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Recommended Citation

Bahl, Roy, and Larry Schroeder. Philippine Intergovernmental Grants: an Evaluation. *Asian-Pacific Tax and Investment Bulletin*. 2(10), Oct. 1984, 403-410.

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PHILIPPINES INTERGOVERNMENT GRANTS: AN EVALUATION*

ROY BAHL AND
LARRY SCHROEDER**

As is the case in developed and developing countries throughout the world, local governments in the Philippines are dependent upon the central government for a significant share of the resources at their disposal. For example, in 1977 the 98 municipalities within the Provinces of Albay, Bulacan, Iloilo and Sorsogon obtained an average of 35.2 percent of their general fund revenue from government grants. Cities (excluding those in Metropolitan Manila), with their more extensive tax base, had an analogous 24.2 percent reliance on grants. In light of this importance, it would seem useful to consider the possibilities for evaluating the performance of this intergovernmental system.

Three purposes underlie this paper. One is to outline how any intergovernmental grant system might be evaluated. The second is to evaluate the system operating in the Philippines, with special emphasis on the Bureau of Internal Revenue (BIR) Allotment and Specific Tax Allotment (STA) programmes. The final section of the paper suggests policy directions that might improve the system.

Grant Evaluation Criteria

There are several criteria by which a grant system must be evaluated: allocative effects, equalizing effects, effects on fiscal planning, revenue growth and implications for decentralization and fiscal autonomy. The task of *overall* evaluation, however, is complicated because these criteria often conflict, e.g., an "equalizing" grant may not stimulate local government revenue effort. This means that the outcome of the overall evaluation may differ depending upon the perspective of the evaluator – from a central government or a local government vantage.

Allocative Effects

The allocation is related to the general question of whether or not a grant system alters the level and allocation of local government fiscal resources relative to what they would have been in the absence of the grant. Three specific questions generally arise: (1) does the grant system make local governments less accountable thereby encouraging less efficient operations; (2) does the system cause local governments to alter budgetary choices; and (3) does the grant discourage localities from mobilizing their own resources?

Operational Efficiency. When local governments are neither penalized nor rewarded for changes in operational efficiency in response to intergovernmental grants, there is no incentive for localities to undertake initiatives to improve local administration. Full cost reimbursement grants, for example, are especially likely to thwart such initiative since all expenditures made at the local level will be borne by the Central Government Treasury. In this case, the local government is responsible to neither the Central Government nor to their own taxpayers for the efficiency with which they operate.

Budget Distortions. Grants can cause local governments to change their expenditure pattern. Partial cost reimbursement grants and conditional grants are likely to have this effect. By

requiring a local expenditure match the grant effectively lowers the local "price" of that activity. This, in turn, encourages the locality to spend more on the aided function and relatively less on something else. Whether or not such changes are desirable is, of course, a normative question that cannot be determined *a priori*. Nevertheless, these effects must be recognized in any grant system review.

Tax Effort. One potentially damaging effect of grants is that they may discourage the locality from using its own revenue base as extensively as it otherwise would. That is, a locality may choose to 'substitute' grants for local taxes. One way in which such response can be neutralized is by building a tax effort measure directly into the allocation formula thereby providing an incentive to a locality to tap its own taxable resources. In this way a jurisdiction putting forth relatively greater effort in mobilizing local resources is rewarded with relatively greater grant flows. A practical problem with this approach (in the Philippines and everywhere else) is that of deriving timely and accurate measures of revenue effort. Partial cost reimbursement grants are another potential incentive to increased local revenue effort – they encourage localities to raise additional revenues to pay for their portion of total project costs. The latter solution is not effective, however, if the locality simply decreases spending in other areas in order to pay the local matching requirement.

Equalizing Effects

One difficulty with the equalization goal is ascertaining what it really means. One interpretation is that it refers to equalizing the revenue-raising capacity of local governments, often thought to be most adequately measured by the personal income level in the jurisdiction. An alternative approach to equalization involves distribution grants according to "needs". While this approach may not require as extensive data as would the income approach to equalization, it suffers from the lack of any well-defined concept of "need" and is to political influence in ascertaining which communities are more or less needy.

Fiscal Planning Effects

Local governments can plan and budget their resources effectively only if some degree of certainty can be attached to their revenue expectations. This is especially important if grants from higher level governments constitute a significant portion of a local government's total revenues. Thus, grant systems which provide fluctuating grant funds from year to year, or grants that are promised early in the fiscal year but never materialize or grant allocations that are made only when the fiscal year is nearly complete all hinder effective local financial management. While a central government may face severe fiscal stress itself and therefore may find it necessary to cut back budgeted amounts from time to time, the central government should also realize that such actions are not conducive to a well-administered local government sector. Similarly, while spatial reallocation of grants may be deemed

*This paper draws heavily on Roy Bahl and Larry Schroeder, "Intergovernmental Fiscal Relations," Chapter IV in Roy Bahl and Barbara D. Miller (eds.), *Local Government Finance in the Third World* (New York: Praeger Publishing Co, 1982). That book also contains analyses of the role local taxes, public enterprises and credit play in Philippine local government finance.

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necessary to promote domestic tranquility, such political manipulations of a grant system soon render it as no system at all.

Revenue Growth

It is also desirable that grants increase to help meet the increased spending needs of localities brought on by inflation, increased population and increased demands for public sector services. As importantly, the growth in the grant pool will preferably grow automatically rather than be dependent upon discretionary political decisions. (This automatic feature would also help attain the previously-discussed goal of promoting local fiscal planning).

In order to attain automatic growth in the grant pool, it is preferable that it be tied to an elastic central government tax base. That is, if some proportion of a central government tax source such as in income-based or sales-based tax is assigned to local government grants, localities are more likely to observe annual growth in their grant-based revenues.

Decentralization and Fiscal Autonomy

Perhaps the most obvious area in which the goals of the central government and its constituent local governments are likely to diverge concerns fiscal decentralization. While central governments may verbalize a desire for local government autonomy in fiscal decision-making, seldom do governments in either the developing or developed world feel it expedient to give up all control over a portion of the revenues that were originally collected centrally.

On the other hand, to the extent that local spending needs differ, economic efficiency can be attained only if localities have the power to use resources as they see fit. Furthermore, a vast system of controls over the spending of grants adds considerably to the cost of administering these monies.

Unfortunately, this dilemma is not easily settled. One can only try to devise a compromise system that provides local governments with some flexibility to react to special local needs while recognizing the desire by central governments of maintaining some control over the use of the monies.

The BIR Allotment System

Under the BIR Allotment Scheme, initiated in Presidential Decree (PD) 144 (March 3, 1973), 20 percent of national internal revenue taxes were to be transferred to local governments. PD 144 specified that these monies were to be distributed among the three major levels of local governments according to the following percentages: 30 percent to provinces; 45 percent to municipalities; and 25 percent to cities. With increasing emphasis on barrangays, this allocation was changed in 1976 to: 25 percent to provinces; 40 percent to municipalities; 25 percent to cities and 10 percent to barrangays.

Within each level of government a three-factor formula was used to allocate the shares among the constituent bodies: 70 percent according to population, 20 percent according to land area and 10 percent as equal shares. Finally, since there was concern that the grants be used for developmental purposes, PD 144 specified that 20 percent of a jurisdiction's allocation was to be earmarked for developmental projects approved by the Ministry of Local Government and Community Development (MLGCD).

While the formula basis of the BIR would seem to imply that the allotments would grow systematically as BIR collections grow or decline as particular jurisdictions lose population, the central government has altered the system from time-to-time by restricting the annual percentage increases or decreases in the amounts flowing to jurisdictions. Also important was PD

1231 (1977) which held that the allocations for fiscal years 1978-1980 would be equal to those determined for 1977. This then amounted to a decline in the real level of grants provided to local governments since inflation was eating into the purchasing power associated with the grants.

In light of the previously-discussed criteria for a grant system, how does the BIR perform?

Equity

It is not clear whether the Government of the Philippines is attempting to use the BIR to equalize per capita personal incomes, local government fiscal capacity, local government spending or according to needs. By including population and land area in the distribution formula, one might argue that there is an attempt to equalize according to spending needs. However, this will equalize incomes only if more populous areas tend also to be poorer.

In order to measure biases in the actual allocations, we determined the simple correlations between per capita BIR allotments in 1977 and per capita personal income, per capita assessed value, per capita expenditures and population size. The correlations were computed for a sample of 40 cities throughout the country and 96 municipalities in the provinces of Albay, Bulacan, Iloilo and Sorsogon. The results, shown in Table 1, suggest that for cities there is no significant statistical relationship between per capita BIR and any of these socio-economics variables. Either grants to cities are systematically related to some other variables not included here or they are distributed in a random ad hoc manner.

TABLE I

SIMPLE CORRELATIONS BETWEEN PER CAPITA BIR ALLOTMENT AND SELECTED INDEPENDENT VARIABLES, FOR SELECTED CITIES AND MUNICIPALITIES: 1977

Independent Variable	Cities ^a	Municipalities ^b
Per Capita Personal Income	-0.07	0.09
Per Capita Assessed Value	0.14	0.27
Per Capita Expenditures	0.10	0.52
Population Size	-0.02	-0.34
(Number of Observations)	(40)	(96)
Correlation Required for Significance:	.31	.20
at .05 level		
at .10 level	.25	.16

^aIncludes all cities outside metropolitan Manila less two for which data regarding the BIR Allotment were deemed to be in error.

^bIncludes the municipalities in Albay, Bulacan, Iloilo and Sorsogon.

SOURCE: Computed by authors.

The amounts distributed to municipalities shows a more consistent pattern. Significantly greater amounts of per capita BIR allotment were distributed to jurisdictions that had greater fiscal capacity (as measured by per capita assessed value) and to those that made higher per capita expenditures. Jurisdictions with smaller populations received significantly larger amounts. With respect to municipalities, then, the resulting per capita distribution would not seem to reflect the intent of the population-land area-equal share formula. The special provisions of the various PDs since PD144 have created a kind of ad hoc distribution that favours jurisdictions that already have a greater capacity to finance. While this kind of bias is not without its virtues, it suggests that the system was not successful in equalizing income, fiscal capacity or expenditure levels among municipalities. Indeed, it may even be

counter-equalizing. Finally, the difference in results between cities and municipalities lead us to conclude the BIR Allotment system does not appear to be a system at all, but a combination of grant programmes for cities, municipalities, etc.

Fiscal Stimulation

The BIR is a lump sum grant with no matching requirement or maintenance of tax effort clause, thus economic theory would suggest that a peso of allotment would be divided between, (a) increased expenditures, (b) tax relief, and (c) increased cash balances (at least if public officials were risk-averse). On the other hand, the BIR Allotment may turn out to be less substitute than one might expect. One reason is that there is a large backlog of unmet public service needs which suggest that any increased amount of revenue available to the local government would find its way into the local budget. This would reflect a combination of high income elasticity of demand for local public goods and the fact that once a government receives grant money it is more likely to spend the money than return it in tax relief, the so-called "flypaper effect."¹

The issue of fiscal stimulation in developing countries is most adequately addressed by considering two questions. The first is the overall fiscal impact of the grant and the second is the impact of the grant on economic development expenditures. In Philippine municipalities development expenditures can take place in either the General Fund or the Infrastructure Fund. This greatly complicates the analysis.

A rather complex model developed in Bahl and Schroeder² allows for the interdependence of the General Fund and Infrastructure Fund and attempts to measure the effect of a change in per capita BIR Allotment on (a) per capita General Fund spending, (b) per capita Infrastructure Fund spending and (c) per capita development expenditures flowing from both funds.³ The results make difficult to argue that the BIR Allotment has a stimulative impact. While the point estimate of the effect of a ₱1 increase in per capita BIR Allotment is associated with ₱1.33 increase in General Fund spending, it is not statistically significant. Likewise, the estimated (but direct) effect of the BIR monies on Infrastructure Fund spending was not found to be statistically significant.

Allocative Effects

Lump-sum grants of the BIR Allotment type do not mandate any particular actions on the part of local governments and, as such, do not foster increased accountability. For example, since there are no matching requirements in the Philippine grant system, monies obtained from these grants are essentially "costless" to the decisionmakers. Had local officials been forced to raise a matching amount of local taxes in order to receive the grant, they would have been held accountable for the use of this money by local taxpayers.

There is no tax effort requirement in the system. Thus, rather than mobilizing additional resources at the local level, there is the possibility that local governments will respond to grants by cutting back on their revenue-raising effort. Interestingly, however, the per capita BIR Allotment is positively and significantly correlated with local tax effort.¹ That suggests that larger BIR Allotments do flow to jurisdictions making greater efforts. Still, if the tax effort index were built directly into the allocation formula, one would anticipate an even stronger relation.

To investigate the effects of including tax effort directly into the BIR allocation formula an experimental simulation was performed with local tax effort inserted in the distribution formula in place of the equal shares component. The distribution weights used in this simulation were population, 50 percent; land area, 20 percent; and tax effort, 30 percent. Alloca-

tions were simulated for 83 municipalities in the Provinces of Albay, Bulacan and Iloilo. Whereas the current scheme shows that a 1 percent increase in tax effort is associated with ₱1.13 increase in BIR Allotment per capita, the simulation results show that a 1 percent increase in tax effort would be associated with a ₱3.84 increase in grants per capita. Such an inducement could have a quite substantial impact on the effort put forth by localities in mobilizing their own resources.

Revenue Growth and Certainty

Since the BIR Allotment is a fixed percent of central government taxes, it should provide an adequate growth in grant revenue to local governments. This has not, in fact, been the case, because the total local government entitlements have not been distributed.

It is well known among local government officials in the Philippines and clearly shown in Table 2 that the Allotment system is quite income inelastic – it would appear to have responded neither to GNP nor to inflation. PD 1231, which the BIR Allotment constant in nominal terms for the period 1977-80, has had a great deal to do with this inelasticity. In addition, however, the BIR base has fallen relative to GNP in recent years. Together these factors have resulted in an implicit income elasticity of only 0.14 for the period 1976-80. If the Allotment had been issued at its full authorized level, the income elasticity of the BIR would have been unity over this period.

Not only does this slow growth in the Allotment put an added strain on local government financial health, it also affects fiscal planning. Efficient local government budgeting and financial planning requires some reasonable estimate of how much can be expected from each revenue source. Such projections have not been possible in recent years because distributions have been primarily determined by ad hoc government policy. There have, of course, been competing needs at the national level for the relatively scarce resources obtained through national taxes. Nevertheless, if the central government is serious about using local governments as an important instrument in its overall development strategy, some of this uncertainty needs to be removed.

The Specific Tax Allotment

The second major programme of intergovernmental assistance to local governments is based on PD 436 (1947) which amended the Internal Revenue Code as it pertained to specific taxes on a variety of petroleum products. Most important for this discussion, it earmarked a designated portion of these taxes for sharing with local governments. The basis for the Specific Tax Allotment (STA) is the designated tax collection in the second preceding year. The monies are distributed among provinces (20 percent), municipalities (30 percent) and cities (50 percent) with another portion retained in a special fund allocated by the President to barangays for road

¹Edward Gramlich, "Intergovernmental Grants: A Review of the Empirical Literature," in *The Political Economy of Fiscal Federalism*, ed. by Wallace Oates (Lexington, Mass.: Lexington Books, 1977), Chapter 12.

²Bahl and Schroeder, "Intergovernmental Fiscal Relations," pp. 106-166.

³Furthermore, since the Specific Tax Allotment (discussed in more detail below) also constitutes a grant revenue source, it too is included in the model. The empirical testing of the model was based on the cross section of municipalities in the provinces of Albay, Bulacan and Iloilo for 1977.

¹ $r = 0.33$. Local 'tax effort' is measured as the ratio of local own-source revenue to personal income.

TABLE 2

GROWTH IN BIR ALLOTMENT
(in millions of pesos)

Year	Total Allotment Due	Actual Distribution	GNP	BIR Basis	Amount Distributed as a Percent of	
					GNP	BIR Basis
1981 ^a	2472.6	—	—	12,363.1	—	—
1980	1853.0	658.9	274,334 ^b	9,502.4	0.24	6.93
1979	1332.6	658.9	220,438 ^c	7,593.3	0.30	8.68
1978	1117.3	658.9	178,543	6,366.3	0.36	10.35
1977	1140.6	658.9	154,280	6,498.9	0.43	10.14
1976a ^d	422.6	315.9	—	2,408.2	0.48 ^e	13.08
1976	878.2	547.8	131,938 ^f	4,391.2	0.42	12.47
1975	799.8	505.4	114,265	2,999.2	0.44	16.85

^aBudgeted.^bProjected.^cPreliminary.^dSix-month Transition.^eBased on one-half of estimated 1976 GNP.^fNot final estimate.

SOURCE: Accounting Divisions, BIR, MOF, and NEDA.

and bridge construction, improvement and maintenance. The amounts flowing to provinces, municipalities and cities are distributed according to the same three-factor formulae as used for the BIR Allotment. The entire amount of STA flows to the Infrastructure Funds of the recipient governments.

Equity

The distribution of the Specific Tax Allotment is equalizing among cities — those with a lower per capita personal income get more (see Table 3). Smaller cities also get more (despite the use of population in the allocation formula). The patterns are similar but not as strong in the case of municipalities. In general, the STA seems to behave more like a grant system than the BIR in the sense that the city and municipal components are more alike in their distribution.

Fiscal Stimulation

Given that the entire amount of the STA flows to the Infrastructure Fund, it seems clear that the major goal of the grant is to stimulate spending on developmental projects. Though the system carries no matching or maintenance of tax effort clause, it may well achieve this stimulation because the Allotment is earmarked and because capital projects often require supplementary local government expenditures. On the other hand, three factors might dampen or even negate this stimulation effect. First, higher STA might induce local governments to reduce transfers from the General Fund to the Infrastructure Fund. Second, localities might substitute higher Infrastructure Fund expenditures for lower economic development spending from the General Fund thereby not increasing overall capital expenditures. Third, a part of the STA may simply be banked in the form of increased cash balances.

We used the same model cited above to investigate these possibilities. While statistical significance is still a problem, there is some basis for arguing that the STA is stimulative of local government spending. The estimated partial effect of a one peso increase in per capita STA grant is ₱2.34 in per

TABLE 3

SIMPLE CORRELATIONS BETWEEN PER CAPITA SPECIAL TAX ALLOTMENT AND SELECTED INDEPENDENT VARIABLES, FOR SELECTED CITIES AND MUNICIPALITIES: 1977

Independent Variable	Cities	Municipalities
Per Capita Personal Income	-0.336	-0.138
Per Capita Assessed Value	0.038	-0.100
Per Capita Expenditures — General Fund	-0.107	-0.191
Per Capita Expenditures — General Fund and Infrastructure	0.015	-0.142
Population	-0.383	-0.263
(Number of Observations)	(41)	(96)
Correlation Required for Significance:		
at .05 level	.31	.20
at .10 level	.25	.16

SOURCE: Computed by authors.

capita General Fund spending and ₱0.90 for Infrastructure Fund spending. Secondly, the STA appears to be stimulative of economic development expenditures. A peso more of per capita STA, on average, means nearly a peso more of Infrastructure Fund spending, but it also stimulates about ₱1.28 more economic development spending in the General Fund. In total, then, about ₱2.18 more economic development spending occurs for each additional peso of STA per capita.

Elasticity

The specific Tax Allotment is not like an elastic tax, i.e., since it is not *ad valorem* it will not respond to income growth or inflation. Revenues grow only in response to discretionary changes or to increases in the volume of consumption. Revenues from the STA remained approximately constant for 1976 — 1978 but increased markedly in 1979 because of specific tax rate increases in 1977. (The STA depends on tax collections two years previous.) Rates were further increased in 1979 thus another spurt in STA revenues could be expected in 1981 (see Table 4).

The rationale for tying the STA to petroleum taxes is understandable: the original intent was to use the funds for road construction and maintenance, and petroleum consumption seemed a reasonable basis for identifying beneficiaries. However, the programme has since expanded to a more general infrastructure type of assistance and is an important source of general revenues for local governments. The specific tax does not provide any growth in this important revenue base. Furthermore, changes in petroleum tax rates are more likely to be dictated by national energy policy than by the financial needs of local governments. It would, therefore, seem to make considerably more sense to consolidate the BIR and STA Allotments (together with the National Tax Allotment programme described below) into a single, unified grant system tied to overall national tax revenues (with this tying arrangement adhered to by the central government without ad hoc adjustments).

Summary Evaluation of the Philippine Grant System

To analyze the working of the Philippine grant system, we make use of the knowledge that every grant programme has two discretionary dimensions: (a) determination of the total amount to be allocated and, (b) determination of the distribution of this amongst local governments.¹ The matrix in Table 5 suggests the possible combinations that a country may follow in structuring its grant system. The columns describe the methods of determining the total grant fund and the rows

TABLE 4

GROWTH IN SPECIFIC TAX ALLOTMENT
(in millions of pesos)

Year	Total Amount Due	Actual Distribution	GNP	Actual Amount as a Percent of GNP
1981 ^a	881.8			
1980	767.0	n.a.	274334 ^b	
1979	525.1	528.9	220438 ^c	0.24
1978	115.3	94.6	178543	0.05
1977	115.3	124.8	154280	0.08
1976 ^d	54.7	144.6	131938 ^e	0.11
1976	118.2			
1975	142.8	n.a.	114265	

n.a.: not available

^aBudgeted.

^bProjected.

^cPreliminary.

^dSix-month transition.

^eNot final estimate.

SOURCE: Computed by authors.

describe the methods of distribution among local governments. For example, a type C grant is one in which the total grant fund is determined on a shared tax basis (e.g., as a percent of BIR collections) and the distribution among local governments is made by formula.

Many combinations of these choices are used in developing countries. Programmes of the A and C type would give local governments more control and autonomy in that the total grant distribution is a fixed share of some national tax and the share of each local government is determined on some objective basis, i.e., according to how much is collected in the local area or according to some predetermined formula. Program E would provide maximum central government control in that both the total grant fund and the distribution among local units would be determined subjectively by the central government. Programs B, F, and H are also relatively centralized options.

In the Philippines, the *legal* structure of the grant system provides for a great deal more local government autonomy than the system actually practices. In theory, it is a mixture of B and C type programmes, but in practice it is much more centralized combination of C, E, and F. The first column in Table 6 shows the typology of Philippine grants,¹ according to their legal definition, and the second column according to actual practice. Columns (3) – (6) of Table 6 compare amounts due with actual distribution, and show that only about half of these funds were actually distributed in 1979. With this scheme we may compare distributions under the legal grant system with those under the practiced grant system.

By law, all grants are to be distributed as shared taxes (column 1 of Table 5) and 71 percent of this amount is to be distributed amongst local governments on a formula basis (row 3). In fact, only 43.7 percent is distributed as a shared tax but 91 percent of that total is distributed on a formula basis. In other words, the government has chosen to distribute only about half of total entitlements, but to do that primarily on a formula basis. Even here, however, the formulae have been frequently adjusted or constrained by the government.

TABLE 5

POSSIBILITIES FOR STRUCTURING A GRANT SYSTEM

Methods of Distribution Among Local Governments	Methods of Determining the Grant Fund		
	Shared Tax	Ad Hoc	Cost Reimbursement
Origin of Collection	A	—	—
Ad Hoc	B	E	H
Formula	C	F	—
Cost Reimbursement	D	G	I

SOURCE: This methodology for grant impact analysis is developed in Roy Bahl and Johannes Linn, *Urban Public Finance and Administration in Less Developed Countries* (Washington, D.C.: The World Bank, unpublished manuscript).

One important concession to the formula distribution intent of the Philippine grant system came about with the increased allocation to the barangays in the late 1970s. Paradoxically, this programme to move government closer to the people actually resulted in a greater degree of centralization of the grant system — since it places a substantially greater amount of grant distribution under Presidential discretion. If these amounts are increasingly distributed, they will reduce the share of grants distributed on a formula basis (they will be “E-type” grants in Table 5).

In sum, we might argue that the Philippine grant system in practice is much more centralist-oriented than its design would suggest. With this in mind, we may turn to an evaluation of its overall effectiveness.¹

Elasticity

Grants are not an income elastic revenue source for Philippine local governments. In theory, however, the grant system has a much greater responsiveness to GNP than it has in practice. The problem has come about because of central government policies.

Legally, all grants are somehow tied to tax collections. Where the basis is lagged BIR collections, this would seem to have the decided advantage of a steady growth in the overall grant amount and a responsiveness of grants to real income growth and inflation. This potential advantage has been lost — perhaps because of higher priority national economic objectives faced by the central government has limited effect on the actual distribution. As a result, the BIR Allotment share of GNP has fallen from 0.44 percent in 1975 to 0.24 percent in 1980, i.e., the General Allotment has behaved as an inelastic tax. The sharing of the tax on petroleum products does not result in an automatic growth in the grant fund because the

¹This approach is fully developed in Roy Bahl and Johannes Linn, *Urban Public Finance and Administration in Less Developed Countries* (Washington, D.C.: The World Bank, unpublished manuscript).

²We included as grants all intergovernmental transfers: the two allotment programs discussed above as well as the National Tax Allotment, the barangay share of the local property tax and the local government grant to the barangay.

³Two good reviews of grant systems in developing countries are Lady Ursula Hicks, “Intergovernmental Relations with Special Reference to the Developed Countries,” Occasional Paper No. 29, Metropolitan Studies Program, The Maxwell School (Syracuse, New York: Syracuse University, June 1976); and Richard M. Bird, “Intergovernmental Fiscal Relations in Developing Countries,” *World Bank Staff Working Paper No. 304* (Washington, D.C.: World Bank, 1978).

TABLE 6

LEGAL AND ACTUAL CLASSIFICATION OF PHILIPPINE GRANT SYSTEM^b
(amounts in millions of current pesos)

Program	Legal Definition	Actual Practice	1979 Amounts Due	Percent of Total	Amounts Distributed	Percent of Total Distribution
Barangay Share of Local Property Tax Collections	A	A	40.0 ^a	1.5	40.0	3.2
Barangay Share of BIR General Allotment ^d	B	E	148.1	5.7	25.2 ^e	1.9
Barangay Share of Specific Tax Allotment ^d	B	E	175.0	6.7	25.2 ^e	4.0
National Tax Allotment	B	E	379.7	14.6	52.0	4.0
Province, City and Municipal Shares of BIR General Allotment	C	F	1332.6	51.2	658.9	50.2
Province, City and Municipal Shares of Specific Tax Allotment	C	C	535.1	20.2	528.9	40.5
Total			2600.5	100.0	1305.0	100.0

^a1977 amount is latest available.

^bExcludes local government contributions to barangay.

^cActual amounts distributed are not known.

^dAmounts due.

^e+25.2 (2.6 not yet released plus 22.6 with advice of Allotment for actual release).

SOURCE: Computed by authors.

tax rates are specific and the volume of petroleum consumption has not been increasing. Discretionary increases in the tax rates have been necessary to stimulate growth to the Specific Tax Allotment amount. The barangay shares of both Allotments, and the National Tax Allotment, are shares of BIR collections and thus are responsive to inflation and real income growth, but again, only a small proportion of these have been distributed.

We have estimated that the most elastic component of the grant system – the BIR Allotment – has a statutory elasticity of about unity. From this, we can guess that the statutory elasticity of the total grant system is something less.

This raised an important problem. In a highly centralized system, such as the Philippines, grants are given to local governments as a substitute for local government taxes in order to enable local governments to finance more than simply housekeeping functions. The income elasticity and responsiveness to inflation are important elements of the grant system in that they help the local government to keep up with growing expenditure needs. If the central government is not prepared to maintain at least the higher legal elasticity of the grant system, then it must consider either relinquishing a more elastic tax base to the local government or taking back some of the expenditure responsibility it has assigned them. In any case, an income inelastic grant system is simply not compatible with the decentralization objectives which are part of National Government policy.

Equity

Again, the absence of data on actual grant distribution makes it difficult to determine whether grants are distributed on an equalizing basis, i.e., whether poorer jurisdictions receive larger grant amounts. The analysis above suggests that the BIR General Allotment is probably counter-equalizing with respect to its distribution among municipalities, but appears to be neutral in terms of its distribution among chartered cities. The Specific Tax Allotment, on the other hand, appears to be distributed on a mildly equalizing basis – for both cities and municipalities. These two programmes, which

account for about 90 percent of all grants distributed, would seem to have offsetting effects. There are no data on the distribution of the barangay shares or the National Tax Allotment.

On a conceptual level, there is no reason to expect that the grant system in total will be equalizing. Measures of fiscal capacity or personal income do not enter into any of the distribution formulae and there does not appear to be a strong government policy on increasing the flow of resources to the lowest income local governments.

Stimulation of the Tax Effort

We could not find convincing evidence that the grant system is stimulative of local tax effort. Though our statistical analysis is subject to some quite serious data problems, and our conclusions can be no more than tentative, it would appear that the Specific Tax Allotment is more stimulative than the BIR Allotment, perhaps because capital expenditures require some sort of matching in the form of supplementary expenditures or maintenance costs.

In theory, the system is not designed to be stimulative of tax effort. No tax effort provision enters the formulae and the grants are not conditional upon the local government providing a matching share of costs. If the barangay shares and the National Tax Allotment are distributed, the overall system will become even more substitutive. More data and testing are needed, but the evidence suggests that the grant system is not stimulative, and if fully distributed may well be substitutive.

Economic Development Expenditures

Our results suggest that the Specific Tax Allotment leads to more economic development expenditures than otherwise may have occurred. This happens in two ways. First, the Specific Tax Allotment paid to the Infrastructure Fund is spent. Second, a higher level of grants to the Infrastructure Fund dampens the transfer from the General Fund to the Infrastructure Fund and results in more economic development expenditures in the General Fund. Our results suggest

that a single grant programme of the same amount – such as the BIR – would not have accomplished as much stimulation of economic development expenditures.

Financial Management

The grant system does not presently encourage effective financial planning. In its legal form, where the basis for grant is lagged three years (BIR) and two years (Specific Allotment) and where formula distributions are easily calculated, the system could be effectively integrated into the local government budgeting process. But as practiced, the total grant amount is decided on an ad hoc basis and there is much less certainty about the amounts to be distributed. Surely this does not provide an incentive for effective financial planning and will be a detriment to any reform designed to make better use of local budgets as financial plans.

Central Government Flexibility

A final criteria in evaluating the grant system is the flexibility which the National Government has in adjusting the system to meet the exigencies of national economic and social objectives. The law would suggest that the government has a great deal of control over the former via an *ad hoc* distributions of the National Tax Allotment and the barangay shares, but relatively little control over the latter because of the shared tax bases of determining the grant funds.

In practice, just the opposite has resulted. Presidential Decrees to limit the increase in grants and suspensions of full distribution have provided substantial flexibility to the central government. However, since the barangay shares and National Tax Allotment have been held back, the distributions actually made are formulae-based. This reduces the government's flexibility to affect the regional flow of funds.

Recommendations for Change

There is a substantial difference between the Philippine grant system that exists in the Statutes and the one that is actually practiced. A first need is to establish and stay with a grant system and to back away from *ad hoc*, year-to-year adjustments. In this context, the structure of the Allotment system should be re-thought, and appropriately reformed.

These reforms must be based on a considered set of objectives; in particular, to re-ask the question "what is to be accomplished?". The central government's objective of strengthening the role of local government in the financing and delivering of public services, and thereby decentralizing government finances, will likely remain at the center of these reforms. Consistent with this general goal are four important subobjectives: (a) to induce local governments to mobilize more revenues, (b) to stimulate infrastructure/economic development expenditures by local governments, (c) to improve the financial management and accountability aspects of local government finances and, (d) to provide local governments with an adequate and dependable source of revenue. By restructuring the grant system to provide appropriate incentives, these objectives can be achieved. However, there will be costs to such a program. One is that much less focus can be given to equalizing the financial capacities of local governments within the country. The objectives of equalization and fiscal stimulation are not fully compatible. Equalization might best be left to other policy instruments – for example, the tax system and central government subsidies – which are much more effective in altering the distribution of income. Another cost will be the loss in flexibility at the central government level. Once a grant system is established with some certainty, the central government will have much less discretion to make arbitrary changes in the amount distributed or in the distribution basis. These disadvantages notwithstanding,

grant reform should focus on strengthening the financial performance capabilities of local governments rather than on redistributing income.

We have recommended a rather major reform of the Allotment system,¹ along the lines of the following:

- a. a combining of the various Allotment programmes into a unified system;
- b. the provision of incentives and financial resources to stimulate development spending;
- c. the provision of incentives to stimulate the mobilization of additional local revenues, and,
- d. a rethinking of the proper role of the barangay in financing and delivering local government services.

Consolidating Grant Programmes

The present system is unduly fragmented. The National Tax Allotment, a discretionary fund which has not been fully used, should be abolished as a separate programme and there is no longer a need to tie the Specific Tax Allotment to petroleum taxes. The funds are presently used for much more than road and bridge construction and maintenance, hence, it is no longer possible to justify petroleum taxes as a charge to beneficiaries. Moreover, because petroleum taxes are specific rather than *ad valorem*, the grant has a low income elasticity.

At 1979 Statutory levels for each grant programme, a consolidated Allotment system would imply a grant amount equivalent to about 30 percent of BIR collections (lagged three years).¹ Whatever share of BIR revenues is chosen, however, should be held to rigidly. The consolidated system, in keeping with the present distribution of Allotments could earmark two-thirds of the total for the Infrastructure Fund. This would protect the more stimulative features of the Specific Tax Allotment and the objectives of promoting capital expenditures.

Mobilizing Additional Local Revenue

As it presently stands, the formula distribution system does not provide a major inducement for increased revenue mobilization. To address this shortcoming, we recommend two changes in the system. First, some measure of tax effort should be introduced into the distribution formula. This could provide a substantial reward for increasing tax collections, and it might also increase the accountability of local governments, because grants would no longer be costless.

We also would recommend that the Allotment distribution be amended to provide other incentives for improving the capacity of local governments to assess and collect property taxes. For example, Allotments earmarked for economic development expenditures should be available for coverage of the local share of tax mapping costs or it might be used to partially cover the cost of an additional property tax clerk to deal with a backlog of record-keeping problems.

¹These were originally proposed in Roy Bahl, David Greytak, Kenneth Hubbell, Larry Schroeder and Benjamin Diokno, "Strengthening the Fiscal Performance of Philippine Local Governments: Analysis and Recommendations," Monograph No. 6, Metropolitan Studies Program, The Maxwell School (Syracuse, NY: Syracuse University, June 1981).

¹We can't be completely sure of this percentage, based on the data provided to us. The BIR and National Tax Allotments together constitute 25 percent of lagged BIR collections. If ₱525 million is the correct entitlement under the Specific Tax Allotment in 1979, then the Consolidated Allotment share will be 32.5 percent of BIR collections, lagged three years.

Stimulating Economic Development Expenditures

In a sense, many of the reforms suggested above lead to increased spending for capital projects, in that they make more resources available. The objective of more capital spending, however, raises the specific question of what incentives might be provided to redirect more general revenues to capital projects. One incentive, of course, is simply to earmark a share of the Allotment to the Infrastructure Fund – a practice we recommend continuing.

Barangay Programmes

The time is probably right to reassess role of barangays in the local finance system. Some of the increased barangay involve-

ment is beneficial and clearly should be retained, e.g., the 10 percent property tax share for barangays serves any number of useful purposes. The merit of some other programmes, and their cost, would seem to call for re-evaluation. While it is clear that more input at the barangay level can improve the decision-making process markedly, it is equally clear that the barangay unit is capable of very little technical or financial planning or management.

In summary, the intergovernmental grant system in the Philippines accomplishes some goals often deemed desirable in such systems. Nevertheless, improvements can be made. Given such reforms the system can help greatly strengthen the role of local governments.