.g., build, build, build program) the PhP 22.3 billion that is in excess of the amount required to fund the increase in the IRA as a result of the SC ruling on the Mandanas-Garcia IRA petitions?”

This paper’s response to this question:

The national government should consider using the amount of appropriations for re-devolved PAPs that used to be included in GAA budgets of some NGAs that is in excess

of the increase in the IRA due to the SC ruling on the Mandanas-Garcia IRA petitions for equalization transfers and the government counterpart in matching grants.

Moving forward, there is a need to design the equalization grant to address the horizontal fiscal imbalance across individual LGUs within each level of local government and the matching grants program before 2022. Also, there is a need to revisit the relationship between the LGUs' propensity to generate own-source revenue and the size of their IRA.

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