

SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT (DECENTRALIZATION AND LOCAL GOVERNANCE)¹

A. Sector Performance, Problems, and Opportunities

1. **The Local Government Code.** The Local Government Code (LGC), passed in 1991, transferred responsibility for the delivery of a large number of basic services in the health, agriculture, social welfare, and environmental sectors to local government units (LGUs). Financial transfers to LGUs were increased accordingly, with 40% of internally generated taxes allocated to LGUs through the Internal Revenue Allotment (IRA). Specific and potentially important own-source revenues were assigned to LGUs, although most LGUs have remained largely dependent on financial transfers from the IRA.² Local governments were equally encouraged to explore alternative sources of revenue by exercising their corporate powers in partnership with the business sector. Finally, the LGC laid the foundation for active citizen engagement in local governance by harnessing the energy of nongovernment organizations and civil society.

2. **Context.** While the decentralization reforms provide the legal basis for improved service delivery at the local level, reforms need to be assessed in the context of the country's political economy, which is characterized by strong political ties between the national and local governments and the tendency of the government to use the intergovernmental fiscal system for patronage purposes and to ensure national unity. Several parts of the country, including Mindanao, are affected by violent conflicts involving communist insurgencies and armed conflicts between families and clans, which are mainly about the control of land and natural resources.³ A more efficient intergovernmental fiscal relations system may help diffuse regional tensions by providing LGUs with adequate financial resources and the ability to match service delivery to local preferences and needs. The LGC has been in place for almost 22 years but has never been substantively reviewed, despite a provision that reviews be conducted every 5 years. Most stakeholders agree on the need to initiate a review process that includes (at a minimum) the main elements of the intergovernmental fiscal relations system; these are interconnected, and comprise the expenditure and revenue assignments, the system of fiscal transfers, and the LGU borrowing powers.

3. **Expenditure assignments and service delivery mandates.** The significant devolution of service delivery responsibilities to LGUs implemented under the LGC is largely unfinished. In comparison with neighbouring countries such as Indonesia, the Philippines have not progressed in terms of the clarification of roles and responsibilities across tiers of government. The lack of clarity in the assignment of service delivery responsibilities between the national government and the LGUs leads to important problems, including claims that unfunded mandates for LGUs are multiplying (service delivery obligations by national departments that need to be financed by LGU sources of revenue). Further clarification of service delivery responsibilities will also help in implementing performance-based monitoring systems, and in simplifying the financing framework for LGUs.

¹ This summary draws on ADB. Forthcoming. *Southeast Asia Department Subsector Assessment: Decentralization and Local Governance*. Manila.

² According to the Department of Finance, transfers from the IRA represent on average 66% of total local government revenues.

³ International Crisis Group. 2011. The Communist Insurgency in the Philippines: Tactics and Talks. *Asia Report* (202). 14 February.

4. **Intergovernmental fiscal transfers.** Broad trends in intergovernmental financing over the past few years have seen relative increases in total resources available to LGUs. The IRA, which is set at 40% of the actual national government tax collections 3 years prior to the current year, has steadily increased to about 18% of the total national government expenditure. The IRA has been criticized for two main failings: (i) lack of balance in allotments, at the expense of poorer municipalities and provinces in comparison with comparatively wealthy urban areas; and (ii) the perception that the use of IRA funds by LGUs has not been efficient in improving the daily lives of citizens throughout the national territory. There is widespread agreement regarding the design flaws of the IRA, and that IRA reform is not politically viable, as it would require a review of the LGC. Several stakeholders have proposed marginal reform options as a result.

5. **Performance Challenge Fund.** The Performance Challenge Fund is a recent milestone in the incorporation of incentives for good local governance in the system of transfers. The fund provides financial support on a competitive basis to LGU infrastructure projects that have met a series of good governance conditions—described by the “Seal of Good Housekeeping”—which aims to improve LGU financial management. The Seal of Good Housekeeping will be awarded to LGUs with (i) proven comprehensive development plans and implementation agendas; (ii) sound fiscal management systems, including no adverse findings from the Commission on Audit, and up-to-date financial reporting; and (iii) compliance with the Anti-Red Tape Law, and full disclosure of local budgets.

6. **Local own-source revenues and tax administration.** Local own-source revenue collection has shown recent slight growth, and is 33% of total LGU revenues. Despite recent progress, developing the scope for further increases in own-source is an important policy issue. The LGC provision that allows LGUs to create tax and non-tax instruments provided that the tax bases are not used by other levels of government leads to inefficiencies and may pose limits to local economic development. There is also a need to improve the collection of local business and real property taxes by improving the capacity of local financial managers and systems and increasing revenue generation from nontax sources.

7. **Lack of access to development credit financing.** There is a need to increase the access of LGUs to development financing by using official development assistance more efficiently, improving direct credit financing to lower-income LGUs, and increasing LGU access to private capital markets and to available government-sponsored credit lines for LGUs. Although LGU borrowing powers are granted under the LGC, there are implicit provisions that may restrict credit financing, such as the difficulties in opening depositary accounts in non-government financial institutions; limitations that restrict the use of credit financing or bonds to “self-liquidating, income-generating” projects; or the central bank requirement that all banks lending to LGUs must secure a no-objection from the monetary board.

8. **Weak public financial management systems, local development planning, and expenditure management.** The reliability of local budgeting is distorted by poor revenue estimates during budget formulation. In addition, local budget formulation guidelines need to be harmonized with multiyear planning processes. The following are specific issues relating to public financial management (PFM): (i) an apparent mismatch between school requirements and special education fund spending patterns by LGUs; (ii) spending on personnel accounts for a significant portion of total LGU spending, crowding out maintenance and other operating expenses and capital outlays and negatively effecting service delivery; (iii) deficient financial management of local economic enterprises, which report significant losses, jeopardizing the overall fiscal stability of the public sector; and (iv) the low technical capacity of local budget officers and treasurers requires that competency certification systems be established.

9. **Lack of effective performance measurement.** The local government performance measurement system is ineffective due to insufficient resources to improve existing systems and lack of incentives for LGUs to increase performance. The tool relies on self-assessment, which limits its application to third parties. In addition to the Performance Challenge Fund, initial steps taken by the government indicate an emphasis on strengthening the performance orientation and accountability of LGUs and sector programs at the LGU level (e.g., Department of Health, Department of Public Works and Highways).

10. **Lack of local-level transparency and accountability mechanisms.** The government is taking important steps to improve transparency and accountability in local government management. The 2012 General Appropriations Act enacted the Full Disclosure Policy, which obligates LGUs to disclose the following information to the public: (i) annual budget reports; (ii) statements of receipts and expenditures; (iii) Priority Development Assistance Fund (PDAF) utilization; (iv) quarterly reports of the special education fund; (v) expenditures on social development, economic development, and environmental management under the IRA; (vi) annual gender and development accomplishment reports; and (vii) key procurement documents.

B. Government's Sector Policy, Institutional Arrangements and Planning Framework

11. **General strategic agenda for decentralization.** The government's decentralization reform efforts have focused on developing broad-based capacity at all levels, particularly in PFM, including planning, budgeting, budget execution, procurement, accounting, reporting, and internal and external audit. Important medium-term policy issues and reforms that are being pursued by the government and supported under the Local Government Financing and Budget Reform (LGFBR) program include (i) organizing regular consultation forums of national and local stakeholders to coordinate policy responses to important decentralization issues through a Coordination Committee on Decentralization; (ii) defining functional assignments more clearly to remove any mismatches between devolved functions and transferred resources, and improving implementation of devolved functions, especially in the education sector; (iii) LGU capacity building for sector management and PFM strengthening to improve resource planning, budgeting, and expenditure management in key service delivery areas (e.g., health, education, and public infrastructure); (iv) increasing the effectiveness of performance measurement systems that link LGU investments to public service delivery outcomes; (v) increasing the effectiveness of mechanisms to increase local government access to credit financing, including nontraditional financing sources (e.g., bonds), and development and expansion of creditworthiness rating systems; and (vi) increasing LGU taxing powers, improving collection of real property taxes, and generating other local sources of revenue (e.g., from economic enterprises).

12. ADB dialogue with stakeholders has repeatedly underlined the need to review the LGC to address the systemic obstacles to efficient fiscal decentralization and local PFM. The impact of the current approach—which relies on marginal reforms that do not require a review of the LGC—is limited and does not offer greater chances of success than a comprehensive review.

C. Asian Development Bank (ADB) Sector Experience and Assistance Program

13. Since 2004, ADB has provided two program loans and several technical assistance (TA) projects supporting the government's decentralization efforts. The LGFBR program was designed as a program cluster with program lending and TA. Subprogram 1 of LGFBR 1

covered 2006–2007 and provided a comprehensive policy framework and matrix that assisted with finalization of the legal and regulatory framework while broadening policy reforms in five areas: (i) improving completeness, timeliness, and transparency in the release of intergovernmental fiscal transfers; (ii) enhancing efficiency and accountability in fiscal management, planning and public expenditure management; (iii) enhancing the effectiveness of the LGU performance measurement system and linking it to service delivery; (iv) improving local government access to public and private sources of credit; and (v) developing sources of local own-source revenues. Subprogram 2 covered 2008–2009 and continued work in the same target areas, with intensified effort and finalization of a number of key actions begun in subprogram 1.

14. Various TA activities have helped to continue the policy dialogue, addressed gaps and constraints in the five LGFBR core areas, and developed capacity. The latter includes work on local own-source revenues and credit financing, gaps in planning and performance measurement, and on the formalization of the Coordination Committee on Decentralization as the national and local forum for brainstorming policies and programs in the LGU sector. TA assistance has provided assistance with intergovernmental fiscal relations, local resource mobilization, expenditure management, and LGU performance measurement, resulting in a reduction in the release time for LGU shares in national wealth, recommended improvements in the use of the special education fund, and refinements in the architecture of the local governance performance management system.⁴ The TA on Local Government Revenue Generation and Land Administration Reforms will enable participating LGUs to use improved land management and administration systems, including property valuation and taxation innovations, to generate increased local government revenues.⁵

15. Drawing on its strong experience and demand from the government, ADB's future strategy on decentralization will support sound financial management and planning and enhanced competitiveness at the local level. The intended outcome is that LGUs will have more resources and improved capacity to plan and budget for the general welfare of their citizens in a transparent and accountable manner. The key output areas to achieve these objectives are (i) creating a conducive fiscal framework for inclusive growth; (ii) developing an adequate and equitable resource framework for fiscal sustainability; (iii) strengthening public financial management to assist efficient LGU service delivery; and (iv) fostering good local governance, transparency and accountability. The Local Government Finance and Fiscal Decentralization Reform Program (FDRP) in 2013, with ADB contribution of \$250 million [plus \$100 million co-financing from Agence Française de Développement (AFD)], will support government efforts in the above reform areas.

16. The Subsector Results Framework on page 6 presents the outcome and outputs indicators and ADB's indicative program. ADB will consider expanding the approaches applied during 2015–2016.⁶

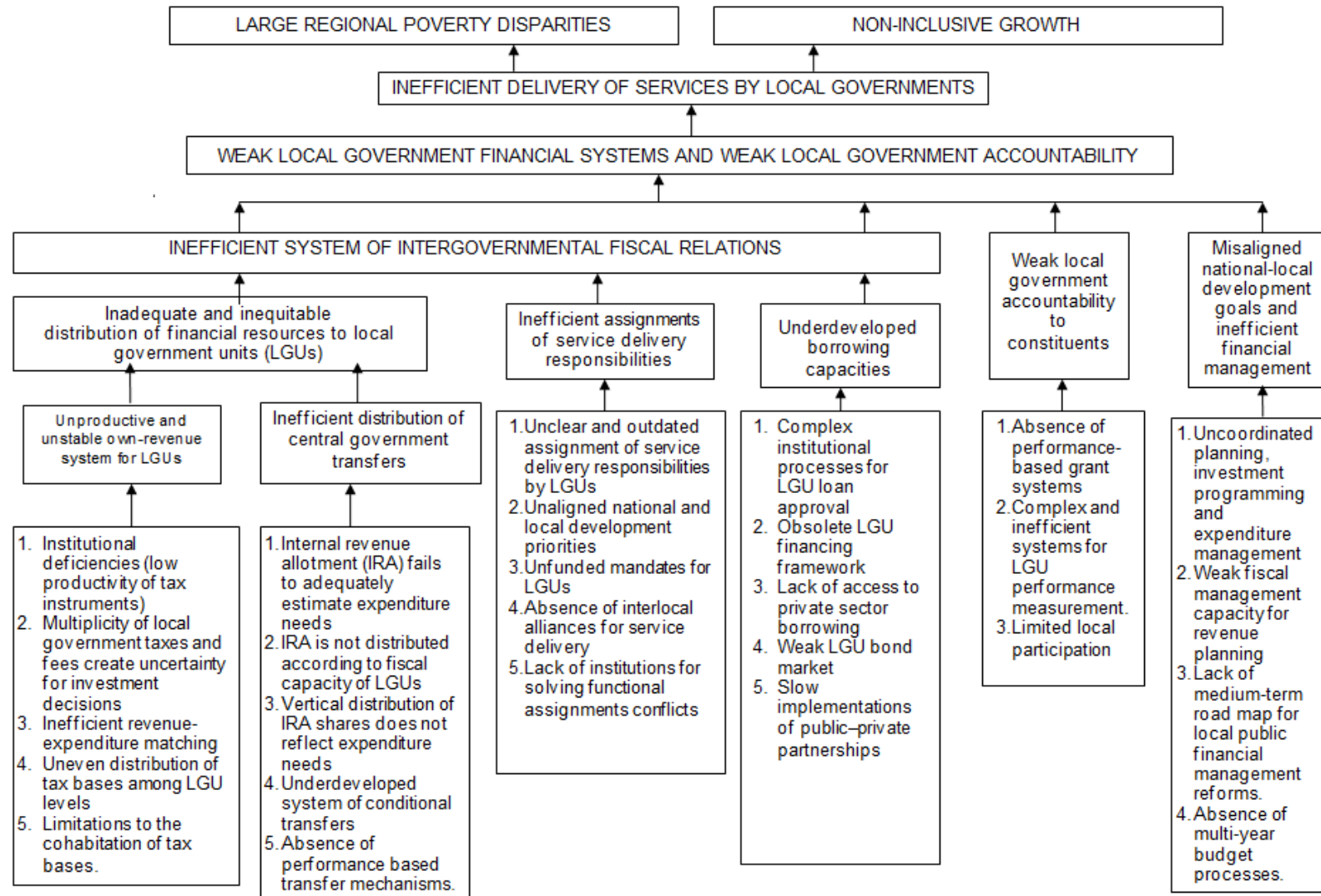
⁴ ADB. 2006. *Technical Assistance to the Republic of the Philippines for Local Governance and Fiscal Management*. Manila.

⁵ ADB. 2011. *Technical Assistance to the Republic of the Philippines for Support to Local Government Revenue Generation and Land Administration Reforms*. Manila.

⁶ ADB. 2011. *Philippines: Country Partnership Strategy (2011-2016)*. Manila.

PROBLEM TREE

(Source: Asian Development Bank)



Subsector Results Framework (Decentralization and Local Governance, 2011—2016)

Country Subsector Outcomes		Country Subsector Outputs		ADB Subsector Operations	
Outcomes Supported by ADB	Targets with Indicators and Baselines	Outputs Supported by ADB	Indicators with Incremental Targets	Planned and Ongoing ADB Interventions	Main Outputs Expected from ADB Interventions
Increased utilization of improved, expanded, and transparent critical LGU public services by citizens.	<p>Real local government revenues, including access to public and private sources of credit, increase by 15% in 2015 from 2009 levels in most provinces and highly urbanized cities and in most 4th–6th income class LGUs</p> <p>Real expenditures for service delivery increase by 10% in 2015 from 2009 levels in most provinces and highly urbanized cities and in most 4th–6th income class LGUs</p> <p>Number of fraudulent cases reported by COA decrease by 30% in 2015 from 2009 level at all subnational levels</p>	<p>Efficiency and accountability in local financial management, planning, and expenditure management are improved</p> <p>Effectiveness and transparency in the delivery of critical local public services is enhanced</p> <p>LGU access to public and private sources of capital for financing policy reforms and development projects is improved</p> <p>Additional local sources of revenue developed, thereby reducing dependency on IRA</p>	<p>Government's program for sustainable delivery of capacity development for LGUs in planning, revenue mobilization, expenditure management, and budgeting delivered according to schedule every year through 2015</p> <p>Performance evaluation system implemented as the basis for appointing and promoting local treasurers by 2014.</p> <p>Private sector financing of LGU projects from all sources increased by 30% in 2014 from 2009 levels</p> <p>BLGF creditworthiness rating system available by 2014</p> <p>Local tax revenue collections from all sources increase by 20% in 2015</p> <p>Real property tax collections increased by 20% in 2015</p>	<p>Pipeline projects Local Government Finance and Fiscal Decentralization Reform Program (LGFFDP) subprogram 1 (2013: \$250 million) LGFFDP subprogram 2 (2015: \$250 million) PPTA on LGFFDP subprogram 1 (2013: \$1.0 million) CDTA on LGFFD (2015: \$0.75 million) CDTA on Rationalizing Local Government Non Tax Revenues (2014: \$1.5 million) CDTA on Strengthening Local Government Revenue Generation and Land Management (2014: 0.4 million) CDTA on Local Government Revenue Generation and Land Administration Information Systems Investment Project (2015: \$0.9 million)</p>	<p>Pipeline projects Conducive LGU fiscal and local resource framework for inclusive growth and fiscal sustainability developed</p> <p>LGU public financial management and revenue generation to assist efficient LGU service delivery strengthened</p> <p>Comprehensive Land Use Plans sensitized to disaster risks and climate change developed by LGUs</p> <p>Ongoing projects Gender and development integrated into land management and administration</p> <p>Citizen engagement processes in mitigating governance risks are developed and tested in selected LGUs</p>

ADB = Asian Development Bank, BLGF = Bureau of Local Government Finance, CDTA = capacity development technical assistance, COA = , IRA = internal revenue allotment, LGFFDP = Local Government Finance and Fiscal Decentralization Reform Program, LGPMS = local governance performance management system, LGU = local government unit, PPTA = project preparatory technical assistance.