

Public Expenditure Management

Compressed discretionary expenditures have resulted in low levels of public investment, limiting facilitation of long-term growth and the Government's ability to combat poverty. The fiscally constrained environment makes it important to focus on more effective management of public expenditures. Given poor revenue performance, unless recurrent expenditures are contained, the Government will continue to lack the resources to improve human resource investments, protect the poor, and address critical shortcomings in infrastructure. Major areas for reform include controlling personal service expenditures; adjusting allocations to local government units; reducing deficits of government-owned and controlled corporations; and continuing to strengthen the budget process by improving financial management and controls and implementing the new procurement regime.

Background

The Government is aiming for a balanced budget by 2009. Currently, however, its ability to finance poverty-reducing programs, among others, is at risk.

In particular, discretionary expenditures no longer provide adequate flexibility to respond to evolving needs. They are severely constrained by low revenue collections, rising debt and debt service, growing transfers to local governments, and high personal services expenditures.

Revenues have declined from 19.4 percent of GDP in 1997 to 14.4 percent in 2003. Expenditures remained more stable over 1997–2002, ranging from 19.3 to 19.8 percent, but contracted to 17.5 per cent of GDP in 2003.¹ It is not the rise or fall of any individual item, but the combined effect of decreasing revenues and increasing statutory obligations that is having a pincer-like impact on the Government's expenditure program.

Compressed discretionary expenditures have resulted in low levels of public investment, limiting public sector facilitation of long-term growth and diminishing the Government's ability to combat poverty. In addition, maintenance and other operating expenditures (MOOE) have been significantly squeezed. Lastly, the public perceives that a significant share of public expenditure

is misspent through waste, inefficiency, or fraud. This view is fueled by systemic leakages, such as those from public procurements, which further erode public spending effectiveness.

The overall constrained environment makes it important to focus on more effective management of public expenditures. Given poor revenue performance, unless recurrent expenditures are contained, the Government will continue to lack the resources to improve human resource investments, protect the poor, and address critical shortcomings in infrastructure.

Issues and Options

The major areas² for reform and adjustment on the expenditure side include: controlling personal services expenditures to enhance efficiency and flexibility;³ adjusting, perhaps on a temporary basis, transfers to local government units (LGUs) and reducing allocations to government agencies for devolved functions; reducing deficits of government owned and controlled corporations (GOCC); continuing to strengthen the budget process; implementing the new procurement regime; strengthening financial

¹ Source: Department of Finance *Fiscal Update*.

² Other issues relevant to expenditure management, such as managing contingent government liabilities, reforming pensions, and reducing power sector losses have been covered in other discussion briefs.

³ This is discussed in the Civil Service Reform discussion brief and will not be covered here.

management and controls; and reducing and rationalizing “pork barrel” funds to legislators.

Local government

The Local Government Code of 1991 provided the policy framework for the increased role of LGUs in the provision of quality public services. As a result, LGU expenditures have increased from 1.68 percent of GNP in 1990 to 3.75 percent in 2001. In 2001, LGUs were responsible for 19.7 percent of general government spending (25.6 percent net of debt service) while directly collecting only 7.2 percent of revenue.

Despite being on the front line of basic service delivery, however, LGUs account for a small portion of total government financial resources: the average percentage share of LGUs in total consolidated expenditures during 1994–2000 was only 3.7 percent, as against the government share of 17.6 percent and the GOCC share of 60.4 percent. However, it is not the quantum of LGU expenditures but rather their impact on governance and service delivery that is relevant.

LGUs are characterized by dependency: they predominantly rely on national transfers (i.e., the Internal Revenue Allotment) to meet their financing needs, and have not succeeded in mobilizing revenues from measures within their purview.⁴ Internal Revenue Allotment transfers account for 64 percent of LGU resources, and are among the fastest growing items in the government budget, rising from 7.5 per cent in 1992 to 19.5 per cent in 2001. The large financing requirement now weighs heavily on the Government and must be addressed as part of a comprehensive program to strengthen public finances.

In addition, several government departments and agencies still receive budget allocations for functions that are devolved to LGUs, thereby increasing confusion over expendi-

⁴ This is discussed in the Decentralization discussion brief.

ture assignments and functional responsibilities.

Government owned and controlled corporations

GOCCs were mainly established to improve provision of infrastructure services. The Government privatized more than 200 GOCCs and strengthened the performance of the remainder. The number of GOCCs now stands at about 98 (including subsidiaries). A supervision unit was established within the Department of Finance (DOF) to monitor the activities and operations of 14 major GOCCs.⁵

Many GOCCs still depend on government resource transfers. The 14 monitored GOCCs decreased capital expenditures from P68 billion in 1996 to P35 billion in 2001. Excluding the National Power Corporation (NPC), internal cash generation in the aggregate financed 61.8 percent of GOCCs’ financial requirements between 1990 and 2000, domestic borrowing 14.9 percent, and external borrowing the remaining 23.3 percent. The NPC’s borrowings have accounted for about 50 percent of the total contingent liabilities of GOCCs.⁶

Key reasons for poor GOCC performance include the lack of an effective performance framework for GOCCs, lack of financial viability in the case of some GOCCs, and laxity in management.

Strengthening the budget process

There has been substantial progress by the Department of Budget and Management (DBM) and the National Economic and Development Authority (NEDA) in linking the budget planning, execution, and monitoring processes with nationally articulated priorities. The Government has promoted

⁵ The 14 GOCCs comprise EPZA (later renamed PEZA), LWUA, LRTA, MWSS, NDC, NEA, NFA, NHA, NIA, NPC, PNOC, PNR, PPA and MMTC. In 1994, MMTC was privatized. Effective 2000, the Home Guaranty Corporation was considered a monitored GOCC.

⁶ Power sector issues are covered in a separate discussion brief.

transparency—budget and fund release information is now posted on the DBM website. NEDA is undertaking an exercise to better link national, regional, and local planning. However, while the executive order that still forms the basis of the budget process—EO 292—provides a comprehensive and sound budget framework, it has not been fully implemented, nor has it been updated. It has a relatively low legal status given the importance of the national budget.

Public procurement

From FY1997 to FY2001, annual outlays for procurement of goods, works, and services by national agencies, averaged more than P113 billion. This excludes procurement undertaken by LGUs and GOCCs, which amount to about P50 billion a year and build-operate-transfer (BOT) projects, estimated at about P372 billion in 2001. The Ombudsman, the Commission on Audit, and the Philippine Center for Investigative Journalism have reported that large amounts of public funds are being lost to procurement-related corruption. The perception of large leakages is prevalent. An October 2001 study by Procurement Watch, Inc. reported that the potential leakage from government funds through procurement corruption could have run to about P21 billion in 2001 (equivalent to 14 percent of the budget deficit that year). The additional potential leakage in public-private transactions under BOT projects was estimated, conservatively, at P74 billion.

The potential for budgetary savings realizable from more transparent and accountable procurement is high. The experience of textbook and drugs procurement under World Bank-financed projects has demonstrated that adoption of more transparent procurement processes and greater use of international competitive bidding practices can reduce unit prices of textbooks by about 40 percent. In one example, this translated into a saving of about P1.2 billion⁷ for the Department of Education. In the Department of Health, unit prices of tuberculosis drugs were cut by 33 to

94 percent, similarly translating into substantial savings.

Appropriately, therefore, the last several years have seen a continued impetus from the executive for reforming public procurement. In 2003, a new public procurement regime was ushered in by the Government Procurement Reform Act, and is applicable to the national Government, local governments, and GOCCs. Its implementation is now appropriately the top administration priority in procurement reform. In addition, DBM has spearheaded the implementation of an electronic procurement system (still in its early stages). The Philippines has also been prominent in involving civil society in the public procurement process as a means to enhance accountability and transparency, at both the national and local levels.

However, challenges abound: (i) procurement staff require training and professionalization; (ii) the electronic procurement system is still in its infancy and requires further development; (iii) mechanisms for transparency, complaints handling, and supplier evaluation are still weak.

Financial management

The Government has been implementing a wide-ranging reform of its financial management system to support its performance-oriented management framework, make financial reports more timely and understandable, and strengthen cash management.

A new National Government Accounting System (NGAS) has been in operation since January 1, 2002. The NGAS aims to simplify government accounting, conform to international accounting standards, and generate periodic and relevant financial statements for better performance monitoring. The Commission on Audit (COA) has also developed an accounting software package for computerization of the NGAS. The NGAS is expected to generate better information for management control and decision making. In addition, Administrative Order 70 of April 2003 mandated the establishment of internal audit units in all agencies of the Government

⁷ Sta. Ines, Noel. 2001. "Textbook Procurement, A Philippine Experience."

and LGUs. Other key measures include a fundamental restructuring of COA to strengthen its external audit function, promulgation of a government accounting and auditing manual, and the strengthening of local government financial management capacity.

A major issue is the extent to which user departments and agencies are being consulted by the COA on its initiatives. Lack of consultation in the past is one of the reasons for the slow progress in NGAS implementation. A second issue is the extent to which NGAS implementation is diverting COA resources from its core supreme audit function.

Internal control weaknesses and resulting risks in cash management arise from (i) Bureau of the Treasury (BTR) reliance on bank information on deposits to account for revenue collection; (ii) delayed ability or inability to fully reconcile bank information with collecting agency records; (iii) reliance on bank information on payments for replenishment of service bank accounts and the backlog of reconciliation with agency records; and (iv) large sums of cash and bank deposits maintained by agencies or disbursing officers outside BTR control.

The Government has been trying to strengthen cash management through the Modified Disbursement System (MDS), designed to rationalize the payments system to a few bank accounts (currently only four banks are used) and eliminate idle cash by centralizing the cash floats to these banks. However, the MDS system has some control weaknesses. Although BTR regional and provincial offices are required to reconcile the bank accounts with summaries of issued checks sent by the agencies, reconciliation is carried out several months in arrears. In addition, BTR has no access to agency books of accounts (such access is given only to COA). Instructions on reconciling these pro forma accounts with the accounts kept by banks have yet to be developed.

Another issue relates to the bank accounts maintained by secondary recipients of notices

of cash allotments (NCAs). Although primary recipients of NCAs are required to use MDS bank accounts for disbursing funds, any secondary allocation of NCAs to district offices or another agency requires funding by commercial check. The recipients of these secondary allocations deposit these checks in separate bank accounts until they are actually disbursed. There are several thousand such accounts currently in existence. The total amount in deposit in 2000 amounted to P52 billion. DOF-DBM Joint Circular 1-90 requires that the provincial offices and operating units receiving these funding checks withdraw the unexpended balance of the deposit account at the end of the year and remit the amount to BTR. A copy of the remittance advice is given to the relevant regional office of the agency concerned. In addition, cash advances are made from the MDS bank accounts to disbursing officers for payment of salaries and other expenses. The unliquidated cash advances with government disbursing officers at the end of year 2000 amounted to P11 billion. The above cash balances are outside BTR control and pose a serious fiduciary risk.

Reconciliation of remittances with Bureau of Internal Revenue and Bureau of Customs records are carried out by the accounting group at BTR (in the past, such reconciliation has proved difficult and has been a cause for concern). As with cash payments, delays in reconciling bank deposits with Bureau of Internal Revenue and Bureau of Customs records pose a serious control weakness in the current system.

Countrywide Development Fund

The executive's discretionary funds, already squeezed, are further curtailed due to the Countrywide Development Fund (CDF)⁸ available to national legislators. Annual CDF allocations per congressman are currently P80 million annually, and per senator about P200 million. Two aspects make the pork barrel system more potent in the Philippines than in other countries: *first*, the fact that

⁸ The "pork barrel" funds.

legislators are allowed to exercise complete discretion in the assignment of such funds, from the direction of their use to the selection of contractors, makes these a common source of rents; *second*, these allocations are not subject to the same evaluation and audit standards as other expenditures.

Suggestions for Priority Actions

The top priority is to focus on a limited number of strategically important doable actions to start achieving results. These would comprise:

Adjust the financing arrangements for devolved functions and, if necessary on a temporary basis, for LGUs. A two-pronged action plan could comprise: (i) identifying and then reducing, if not eliminating, allocations for line departments for programs, activities, and projects that relate to functions devolved to LGUs; and (ii) reducing, on a temporary basis if needed, the central transfers to LGUs.⁹ The latter option should be entertained only in case of dire necessity and with a clear indication of the temporary nature of the financial emergency that alone can justify such an action.

Reduce the pressure on national finances arising from GOCC financing needs. Streamlining GOCCs by formulating policy directions, proposals for specific GOCCs, and a GOCC performance monitoring framework. The Government has already initiated this process and begun an assessment of the financial viability of GOCCs to identify those with financial and liquidity problems. A performance audit will be conducted for relevant GOCCs. It would be desirable to complete this work quickly, establishing a timeline for proposed actions and identifying responsible agencies.

Strengthen the budget process and framework. Actions would comprise (i) sustaining the medium-term expenditure program (three-year rolling budget) in close coordination with the development plan—this

could be done by including a statement of the medium-term expenditure framework (MTEF) in the Medium-Term Philippine Development Plan, with sections on medium-term budget composition and on the explicit link between planning and budget priorities; (ii) submitting the MTEF to the Cabinet for approval and making the approved MTEF a public document; (iii) updating EO 292 to take account of the Local Government Code and upgrading it to a generic budget law; (iv) managing MTEF reform at the highest levels of the executive branch, according to an explicit time-bound reform program, to improve the chances of successful implementation in line agencies and to build support in congress. To accompany a budget law and a revised Executive Order 292, the existing Public Expenditure Management Manual could be revised and updated to incorporate existing guidelines, such that there is one manual used by all of government.

Intensify the implementation of the new procurement regime. With the passage of the Government Procurement Reform Act and the promulgation of its implementing regulations, the next steps include: (i) speedy implementation of the new regime and completion of training of procurement officials at the national and local levels; (ii) establishing a mechanism for systematic monitoring and feedback on suppliers' performance; (iii) strengthening disclosure of information vital to a fair and open competition, during advertisement, and bid evaluation; (iv) establishing an appropriate protest and complaints mechanism; (v) continued development of the government electronic procurement system to include e-bidding and e-payment. It will also be important to sustain the system improvements and capacity building needed to support procurement reforms to increase competition and transparency: this will have a significant impact on increasing the cost-efficiency of resource use and contribute to strengthening governance.

Continue the financial management reforms already initiated, focusing on NGAS implementation and strengthening

⁹ Provision of incentives to LGUs to strengthen collection of their own-source revenues is covered in the Decentralization discussion brief.

cash management. (i) NGAS implementation still needs to be carefully managed—COA will need to strengthen technical support for line agencies and LGUs. As the NGAS is mainstreamed, it would be appropriate for COA to transfer to another agency, or outsource, the responsibility for system maintenance and troubleshooting. This will enable it to focus on its core external audit mandate; (ii) BTR will need to continue addressing the identified internal control weaknesses, by further tightening cash control and management. Moreover, the establishment of an electronic link among the DBCC member agencies to facilitate the monitoring of the fiscal performance is planned. Consideration should also be given to transfer of the responsibility for issue of NCAs to BTR. This will separate the cash and budget management functions and place BTR as the sole responsible agency for cash management

Reduce the distortionary effect of pork barrel funds. This implies actions on two fronts:

(i) Requiring all allocations for locally funded projects to be subject to the same evaluation standards applicable to other allocations. Congressional reallocation data indicate that funds are reallocated to such projects within departments. For example, in

2001, the Department of Public Works and Highways saw a net increase of P10.2 billion in its budget, with a large rise in locally funded projects, which went up by nearly P12 billion. Congress also created entirely new locally funded projects in infrastructure, local infrastructure projects, other national public works, and water supply projects. The concern is the effectiveness and efficiency of these expenditures, which were not vetted as part of the budget process.

(ii) Issuing and implementing an initial set of rules to strengthen transparency, accountability, and allocative efficiency in the use of CDF. It may not be feasible or realistic to discontinue CDF. It would be more realistic to strengthen the process by which CDF is allocated to individual projects, and subject CDF allocations to the same review, audit, and transparency measures as other budget expenditures.

Intensify governance-improving PEM actions. Overall, there is a need for continued vigorous efforts to enhance PEM and reduce corruption as part of the effort to increase the efficiency and effectiveness of public expenditures. This implies special attention to procurement and financial management-related actions.