

Making Decentralization Work Better

The implementation of the 1991 Local Government Code (LGC) reflects both successes and challenges in the achievement of an adequate and effective local governance and service delivery structure. Five major sets of issues need to be addressed to make decentralization work better: the architecture of decentralization; LGU revenue mobilization; LGU financing; LGU budgeting; and governance and political economy. Actions in each of these areas—some requiring legislation, but others not—are needed now to prevent a deterioration in LGU services.

Background

The 1991 Local Government Code (LGC) represented a fundamental shift in the distribution of expenditure responsibility and revenue authority, and in establishing a framework for increased local autonomy. Its implementation over the past decade reflects both successes and challenges in the achievement of an adequate and effective local governance and service delivery structure. The LGC advanced local autonomy by expanding local government taxing authority and devolving expenditure responsibilities. Local government unit (LGU) expenditures have steadily increased from 1990 to 2003 relative to both GNP (from 1.7 percent to 3.8 percent) and general government expenditures (11.2 percent to 25.6 percent).

Anecdotal evidence suggests that decentralization has encouraged greater innovation at the local level, strengthened local management capability, and promoted greater cooperation with the private sector and other LGUs. However, findings from surveys to assess citizens' satisfaction with the access, coverage, and quality of public services point to mixed results: local governments face myriad problems in accessing adequate resources for development.

Five major sets of issues seem to constrain the quest to make decentralization work better: (i) the architecture of decentralization itself; (ii) LGU revenue mobilization; (iii) LGU financing;¹ (iv) LGU budgeting

¹ LGU financing refers to financial resources mobilized by the LGUs, in addition to central transfers

and resource management; and (v) governance and political economy.

Issues

The architecture of decentralization

Overall, the devolution of expenditure responsibilities to LGUs is consistent with the principle of subsidiarity,² and few devolved activities have spillover benefits outside LGU territorial jurisdictions. However, the expected benefits of decentralization have yet to be fully realized due to numerous constraints such as:

(i) *Key unresolved expenditure assignment issues* such as: (a) the adequacy of compensating transfers for devolved functions; (b) devolution of primary education; (c) nationally imposed personal service expenditure constraints through caps, and compensation and classification schedules; (d) nontransparent national government absorption of salaries of augmented education personnel; (e) difficulties in retaining key personnel; (f) national government budgetary mandates without compensatory fiscal transfers; and (g) local-national capital project coordination.

(ii) *Unclear institutional arrangements for service delivery* in many cases, with national

and own-source revenues. The objective is to enable LGUs to access alternative financing sources on competitive terms.

² An important exception is education: although the LGC devolves construction and maintenance of school buildings to LGUs, the primary responsibility for the provision of education remains with the national Government.

agencies playing a significant role in some functions that should have been fully devolved to LGUs. While Section 17 (b) of the LGC provides an unambiguous delineation of functions across levels of government, Sections 17 (c) and (f) effectively encourage the existence of a two-track delivery system, where both national government agencies (NGAs) and LGUs can initiate devolved activities. Consequently, the budgets of devolved NGAs have often grown disproportionately relative to internal revenue allocation (IRA) to local governments.

(iii) *Overall, insufficient resources for poorer LGUs and weak national government ability to equalize fiscal capacity and monitor LGU financial and fiscal performance.* Specifically, the intergovernment systems suffer from significant vertical and horizontal imbalances.³ The current transfer system is ineffective at closing this gap and is often counter-equalizing in its effect.

(iv) *IRA appears relatively unrelated to the cost of functions devolved to LGUs and unrelated to variations in local resource capacities.*

(v) *The problem of the “missing middle”—provinces have a very weak role in the architecture of decentralization.*

(vi) *The national Government has to deal in some cases with more than 1,500 LGUs.* Not surprisingly, it is sometimes unable to effectively fulfill its facilitative or oversight functions.

(vii) *Currently there is no national forum where key stakeholders, such as elected and appointed officials from the national and LGU-level legislative and executive*

branches, can debate and decide on significant decentralization-related issues and constraints.

LGU revenue mobilization

LGUs are characterized by dependency: transfers via the IRA account for 64 percent of LGU revenues.

High dependence on transfers is a disincentive for LGU revenue mobilization. Hard decisions on raising revenues to cover local expenditures and justifying to the public the need to raise taxes in order to provide public services are avoided by LGU officials. The dependence may also impair the development of local government capital markets, because lending to LGUs has been made largely because of the security given by the IRA intercept.

LGUs are underperforming on own-source revenue collection and administration, reducing the credibility of the local tax system and contributing to a culture of noncompliance. At present, own-source revenue constitutes only 36 percent of total LGU revenues. Moreover, local revenue codes have created a panoply of taxes, fees, and charges, many undercollected and some simply uncollected.

LGU financing

The LGC allowed LGUs to float their own bonds, enter into build-operate-transfer (BOT) arrangements or in general to tap various sources of credit financing. However, the intended "graduation" policy designed under the 1996 LGU Financing Framework (LFF) has failed to work. Government financial institutions (GFIs) remain the main financiers for LGUs and almost all long-term credit to LGUs is sourced from official development assistance (ODA).

³ Vertically, while overall decentralization is rather weak, a considerable gap exists between the revenue derived from subnational sources and the expenditures assigned to LGUs. 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. This imbalance (gap) has grown over time. Horizontally, there is great variability in fiscal capacity and own-source revenue across units of government.

Six major issues have engaged policy makers:

(i) *Use of BOT arrangements.* Despite some progress, very few LGUs have used BOT contracts.

(ii) *LGU bond market development.* Modest progress has been made. The Local Government Unit Guarantee Corporation (LGUGC) was created to guarantee debt issues of LGUs financed from private sources.⁴

(iii) *LGUs' lack of access to credit from private banks* is a constraint, for numerous reasons: lack of information on LGUs, lack of familiarity with LGU lending, concerns about the short political tenure of elected local officials, and lack of loan security that could otherwise be provided by the IRA intercept mechanism and a depository relationship with LGUs.⁵

(iv) *Municipal Development Finance Office (MDFO) restructuring.* The Municipal Development Fund (MDF) was established in 1984 as a revolving fund for ODA-supported projects intended to help promote self-reliance of local governments in undertaking socioeconomic development. However, the MDFO is hampered by lack of personnel, resources, and capacity. Its ability to be effective remains highly sensitive to the national Government's fiscal situation while its role in promoting private funding requires strengthening. The Government has started a second phase of MDFO restructuring and created a Municipal Finance

⁴ Issues impeding further development of the LGU bond market include: higher costs in issuing bonds than direct borrowing, lack of reliable information about LGUs, the possibility of political interference in project management or in debt servicing, uncertainty about management capacity at the LGU level, uncertainty about the quality of feasibility studies, lack of an independent rating agency, lack of a market for secondary trading, and lack of access to IRA as security for LGU obligations. Smaller LGUs may not be able to justify the fixed expenses of bond financing.

⁵ The private banks have indicated that their inability to become a depository bank for LGUs has been the chief structural impediment to their entry into the market.

Corporation (MFC), the primary purpose of which is to provide loans directly or indirectly to LGUs.

(v) *ODA technical assistance and financing.* Long-standing constraints include inconsistent policies, unhealthy competition among ODA projects, and lack of leverage of domestic and private financing.

(vi) *Grants for LGUs.* Matching grants are key instruments in intergovernment fiscal transfer systems. Efficiency and equity reasons justify local government grant financing. However, the policy on grants to LGUs had long been impeded by inconsistent implementation.

LGU budgeting and resource management

(i) *Institutionalized planning is weak in LGUs:* only 30–50 percent of LGUs have local development councils in place. Moreover, the Regional Development Plan (RDP) formulated by the Regional Development Council is seldom, if ever, taken into consideration by the LGUs. Conversely, RDPs tend to focus solely on interprovincial projects and ignore local development plans. There is also a disconnect between national planning on the one hand and regional or provincial planning on the other.

(ii) *LGU budget formulation and execution is largely nontransparent* due to: (a) poor income estimates used by LGUs for budget formulation; (b) the practice of granting additional personnel benefits out of “savings”; and (c) the lack of effective community participation in local budget preparation and monitoring.

(iii) *Personal services expenditures constitute the largest LGU expenditure category, squeezing capital outlays and maintenance and other operating expenditures (MOOE).* The ratio of personal services to LGU expenditure has not changed significantly in aggregate between 1991 and 2003, but there are variations across levels of local government: this ratio declined for cities and increased for municipalities and provinces. Though personal services expenditure is

formally capped at 45–55 percent of total LGU resources, it is higher in reality.⁶

(iv) *Structural rigidities in the system.* The civil service classification and compensation system has accentuated rigidities due to its all-embracing character, and created fiscal burdens for LGUs: the continuance of the “Magna Carta” for public health workers has forced LGUs to realign wage rates for other staff.⁷

(iv) *Information and capacity to control LGU personnel costs remain weak.* In the absence of accurate data on the size and structure of LGU complements, total LGU employment is estimated at 250,000 permanent employees and 95,000 temporary employees. This is likely an understatement. Limited Department of Interior and Local Government (DILG) and Civil Service Commission (CSC) capacity has prevented the setting up of effective LGU establishment control mechanisms, and Department of Budget Management (DBM) has had to shoulder much of the burden of trying to control LGU wage expenditures.

(v) *Congressional insertions and allocations*—mostly spent on local infrastructure projects—are a major source of funding at the local level, but they are often only partially aligned with local plans and priorities. Such expenditures are identified by members of Congress but implemented by an NGA, an LGU, or a government owned and controlled corporation, diminishing the credibility of the government’s

strategic allocation and fiscal discipline efforts.⁸

(vi) *Accountability and transparency in LGU procurement leave much to be desired,* despite a growing number of innovations and examples of good practice. Administrative controls over procurement are generally weak, and effective mechanisms to track LGU procurement are lacking.

(vii) *Financial management capacity in most LGUs is weak and based on manual systems.* The LGU internal control environment is characterized by low financial management skills, lack of leadership, and weak oversight by NGAs. Internal control over cash and property management needs major improvement to safeguard LGU assets and strengthen accountability.⁹

Governance and political economy

The 1991 decentralization was an attempt to fundamentally restructure the state following a lengthy period of centralized authoritarianism. Power was devolved from national institutions to local ones. However, at the local level, institutions continue to be captured by elites, especially dominant political families that seek to perpetuate political dynasties within LGUs and, for the more successful ones, across government levels.

⁶ It is common practice to charge some contractuels’ payments to MOOE or against development projects, and even for positions whose costs are meant to be funded entirely from the national budget, LGUs commonly supplement such allocations.

⁷ The legal provisions imply that in lower-class LGUs, the salary of transferred (devolved) personnel may be higher than that of their mayors. In reality, LGUs in a lower income class pay their employees less than those in the national Government because of a lack of resources. Furthermore, more than one-third of LGU employment comprises non-career personnel: this makes centralized classification and incentive structures difficult to design and implement.

⁸ Opacity renders the estimation of Congressional allocations and initiatives in all their forms extremely difficult, though rough estimates put them at P15 billion annually.

⁹ The New Local Government Accounting System (NLGAS) was introduced from January 2002 but its implementation has been slow and there are issues of appropriateness of design, LGU capacity, and financial resources.

The dominance of particular political “clans” has had discernible effects on LGU performance.¹⁰

Major issues include:

(i) The political economy within which decentralization operates limits the extent to which such advancements and pro-poor policies can be institutionalized beyond individual progressive executives. Quick results should not therefore be anticipated.

(ii) The three-year term limit for local chief executives constrains their ability and willingness to entertain or conceive development projects whose implementation period extends beyond their term.

(iii) Issues of governance, accountability, and capture constrain LGU performance in core areas such as revenue collection, procurement, and financial management. Formal adherence to personnel policies and practices tends to conceal the true extent of civil service subjugation and capture—through promotions, appointments to nonpermanent positions, transfers, and monetary or nonmonetary incentives.

(iv) Formal institutions of accountability have been challenged in their effectiveness—especially the DILG in two ways. First, it has severe capacity constraints in pursuing its agenda-setting or supervisory roles. Second, while in some ways the DILG mirrors the problems inherent in national departments overseeing LGUs, it also has a

¹⁰ First, there is very little effective elite circulation, which means there is a strong conservative streak, which not only entrenches persons and patterns of governance but also tends to undermine any possibility of reform measures achieving greater transparency if this (of necessity) unravels dominance. Second, where there is turnover, it usually represents the triumph of one major faction or family over another and leads to radical unraveling of the previous regime, its allied personnel, and projects, and the launching of the new incumbent’s own personnel and projects with little regard for systemic continuity. Third, in the realm of service delivery, institutional grounds for management of public affairs, such as hiring policies and development planning, seem to be tied to the predilections of particular families and their ambitions rather than to a transparent and contestable planning and resource allocation process.

unique problem that emanates from its mixed institutional mandate.¹¹

Suggestions for priority actions

Actions are needed now. Given the mixed track record of decentralization, it would be desirable to review the architecture for decentralization. However, this could take time, and action is needed now to avoid both deterioration in services as well as limitations on funding from the national Government constraining LGU activities significantly in the near future. Some of the immediate actions could be accomplished without legislation, and fairly quickly, by both national and local governments.

Actions not requiring legislation

(i) *Addressing decentralization architecture issues.* A key first step is to provide an institutional consultative forum. Resurrection of a representative body, such as the Oversight Committee on Decentralization, would provide a forum for relevant actors¹² to discuss and obtain consensus on the prioritization, sequencing, and timetable for the next steps in strengthening the architecture of decentralization.

(ii) *Strengthening LGU revenue mobilization.* Own-source revenue collection could be significantly improved through administrative actions, such as providing incentives (a) to LGUs to increase collection of real property tax and business tax, (b) to cities and provinces to conduct the generalized revenue assessment every three years, (c) to cities and municipalities to use minimum (presumptive) gross sales figures to calculate the tax liability for establishments required to pay the business tax, and (d) for

¹¹ For instance, the combination of internal control (peace and security issues) with local administration and service delivery responsibilities is at times inconsistent, leading to an emphasis on one or the other or, more typically, a creeping of the control responsibility into local government oversight and support. The DILG seems to have more capacity to oversee peace and security issues, rather than in policy guidance and general oversight.

¹² Comprising senators, congressmen, local chief executives, NGAs, and oversight bodies.

disclosure of LGU financial information and benchmarking LGU fiscal and financial performance.

(iii) *LGU financing.* (a) *Private financial institutions participation* could be encouraged by establishing an information system on LGU financial performance, by the Bureau of Local Government Finance (BLGF), accessible to all interested parties, and substantially recapitalizing the LGUGC and establishing a bond pooling system to further promote LGU bonds. (b) The next steps in *MDFO restructuring* could comprise developing a detailed business plan covering business objectives, financial products, resource mobilization strategies, lending policies, pricing policies, risk management policies, governance structure, organization structure and staffing policies, etc. The existing MDFO loans should only be transferred to the MFC after completion of such a business plan. Lastly, soon after start of operations, it should consider a pilot domestic bond issue either using a pooled bond structure or an issue backed by its own balance sheet to test market acceptance. (c) The *2002 Grant Policy* could be tightened to incorporate implementation concerns, including affordability to the national Government, better targeting of poor LGUs, further differentiation between provinces and municipalities, and adjustment of the ratios among different sectors. (d) *Closer coordination between donors and government agencies* is necessary to ensure that loan and grant financing as well as technical assistance is used to strengthen LGUs and pave the way for private sector funding of local development in the future. A major effort should also be undertaken to assist LGUs to establish a pipeline of local infrastructure projects and implement them.

An additional issue on which a national consultation and consensus would be required is the appropriate role of provinces in managing decentralization and the number of provinces that are politically, administratively, and fiscally desirable.

(iv) *Budgeting and resource management* could be improved through: (a) streng-

thening planning and investment appraisal including public availability of LGU budget documents; (b) controlling wage bill expenditures including through an effective personnel information system linked to payroll; (c) strengthening LGU procurement through publication by LGUs of unit costs or prices for infrastructure, construction, and goods; promulgation of a manual on procurement procedures; and adequate training, for LGU bids and awards committee members and procurement personnel; (d) strengthening financial management through public disclosure of LGU accounts and COA LGU audit reports by executive order; establishment of an internal audit unit for each LGU, with pilots in class 1 provinces and cities;¹³ establishment of a standing audit committee for all provinces and cities with civil society participation; augmenting BLGF and COA capacity to provide technical support for NLGAS implementation; issuance of policy guidelines requiring mandatory implementation by LGUs of COA audit recommendations; and improving internal controls over cash and property management.

The systems improvements and capacity building implicit in GPRA implementation can improve the transparency and accountability of LGU procurement, leading to increased competition, cost-efficiency of resource use, and strengthened governance. Enhancing LGU financial management and controls is clearly a priority but poses tremendous challenges, among them the need for strengthening the BLGF as the principal oversight agency.

(v) *Strengthening governance.* (a) Examples of successful implementation of administrative reform by LGUs demonstrate that greater transparency in appointments and promotions can improve accountability and strengthen human resource capacity over time. A functioning human resource management and information system could also improve accountability and strengthen human resource capacity. (b) Incentives to encourage LGUs to control personnel costs

¹³ Per AO 70 of April 14, 2003.

and install transparent recruitment processes for nonpermanent positions could significantly strengthen LGU accountability and capacity. (c) Strengthening DILG capacity for administration of the LGC, and its LGU-related policy capacity, could significantly strengthen the management of decentralization.

Actions requiring legislation

(i) *Architecture of decentralization.* The intergovernment assignment of expenditure responsibilities, as well as the transfer system, perhaps needs to be further rationalized. However, this is a complex process requiring extensive consultation and this brief does not address this issue. National government involvement in wage and salary structures and in the spending composition of LGUs interferes with effective and efficient local government administration and could also be reconsidered. It is desirable that NGA direction of expenditures for devolved functions via NGA budgets be eliminated. Split responsibility for primary and secondary education should also be reconsidered, with devolution of administration to LGU and basic financing formalized through a grant structure.

(ii) *LGU revenue mobilization.* Actions dependent on legislative changes include (a) providing incentives for LGUs to collect revenues, that is, allowing the retention of a larger share of revenues collected by an LGU; (b) rationalizing inter-LGU revenue assignment to give provinces and municipalities a discrete assignment of revenue sources; (c) transfer the power to approve the schedule of market value of real property to the national Government from local *sangunians*; (d) allowing LGUs to set their own rates, either under higher ceilings or subject to approval by the national Government; (e) abolishing restrictions on tax-rate changes; (f) providing greater flexibility to LGUs in deciding tax rates and ceilings; and (g) simplifying local revenue codes by reducing the type and number of taxes and fees.

(iii) *Budgeting and resource management.* It may now be time to scrap the compensation

and position classification system for a new system with greater flexibility to LGUs in exchange for heightened accountability, and to examine the feasibility of redefining LGU employees as a separate entity. Some rationalization of this system is required such that regional labor market differences might be better incorporated into staffing and compensation levels. It may also be desirable to review and minimize or explicitly monetize, as the case may be, salary supplements and non-wage benefits. National government absorption of LGU-augmented education staff could also be rationalized and standardized.

(iv) *Governance and political economy.* The appropriate term limits for local chief executives, incentives to induce greater accountability in personnel actions and decisions (e.g., recruitment and promotion), and strengthening the capacity of the DILG to deal with LGU issues comprise key governance-related issues that would require legislative action.

None of the suggestions for action on decentralization are new to Philippine policy makers—but each is fraught with complexity. The challenge is to design the technical solutions and address the political economy challenges through a consultative process, so that an appropriately prioritized and sequenced set of actions—politically feasible, administratively implementable, and fiscally sustainable—can be agreed on and implemented.