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Local Government Structure, Financial Management, and Fiscal Conditions

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LOCAL GOVERNMENT FINANCE IN THE THIRD WORLD

A Case Study of the Philippines

Edited by Roy Bahl
and Barbara D. Miller

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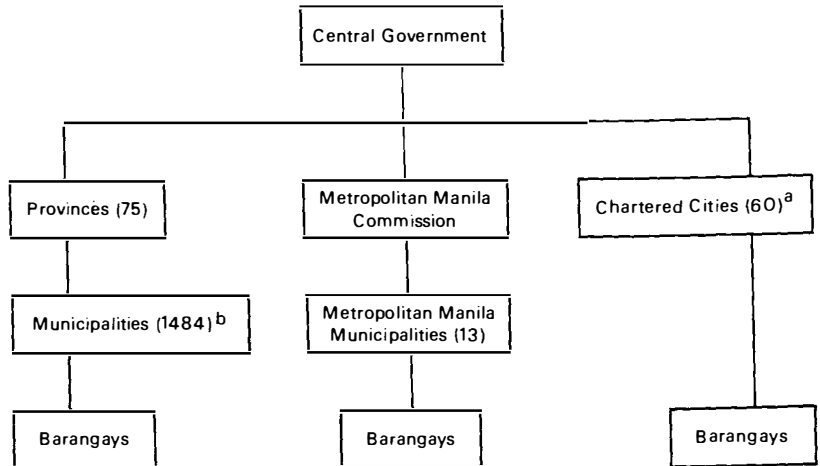
by ROY BAHL and LARRY SCHROEDER

The government structure in the Republic of the Philippines is highly centralized, with the national government selectively delegating powers to its several lower governmental bodies—provinces, cities, municipalities, and barangays (or barrios) (Figure 1.1). The 1959 Republic Act 2264 lifted certain restrictions regarding the taxing power of municipalities, and the new constitution, Article XI, Section 5, allocated power to localities to create their own revenue sources. The centralized orientation, however, has been retained.

The 75 provinces and subprovinces in the Philippines have specific responsibilities and functions. The provincial government collects taxes (some in conjunction with municipalities), constructs highways and bridges, dispenses justice, and supervises the operations of municipal governments. The assessor and treasurer are representatives of the national government rather than the province—a very important feature of the centralized nature of local financial administration in the Philippines.

Each province is fully subdivided into municipalities, which are geographic areas usually containing at least a small semiurbanized market area; there are no unincorporated areas. Currently, there are 1,484 municipalities within the Philippines. The municipality provides some localized services including markets, public works such as local roads, and local justice, and it has some local development responsibilities. The chief financial officers of the municipality, treasurer and assessor, are supervised at the provincial level and therefore implicitly by the central government. A municipal deputy

FIGURE 1.1 The Structure of Local Government in the Philippines



^aIncluding cities in Metropolitan Manila.

^bIncluding municipalities in Metropolitan Manila.

Source: *Philippine Yearbook 1981* (Manila: National Economic and Development Authority, National Census and Statistics Office, 1981).

assessor is appointed by the provincial assessor, but two-thirds of his salary is paid by the municipality.

Juxtaposed against the province and municipality are chartered cities, of which there currently are 60. In general, these cities are more highly urbanized than municipalities, although some contain substantial amounts of agricultural land. Given their administrative independence from provinces, they perform many of the same functions as provinces and municipalities. Their revenue-raising powers are likewise a combination of those prescribed to provinces and municipalities. As in the case of provinces and municipalities, the chief financial officers—treasurer and assessor—are appointed and directed by the central government.

The barangay has existed as a neighborhood unit of local government since the colonial Spanish era. The central government has recently expressed considerable interest in greater participation by the barangays at the local level. They have been given increased grants, increased powers for raising revenues, and increased service provision authority. Most recently the barangay has been used as a

means to organize citizens for various civic purposes through a program known as "barangay brigades."

LOCAL GOVERNMENT FINANCES IN THE 1970s

During the 1970s, the Marcos regime enacted strong fiscal reforms that resulted in a dramatic increase in national government revenues. Between FY 1973 and FY 1976, for instance, government revenues increased by more than 30 percent.¹ In 1964, total revenues were between 9 and 10 percent of the GNP, whereas in 1976 they were 14.6 percent of the GNP. But while central government revenues and expenditures grew, there was a continuing decrease in the size of the local government sector relative to that of the central government.

One can approximate that the size of the local government sector relative to that of the central government declined from 20 percent in 1969 to less than 11 percent by the end of the decade (Table 1.1). If the ratio of local expenditures from own sources to central expenditure is charted, the decline is from 9 percent in 1969 to 7 percent in 1979. It is clear that the trend of the 1970s was increased fiscal centralization. Per capita local government spending did increase during the 1970s but mostly because of inflation (see Table 1.2). In fact, if we adjust for increases in population and prices, there has been virtually no growth in Philippine local government spending during the last decade.

Why has the relative and absolute size of the local government sector not been increasing? One possibility is that centralization of government finances is an overt policy of the central government. There is evidence, however, to the contrary. In addition to Republic Act 2264 and Article XI, Section 5, of the new constitution, official statements of the central government point to increased local government revenues as a national priority. For example, in Presidential Decree (PD) 464, Enacting a Real Property Tax Code, President Marcos noted that "this country cannot progress steadily if its local governments are not potent political subdivisions contributing their proportionate shares to national progress" and that it was imperative for local governments to be able to provide "adequate funds with which to underwrite basic and essential public services within their respective areas of responsibility."² Then Finance Minister Cesar Virata also emphasized the promotion of local economic development through increased local revenue mobilization as a national goal.³

TABLE 1.1
Central and Local Government Expenditure Growth, Selected Years, 1969-78
(millions of current pesos)

	(1)	(2)	(3)	(4)	(5)
	Central Government Expenditures	Total Local Government Expenditures	Local Government Share of Total Central and Local Expenditures (percent) ^a	Central Government Grants to Local Governments	Grants as a Percent of Local Gov- ernment Expenditures
1969	3,611	817	20.7	490	60.0
1971	4,429	1,033	21.1	558	54.0
1973	7,041	1,465	18.8	700	47.8
1975	20,168	2,202	10.2	863	39.1
1977	22,600	2,914	11.9	1,009	34.6
1978	27,110	3,237	11.0	1,049	32.4
1979 ^b	34,380	3,781	10.3	1,474	39.0
Average annual percent change between 1969 and 1978	25.1	16.5	—	8.8	

^aGrants are excluded from central government expenditures but included in local government expenditures.

^bEstimates.

Sources: Budget of the national government for fiscal years 1969-75; president's budget message, calendar years 1976-79; Commission on Audit reports on Local Government Expenditures (1969-71); Ministry of Finance, (1972-79) as reported in Daniel Holland, Michael Wasylenko, and Roy Bahl, "An Evaluation of the Real Property Tax Administration Project," Local Revenue Administration Project, Maxwell School, Syracuse University, Oct. 1, 1980, Table 3, p. 16.

TABLE 1.2
Per Capita Local Government Expenditure Growth,
Selected Years, 1969-78
(in current and constant 1972 pesos)

	Per Capita Expenditure Current Pesos	Per Capita Expenditure Constant Pesos
1969	44.35	67.20
1971	27.25	29.45
1973	36.43	31.27
1975	52.34	31.36
1977	64.31	32.09
1979	78.57	31.36
Average annual percent increase between 1969 and 1979	5.9	-7.3 (0.8)*

*1971-79.

Sources: Commission on Audit Reports on Local Government Expenditures (1969-71); Ministry of Finance Reports (1972-79); Central Bank Statistical Bulletin, 1978; National Census and Statistics as reported in Daniel Holland, Michael Wasylenko, and Roy Bahl, "An Evaluation of the Real Property Tax Administration Project," Local Revenue Administration Project, Maxwell School, Syracuse University, Oct. 1, 1980, Table 4, p. 18.

In spite of the existence of verbalized government policy regarding the national priority of strengthening local governments, several constraints have temporarily halted progress. The 1970s were years of major social and political changes in the Philippines. Internal economic policy changes altered the nature of investment and there were the outside forces of worldwide recession and the growing energy crisis with which to contend. However, in keeping with the central government's stated view that local governments should become more fiscally independent, this study seeks to provide some insights into how the current system, with some reform, could be made more effective.

LOCAL GOVERNMENT BUDGETING AND FINANCIAL MANAGEMENT

Two important bottlenecks impede increased revenue mobilization and a more efficiently functioning local government sector: the

substantial restrictions placed on local government expenditures by the central government, and various shortcomings in the local government budgeting and financial management process. An understanding of the fund structure of the local government accounts and of the extent to which local governments may "control" their budgets is a necessary starting point in evaluating local financial management practices.

Fund Structure

PD 477 (June 3, 1974) established a common fund structure for all local governments in the Philippines. Each jurisdiction has two funds—the General Fund and the Infrastructure Fund. Expenditures from the latter are to be used exclusively for a specified set of purposes, mostly to do with the construction and maintenance of roads, bridges, other public works projects, and public utilities.⁴ The General Fund is the source of all other local spending, other than for education. More specifically, the General Fund

consists of monies and resources not otherwise accruing to any other fund and shall be available for the payment of expenditures, obligations or purposes not specifically declared by law as chargeable to, or payable from, any other fund, though transfers of monies or resources therefrom to other funds of the local government for their augmentation and use may be made by proper appropriation.⁵

The distinction between the General and Infrastructure funds is not synonymous with a separation into current and capital expenditures. Indeed, the General Fund may contain capital construction expenditures, and the Infrastructure Fund obviously contains current spending for maintenance activities on roads, bridges, and so on. Moreover, although expenditures in the Infrastructure Fund are generally developmental in nature, there are also economic development expenditures contained in the General Fund. To complicate matters further, there are substantial interfund transfers.

A third fund (not a focus of this study), administered by the local treasurers, is the Special Education Fund (SEF). It is devoted exclusively to the provision of elementary-level education. The national government directly provides personnel expenditures for education, while nonpersonnel expenditures are supported from the SEF. The primary local revenue source supporting this fund is the

real property tax, although in some localities periodic transfers from the General Fund to the SEF are also made.

Budgeting Problems and Issues

A number of issues have arisen in connection with this fund structure and current budgeting practices. These issues concern transfers between the Infrastructure and General funds, the allowing of supplementary budgets, capital budgeting, and the overall supervision of the budgetary process.⁶

Fund Transfers

Although there is a statutory requirement that funds be transferred from the General Fund into the Infrastructure Fund (8 to 12 percent of General Fund net income, depending on the classification of the jurisdiction), additional transfers are permitted if the purpose for the transfer is clearly stated. However, sizable increases in the petroleum excise tax, the principal revenue of the Infrastructure Fund, raise the possibility that local fiscal conditions may now require transfers from the Infrastructure to the General Fund. The Budgeting Regulations (issued in conjunction with PD 477) state that such reverse transfers are possible "only from the unappropriated balance of the (Infrastructure) Fund and to cover exceptionally urgent needs of the local government" and with the approval of the finance minister.⁷

Supplemental Budgets

Budgeting by local governments in the Philippines appears to be less an exercise in fiscal planning or control than a response to particular statutory requirements placed on the financial managers of the locality. Supplemental budgets are used as a general rule rather than as an exception. Under PD 477 there is a "limitation" of one supplemental budget per month unless exceptional circumstances arise, in which case additional supplementals may be prepared. From discussions with local officials, it appears that the one supplemental per month is indeed used and one official bemoaned the fact that only a single monthly supplemental could be used. This practice does not stimulate serious fiscal planning for the full fiscal year, as it is widely recognized that the annual budget need be only a crude first approximation.

Capital Budgeting

Attempts have been made to establish longer term capital planning as a part of the financial management responsibilities of local government. Each local government, even the barangay, is supposed to produce a capital improvements program (CIP), which contains five-year revenue projections, lists proposed capital projects, and is coordinated with the annual budget process. Little evidence exists, however, that such financial planning has been implemented or that it has contributed to improved fiscal planning, perhaps because neither of the motives that typically lead to an effective use of capital budgeting is present in the Philippines. One such motive is the need to understand the relationship between current and capital expenditure requirements, for example, to know the annual maintenance costs associated with the construction of a new road or bridge.⁸ The second usual reason for capital budgeting—the planning and scheduling of debt repayment—is not a stimulus in the Philippines because there is little use of credit financing by local governments.

Financial Oversight Problems

Several different central government organizations are involved in the financial oversight of localities. This overlap creates problems in the review process.

The Ministry of Finance (MOF) oversees the principal local fiscal manager—the treasurer—and, until recently, also reviewed the annual as well as all supplemental budgets approved at the local level.⁹ After a municipal budget is approved, it is sent to the provincial budget officer, who then sends it with recommendations to the regional Ministry of the Budget (MOB) representative for approval. While this review process considers several aspects of the budget, the only grounds for outright budget veto are conflicts in any way with the several statutory budgetary limitations placed on localities (itemized below).

The budget is also reviewed by the Ministry of Local Government and Community Development (MLGCD). Under PD 144 (March 1973), 20 percent of the Bureau of Internal Revenue (BIR) Allotment to each local government must be spent on “development projects,” which, in turn, must be approved by the MLGCD. A memo from the MLGCD (Circular 73-17) indicates that these include agricultural development projects, infrastructure development projects, tourism projects, cottage industries projects, management tools or other devices that would tend to improve financial positions of local governments, and other projects based on local development priorities.

Finally, overall auditing of the financial affairs of local governments is carried out by the Commission on Audit (COA) of the central government. While not directly comparing budgeted amounts with actuals, this commission is charged with at least measuring the financial soundness of local government units.

In essence, then, the local fiscal management function is overseen by at least four different central government bureaucracies, although this by no means is exhaustive of the list of central government agencies that have influence over local authorities. While there may be considerable rationale for this division of labor, such fragmentation imposes costs. Different ministries have different priorities, which leads to possible conflicts in the directives and requirements given to local governments. Because of these conflicts and the time cost of complying with these requirements, local government fiscal management is less efficient than it otherwise would be.

Controllability of the Local Budget

The centralized orientation of local financial management is most evident in the various restrictions placed upon localities in terms of what they can or must budget for certain, specified functions. While this practice, in theory, enhances the direction that the central government can give, it markedly reduces the discretion that local governments have in determining the size and makeup of their budgets. If the bulk of expenditures in a budget cannot be controlled by the public body, ability of the local government to respond to particular circumstances is limited and the local government feels less accountable for its fiscal actions. If revenue bases are narrowly prescribed and tax rate ceilings and the base coverage are fixed, the options for fiscal response are further narrowed.

In fact, the budget options of local governments in the Philippines are substantially narrowed by central government mandates. The restrictions include:

Statutory Reserve: Two percent of estimated revenues from regular sources must be held in reserve to cover unforeseen circumstances.

Election Reserve: Under the Election Code, contributions to election expenses are on the basis of one-third from the national government, one-third from provincial governments, and one-third from the city or municipal government. To ensure that these

monies are available for elections, an election reserve based on one-quarter of the local election costs from the previous election must be set aside.

Infrastructure Fund Transfer: Between 8 and 12 percent of annual net income in the General Fund must be transferred to the Infrastructure Fund.

Aid to Hospitals: From 5 to 7 percent of net income is to be set aside as a contribution to the provision of hospital services within provinces.

Integrated National Police (INP): Local police and fire protection is supported by a uniform contribution of 18 percent of total General Fund income from regular sources.

Barangay Development Fund: Each municipality, city, and province is urged to make an allocation from the General Fund to the Barangay Development Fund. The amount transferred is not to exceed P500 per year per barangay and, while there is no statutory minimum, our investigation into the accounts of localities suggests that nearly all local governments are making some contribution.

Twenty Percent Development Fund: Twenty percent of the BIR Allotment to the General Fund is to be set aside for "development projects." Two types of eligible projects—training programs for government employees and "other projects based on local priorities"—allow for considerable flexibility within this requirement.

Personnel Expenditures: Several restrictions are placed on personnel expenditures of local governments. One overriding restriction is that total annual appropriations on wages and salaries of all local government employees are not to exceed 45 percent of total annual income from regular sources in first- and second-class jurisdictions (55 percent in jurisdictions lower than second class).¹⁰ This limitation does not include salaries and wages of public school officials and employees, employees of hospitals, health and agricultural services, public utilities, markets and slaughterhouses, or other economic enterprises operated by the jurisdiction.

Emergency cost-of-living allowances are also excluded. The secretary of finance can authorize appropriations that exceed these limits in exceptional cases. Salary ranges for different job titles are set by the central government, although individual jurisdictions can pay the lower bounds in cases of extenuating circumstances.

Likewise, local governments have paid a bonus—for example, some local governments in Iloilo (in 1979) paid “thirteenth month” salaries, thus effectively providing an 8.3 percent increase in pay.

Thus, up to 37 percent of General Fund revenues is earmarked for statutory reserves, Infrastructure Fund transfer, aid to hospitals, and the Integrated National Police (INP). Additional reserves for elections increase this percentage slightly, as does the decision as to how much to transfer to the Barangay Development Fund. Budgetary discretion is further limited by the 20 percent restriction placed on the use of the BIR Allotment. If the allotment accounts for 25 percent of General Fund revenues (a relatively low share), then the use of up to 42 percent of General Fund revenues is in some way restricted.

VARIATIONS IN THE FISCAL PERFORMANCE OF PHILIPPINE LOCAL GOVERNMENTS

The measurement of fiscal performance calls for developing an objective index, but even in countries where data are readily available, this task turns out to be very subjective.¹¹ On the expenditure side is the problem of not being able to measure public sector output, which in turn prohibits direct measurement of the efficiency of government operations, the productivity of government workers, or the quality of public services provided. On the revenue side, good measures of the potential tax base (the amount of income above subsistence, the full market value of property, and so on) cannot be made; hence, evaluation of revenue effort and collection efficiency is more qualified than one would like. This inability leads most analysts to infer fiscal performance from measurement of actual fiscal outcomes, such as deviations from “normal” revenue and expenditure patterns, fiscal surpluses and deficits, and tax effort.

The measurement of fiscal outcomes is complicated in the Philippines by the absence of comparable, current data. The local government financial statistics used here were taken from audited financial reports from the COA. Unfortunately, the latest available information is for FY 1977; hence, recent important trends and developments are not observable. We have compiled the COA data for selected municipalities—those in the provinces of Albay, Bulacan, Iloilo, and Sorsogon—and for all chartered cities outside Metropol-

itan Manila.¹² While these data provide considerable insight into variations in the composition of revenues and expenditures, they do not constitute a random sample.¹³ (See Appendix A.)

Variations in Socioeconomic Structure

Fiscal performance and potential are related to the socioeconomic and demographic configuration of a jurisdiction. Personal income level and distribution, population size and growth rate, and urbanization are the variables examined here. Due to the lack of more recent detailed data, we rely heavily on the findings of the *1975 Integrated Census of the Population and Its Economic Activities*.¹⁴ Background data on the four provinces and selected comparisons with the rest of the Philippines are presented in Table 1.3.

The upper panel of Table 1.3 shows the province-wide levels for four different indicators of social and economic well-being. Albay stands out as considerably poorer and less urbanized than the other provinces in the sample and in the entire nation; at the other extreme, Bulacan is more urbanized and has a high per capita income. One measure of the industrial development of an area is the proportion of income earned outside the agricultural sector—from wages and salaries, manufacturing, or retail activities.¹⁵ Again Bulacan stands out as being most highly developed. Iloilo and particularly Sorsogon appear to be more dominated by agricultural activity, but with average income levels well above that in Albay.¹⁶ Chartered cities, as might have been expected, are more highly urbanized, less dependent on agriculture, and have higher average income levels. One way to gauge the relative wealth of the four provinces is to compare per capita assessed property values. Again Bulacan and the chartered cities have a much greater level of wealth.

The bottom panel of Table 1.3 addresses the issue of whether there are large variations in these indicators within provinces. An affirmative answer is suggested by the coefficients of variation (the ratio of the standard deviation to the mean of the variable) shown there.

Some interesting conclusions can be drawn from these rather simple calculations. First, there is a great range of urbanization that may affect differential fiscal performance. Second, there is much less uniformity in the per capita property tax base in Iloilo and Bulacan, where the average level of the base is higher. Third, the pattern of coefficients of variation for the pooled sample of all municipalities is

TABLE 1.3

Means and Coefficients of Variations of Socioeconomic Characteristics, Selected Jurisdictions, Metro Manila, and the Nation

Jurisdiction	Per Capita 1975 Income	1975 Urban Population ^a	Percent of Nonagricultural Income, 1975 ^b	1977 Assessed Value per Capita	1975 Population ^c
Albay	P 797	8.1%	49.5%	P 403	657,855
Bulacan	1,035	36.0	70.8	1,407	890,133
Iloilo	935	12.2	43.7	674	998,504
Sorsogon	985	16.6	32.8	460	426,570
Four provinces ^d	941	19.0	52.1	803	2,973,062
Chartered cities ^e	1,258	54.9	63.9	2,244	3,902,508
Metro Manila ^f	2,125	100.0	NA	NA	4,970,000
Philippines ^f	1,111	31.6	NA	NA	42,071,000

(Continued)

TABLE 1.3 (Continued)

Jurisdiction	Per Capita 1975 Income	1975 Urban Population ^a	Percent of Nonagricultural Income, 1975 ^b	1977 Assessed Value per Capita	1975 Population ^c
	Coefficients of Variation				
Albay	32.5	97.9	44.8	33.9	46.8
Bulacan	22.2	117.8	20.9	68.8	47.3
Iloilo	31.5	67.6	37.7	98.1	45.1
Sorsogon	27.6	81.0	55.7	33.0	49.7
Four provinces	30.3	123.9	42.4	100.4	53.0
Cities	25.8	80.5	28.5	86.1	78.0

NA = Not available.

^aPercent 1975 population living in urbanized areas. Based on the 1975 definition of urban by the National Census and Statistics Office.

^bIncome from retail sales, manufacturing, and wages as percent of total 1975 income.

^cIn top panel, entries are totals; in lower panel entries are coefficients of variation across municipalities/cities in sample.

^dWeighted mean.

^eIncludes only the 42 cities for which complete data were available from 1975 census. See Appendix A.

^fThese are preliminary estimates based on National Economic Development Authority, Regional Development, *Issues and Strategies, Regional Planning Studies Series*, 1 (Manila, 1978), p. 6.

Sources: Data on assessed property value from Commission on Audit; all other data from the National Census and Statistics Office.

not considerably greater than the coefficients within provinces, suggesting that analysis of the pooled sample will provide results not entirely due to differences in the levels of development across provinces. In other words, the inclusion of higher income Bulacan and lower income Albay in the same (pooled) sample will not hamper interpretation of the results. Fourth, chartered cities appear to be much more homogeneous than municipalities with respect to all variables except population size.

Expenditure Structure and Variations: General Fund

For budgeting and financial record-keeping purposes, General Fund expenditures are classified into four major categories: general government, public welfare and safety, economic development, and other. General government includes spending on the offices of governor or mayor, legislative councils, auditor, treasurer, and assessor; public welfare and safety spending includes such items as courts, register of deeds, health, education, and welfare spending, as well as the INP; the economic development category includes expenditures on the offices of the veterinarian and engineer, transfers to the Infrastructure Fund, and spending for enterprises such as markets and slaughterhouses; other spending includes only debt service and the mandated 2 percent budgetary reserve.

Spending by local governments can be considered with respect to level and composition among the three major functional areas of general government, public welfare and safety, and economic development, and in terms of variability across jurisdictions. For the 97 sample municipalities, average per capita spending in 1977 amounted to about P17, while the 42 cities spent about P56. Obviously, the primary reason for this large difference is that cities are responsible for the combined range of services provided by municipalities and provincial governments.

When the provincial averages are compared, we find an expected pattern of substantially higher spending in Bulacan. On average, municipalities in Bulacan spend twice as much per capita as those in Albay and Sorsogon.¹⁷ This pattern may be due to several factors: Higher income residents demand and are willing to pay for more services; more urbanized areas need to provide more services; provision of services is more expensive in higher income provinces; tax administration is better in higher income provinces and thus there is

more money to spend; or there is provincial government assistance in assessment and in planning and implementing projects.

Still, one might ask whether spending in Bulacan is uniformly higher and that in Albay and Sorsogon is uniformly lower, or whether a few municipalities have pulled the average up or down by an inordinate amount. This possibility can be examined by comparing the coefficients of variation within each province. Interestingly, the greatest relative variation is among the 23 municipalities in Bulacan (see bottom row of middle panel of Table 1.4). This finding leads one to conclude that all municipalities in a province do not share equally in the fiscal benefits of a strong economic base.

When attention is turned to the composition of spending by function, other implications can be drawn. The biggest share of municipal expenditures goes for general government. On average, nearly half of total municipal expenditures went to support the general overhead of government (bottom panel of Table 1.4). Economic development spending, the stated motive for mobilizing additional local government resources, claims a much smaller share.

There is variation in the distribution of spending at the municipal level both across and within provinces. The percent allocated to economic development expenditures varies substantially and appears to be a matter of income level (in the case of Bulacan) and, to some extent, the size of the property tax base (in the case of Iloilo). It would be tempting to draw the conclusion that there is a direct and consistent relationship between the economic base of a jurisdiction and the budget share it allocates to economic development, but there are two reasons for hesitation in arguing this point. First, economic development spending tends to be "lumpy," and thus observations in any given year may distort the long-term pattern. Second, because many economic development projects are financed from the Infrastructure Fund, concentration on the General Fund may be misleading. Both qualifications will be dealt with below.

Municipalities in the provinces of Bulacan and Iloilo spend a significantly lower proportion on general government—42 and 44 percent, respectively—whereas in Albay and Sorsogon the shares are 57 and 58 percent. Again a feasible explanation for this pattern is that a local government must spend some minimal amount to support itself no matter how wealthy or poor the underlying economic base. The amount left over for other functions of government—the residual or "surplus" that is usually associated with public service improvements and economic development—is much smaller for poorer jurisdictions. On average, these municipalities appear to spend

TABLE 1.4

**Per Capita General Fund Expenditures, Selected Jurisdictions, 1977
(pesos per 1975 population)**

Expenditure Category	Mean Amounts					
	Albay	Bulacan	Iloilo	Sorsogon	Pooled Municipal Sample	All Cities ^b
General government	5.71	10.54	7.78	6.28	7.85	17.91
Public welfare and safety	1.98	5.02	5.04	2.07	4.07	20.16
Economic development	2.40	9.56	4.71	2.41	5.12	18.95
Total expenditures ^a	9.95	24.51	17.66	11.52	17.05	56.16
Number of observations in sample	17	23	43	14	97	42

(Continued)

TABLE 1.4 (Continued)

Expenditure Category	Coefficients of Variation					
	Albay	Bulacan	Iloilo	Sorsogon	Pooled Municipal Sample	All Cities ^b
General government	33.77	59.31	35.16	20.95	51.05	41.21
Public welfare and safety	82.40	73.08	66.12	53.23	79.78	70.07
Economic development	58.73	105.25	78.82	68.24	118.88	121.41
Total expenditures	40.53	54.83	39.15	32.47	56.80	63.07
	Percent Distribution					
General government	56.6	42.0	44.4	58.4	46.1	29.8
Public welfare and safety	19.6	20.0	28.8	19.2	23.9	36.9
Economic development	23.8	38.0	26.9	22.4	30.0	33.3

^aThe totals may not equal the sum of the components since all entries in the table are unweighted averages.

^bExcluding cities in Metropolitan Manila.

Source: Report of the Commission on Audit on Local Governments, 1977.

around 20 percent of their General Fund budgets for public welfare and safety, a consistency that results from the required 18 percent contribution for police services.

Chartered cities exhibit different expenditure patterns. Because they have the combined expenditure responsibility and revenue authority of municipality and province, it is not surprising that they spend significantly more on a per capita basis. They nevertheless allocate a markedly smaller share than municipalities to general government purposes and a larger share to public welfare and safety. These differences, however, are deceptive because of the great variation in financial practices among cities. The coefficients of variation show that there are greater differences in spending patterns among cities than among municipalities in this sample and that the variation is especially pronounced for economic development spending.

These patterns can be explored more systematically through the use of correlation analysis. Table 1.5 contains simple correlations between per capita General Fund expenditures, per capita personal income, population, and the percent of the population living in urban areas. The findings are mixed, but some generalizations are possible.

First, with respect to the 98 municipalities taken together, only the extent of urbanization is strongly correlated with per capita total expenditures and its economic development subcomponent. Neither population size nor personal income is found to be significantly associated with total spending or its component parts.

The correlations at the provincial level are quite mixed. Whereas per capita total spending is strongly related to urbanization and total population in Albay, Bulacan, and Sorsogon, the same relationship does not hold in Iloilo. Per person local government expenditures tend to be higher in more populous and urban places within the highly rural provinces of Albay and Sorsogon but not within Bulacan and Iloilo. The findings with respect to personal income are even more mixed.

When the components of spending are examined, even less consistency in results is obtained. The only general conclusion that can be reached is that in the provinces other than Iloilo, greater urbanization is associated with higher levels of public welfare and safety spending and economic development spending. In the cities, on the other hand, each of these three socioeconomic variables is positively associated with total spending. Where income, urbanization, and population are higher, one may expect to find a higher level of per capita expenditures in general and of per capita economic development expenditures in particular.

TABLE 1.5
Simple Correlations Between Per Capita General Fund Expenditures, Per Capita Income and Urbanized Population, Selected Provinces, 1977

Province	Total General Fund Per Capita Expenditures	General Government	Public Welfare and Safety	Economic Development	Absolute Value Required for Significance at Level ^b	
					.05	.10
Albay						
Per capita income	.480	.311	.093	.543	.53	.46
Urbanized population ^a	.729	.298	.401	.300		
Population	.668	.459	-.030	.711		
Bulacan						
Per capita income	.230	.046	.142	.061	.45	.38
Urbanized population	.399	-.134	.301	.539		
Population	-.101	-.528	-.190	.175		
Iloilo						
Per capita income	-.318	-.288	-.217	-.209	.32	.26
Urbanized population	-.058	.157	-.016	.079		
Population	-.252	-.418	-.383	.238		

Sorsogon							
Per capita income	.082	-.277	-.037	.035	.57	.51	
Urbanized population	.617	.289	.455	.362			
Population	.330	-.242	.322	.210			
Four Province Total							
Per capita income	.157	.070	.029	.111	.20	.17	
Urbanized population	.421	.116	.239	.541			
Population	-.003	-.227	-.236	.220			
Cities							
Per capita income	.328	.220	.146	.326	.32	.26	
Urbanized population	.390	.324	.223	.319			
Population	.346	.097	.291	.297			

^aPercent of 1975 population classified as urban.

^bCritical values based on sample sizes and large sample t-test of correlation coefficients.

Sources: Fiscal data from Commission on Audit; per capita income and urbanized population data from National Census and Statistics Office.

Revenue Structure and Variation

Local governments in the Philippines receive grants from the central government and have authority to levy a variety of taxes and fees.¹⁸ Provinces are permitted to levy property taxes, a property transfer tax, and taxes on particular activities including printing, amusement admissions, and specified occupations. Municipalities also derive revenues from the real property tax (RPT), the business license tax, and various fees. Cities, which provide the dual functions of provinces and municipalities, can utilize all of the taxes and fees levied by both provinces and municipalities. In keeping with the centralized orientation of the Philippine finance system, rate ceilings are imposed.

Average per capita revenues of the 98 municipalities and 42 cities included in the sample are shown in Table 1.6.¹⁹ There is substantial variation in the total amounts raised, with municipalities in Bulacan and Iloilo raising substantially more on a per capita basis than municipalities in the other two provinces. The difference is most pronounced for Bulacan, where both business taxes per capita (P3.95) and total property taxes per capita (P4.99) greatly exceed the averages in the other three provinces. There is much less difference in the average per capita amounts received from the BIR Allotment. However, municipalities in Iloilo and Bulacan, in spite of their higher than average incomes or assessed valuation, receive a greater per capita allotment, thereby reinforcing their per capita tax revenue advantage.

Variability within provinces, as measured by the coefficients of variation, suggests that greater diversity is to be found where there are higher levels of per capita revenue generation—in Bulacan and Iloilo. Again, this finding is not surprising given that both urbanization and assessed valuation per capita are greatest in Bulacan and Iloilo and also the most varied.

The distribution of General Fund revenues by type of revenue is described in Table 1.7. The business tax, property tax, and BIR Allotment account for 60 percent of revenues to the General Funds of the represented municipalities. Nontax revenues, especially earnings from enterprises, constitute most of the remainder of General Fund income. The minor taxes are minor indeed. When average reliance on various municipal revenues is compared across provinces, some interesting variations emerge. Surprisingly, the business tax is the major source of revenue to municipalities in Albay and Sorsogon, whereas in Iloilo and Bulacan the business tax is of slightly less importance than the property tax. One might attribute this pattern to a kind of

TABLE 1.6
General Fund Revenues per Capita, Selected Jurisdictions, 1977
(pesos per 1975 population)

Revenue Category	Mean Amounts					
	Albay	Bulacan	Iloilo	Sorsogon	Pooled Municipal Sample	All Cities ^b
Revenue from Local Taxation	2.90	10.49	4.32	3.15	5.34	27.40 ^c
Business tax	1.50	3.95	1.32	1.55	2.00	8.21 ^c
Occupation tax	.03	.08	.02	.01	.03	.27
Residence tax	.19	.56	.20	.17	.28	1.35
RPT—Current	.59	3.66	1.77	.75	1.85	9.00
RPT—Past years	.21	1.11	.43	.30	.53	2.47
RPT—Penalties	.04	.21	.09	.07	.11	.44 ^d
(RPT—Total)	(.85)	(4.99)	(2.28)	(1.12)	(2.49)	(11.71) ^d
BIR Allotment	5.24	6.71	6.50	5.90	6.24	13.45
Nontax Revenues	2.31	7.61	7.96	3.25	6.18	18.59
Aids and Contributions	.04	.06	.67	.33	.37	.49
Total Revenue ^a	10.45	24.81	18.77	12.30	17.75	61.41
Number of Observations in Sample	17	23	43	15	98	42

(Continued)

TABLE 1.6 (Continued)

Revenue Category	Coefficients of Variation					
	Albay	Bulacan	Iloilo	Sorsogon	Pooled Municipal Sample	All Cities ^b
Revenue from Local Taxation	49.85	71.14	78.99	48.72	97.09	82.20
Business tax	75.53	98.09	101.86	79.26	120.32	88.24
Occupation tax	64.49	141.04	64.57	97.24	191.83	88.45
Residence tax	55.70	63.33	46.08	45.19	87.39	79.25
RPT—Current	28.98	84.34	147.64	17.88	136.24	139.01
RPT—Past years	50.97	95.80	60.89	47.24	119.62	153.74
RPT—Penalties	38.31	75.02	52.25	42.74	95.75	127.07
(RPT—Total)	(25.60)	(78.55)	(117.20)	(17.54)	(119.47)	(143.90)
BIR Allotment	15.57	34.81	28.66	26.36	29.75	53.12
Nontax Revenues	96.17	107.03	59.34	78.89	92.05	117.95
Aids and Contributions	412.31	260.86	225.03	141.06	287.99	345.64
Total Revenue	34.59	53.65	37.17	30.93	53.95	60.82

^aIncludes sales of assets, borrowing, and so forth.

^bExcludes cities in Metropolitan Manila.

^cNumber of observations in sample equals 40.

^dNumber of observations in sample equals 41.

Source: Annual Report of the Commission on Audit on Local Governments, 1977.

TABLE 1.7

Percentage Distribution of General Fund Revenues by Source, Selected Jurisdictions, 1977

Revenue Category	Municipality by Province				Pooled Municipal Sample	All Cities ^a
	Albay	Bulacan	Iloilo	Sorsogon		
Revenue from Local Taxation	16.3	42.3	23.0	25.6	30.1	44.6
Business tax	14.3	15.9	7.1	12.6	11.3	13.7
Occupation tax	0.3	0.3	0.1	0.1	0.2	0.4
Residence tax	1.8	2.3	1.1	1.4	1.6	2.3
RPT—Current	5.6	14.9	9.6	6.1	10.4	9.8
RPT—Past years	2.0	4.6	2.3	2.5	3.0	3.8
RPT—Penalties	0.4	0.9	0.5	0.6	0.6	0.7
(RPT—Total)	(8.0)	(20.4)	(12.4)	(9.2)	(14.0)	(14.2)
BIR Allotment	50.1	27.1	35.4	48.2	35.2	24.2
Nontax Revenues	22.2	30.3	44.2	26.2	34.8	29.2
Aids and Contributions	0.4	0.2	3.7	2.7	2.1	0.8

^aExcluding cities in Metropolitan Manila.

Source: Computed from Table 1.6.

“tax handles” argument. At the earlier stages of development, and with lesser degrees of urbanization, local governments may have little to tax other than the few established businesses, or they may find the administration and collection of a broad-based property tax unwieldy. As the local economy develops, the local government may begin to reach more property owners who have a greater capacity and perhaps willingness to pay property taxes.

The other interesting pattern suggested by Table 1.7 is the heavy dependence on central government assistance, especially in the less urbanized and low property tax base provinces of Albay and Sorsogon. Municipalities in each of these provinces receive about half their total revenues from the BIR Allotment. Nontax revenues—receipts from markets, slaughterhouses, and other enterprises—appear as important and as highly variable, although caution has to be exercised in interpreting importance here because gross revenues rather than profits are reported.

Because of their broader taxing powers, chartered cities show much higher per capita revenues in total and from the several specific sources (Table 1.6). The fact that municipal and provincial governments share the BIR Allotment whereas cities receive a single, but comparable total accounts for the nearly doubled level of per capita shares in cities compared to municipalities. While the mean per capita levels of business and property taxes in cities are considerably higher than in municipalities, the variability among cities is greater. In terms of relative shares, cities rely more heavily on local taxation than do the municipalities (except in Bulacan), whereas municipalities rely considerably more upon the BIR Allotment and on nontax revenues.

Consolidated Budgetary Position

A more complete view of the activity of the local public sector requires aggregating revenues and expenditures in the General Fund, Infrastructure Fund, and Special Education Fund. A truer picture of total economic development spending can be had by including the Infrastructure Fund and a better measure of social service spending by including the Special Education Fund. Interfund transfers have been accounted for in making this consolidation, which shows actual expenditures to be one-fourth to one-third higher when the Infrastructure Fund and SEF are included (Table 1.8).

As noted above, Infrastructure Fund expenditures are used for the building and maintenance of roads, bridges, and other capital

TABLE 1.8

Mean Per Capita Revenues and Expenditures by Fund, Selected Jurisdictions, 1977

Fund	Municipalities					Cities
	Albay	Bulacan	Iloilo	Sorsogon	Pooled	
General Fund						
Total revenues	10.44	24.81	18.77	12.30	17.75	61.41
Total expenditures	9.62	24.93	17.73	11.76	17.16	56.16
Infrastructure Fund						
Total revenues	1.53	2.24	3.29	1.68	2.50	13.04
Total expenditures	1.85	5.17	4.33	2.48	3.83	14.94
Special Education Fund						
Total revenues	0.36	4.29	1.12	0.36	1.63	3.92
Total expenditures	0.30	3.99	1.06	0.55	1.55	3.21
Consolidated Budget						
Total revenues	12.33	31.34	23.18	14.34	21.88	78.37
Total expenditures	11.77	34.09	23.12	14.79	22.54	74.31
Number of Observations	17	23	43	15	98	42

Source: Annual Report of the Commission on Audit, 1977.

projects. For the four provinces, average per capita economic development spending from both the General and Infrastructure funds is P4.30 in Albay, P14.60 in Bulacan, P9.03 in Iloilo, and P4.85 in Sorsogon. The results are not different from those reported above: The more developed areas devote a greater share of resources and a greater per capita amount to development spending. If education spending (SEF expenditures) is also classified as economic development, the dispersion is even greater—from a low of P4.60 per capita in Albay to a high of P18.58 in Bulacan. These findings raise two interesting hypotheses. The first is that the grant system, which is the main support for economic development spending, is not equalizing. The second is that resource availability is the principal determinant of spending variations. Both propositions are investigated below.

Tax Effort

One explanation for the greater levels of taxing and spending in higher income areas is that a greater tax effort is exerted: The higher the average income of the jurisdiction, the more willing are its residents to pay for better services and/or the more able is the jurisdiction to collect a higher level of taxes. The most straightforward measure of tax effort—the ratio of taxes to personal income—oversimplifies because it presumes that communities with the same income have the same capacity to raise taxes. Nevertheless, this measure of tax effort is easily calculated and provides a reasonable idea of the variation in the extent to which taxable capacity is used.

Three different tax effort ratios were computed for the sample of Philippine municipalities and cities: (1) Real property tax (RPT) effort is defined as the ratio of 1977 RPT collections (current year plus past years plus penalties) divided by 1975 census estimates of personal income; (2) business tax effort is an analogous ratio based on 1977 business license tax collections; and (3) the numerator in the total tax effort measure is total 1977 locally collected taxes.²⁰

Table 1.9 contains summary data on the jurisdiction-level tax effort ratios. It is clear from these results that local government taxes are quite low. The average effective tax rate for municipalities, even measured against 1975 income, is well below 1 percent.²¹ The range (second column), however, suggests much variation. To understand this variation better, a comparison of a municipality's effective tax rate against some norm is needed. We might view the difference between the average tax effort in the province (\bar{E}_p) and that in the

TABLE 1.9
Tax Effort Ratios for Municipalities by Province
and for Cities, 1977
(in percent)

Province	Range	Simple Average	Aggregate ^a
Albay			
RPT effort	0.05-0.20	0.12	0.11
Business tax effort	0.05-0.52	0.21	0.22
Local tax effort	0.20-0.82	0.42	0.41
Bulacan			
RPT effort	0.22-2.11	0.49	0.42
Business tax effort	0.06-1.40	0.36	0.36
Local tax effort	0.41-3.12	1.00	0.92
Moilo			
RPT effort	0.05-2.54	0.28	0.24
Business tax effort	0.03-0.88	0.16	0.36
Local tax effort	0.12-2.79	0.53	0.45
Sorsogon			
RPT effort	0.07-0.22	0.13	0.17
Business tax effort	0.05-0.59	0.18	0.19
Local tax effort	0.17-0.88	0.36	0.36
Pooled			
RPT effort	0.05-2.54	0.28	0.26
Business tax effort	0.03-1.40	0.22	0.23
Local tax effort	0.12-3.12	0.60	0.58
Cities			
RPT effort	0.08-9.09	1.04	0.79
Business tax effort	0.00-1.78	0.68	0.85
Local tax effort	0.38-9.99	2.32	2.47

^aComputed as $\sum Tx_i / \sum Y_i$, where Tx_i = 1977 taxes in municipality i , Y_i = 1975 income in municipality i , and the summation is across all municipalities in the province. The resulting ratio is essentially a weighted average of the individual ratios.

Source: Computed by authors.

nation (\bar{E}) as being beyond the control of any particular municipality and, more generally, due to the differences in fiscal capacity and to the goals and leadership provided in the provincial treasurer's and assessor's offices. Hence, the tax effort of the i th jurisdiction (E_i) may be compared to the national average from

$$(E_i - \bar{E}) = (E_i - \bar{E}_p) + (\bar{E}_p - \bar{E}) \quad (1.1)$$

where the first term on the right represents the higher/lower effort of i th jurisdiction attributable to its own actions, and the second term is the differential attributable to the generally lower (or higher) level of economic activity and tax administration skill at the provincial level.

This technique has been used to compute tax effort indexes for each of the 98 municipalities in the four sample provinces. An example illustrates the interpretations. The municipality of Pavia in Iloilo collects (municipal) property taxes equivalent to 0.47 percent of personal income. The (unweighted) "national" average collection (\bar{E}) is 0.28²² and the provincial mean is also 0.28 (Table 1.9). Thus, Pavia's property tax effort is 0.19 above the national average, that is, $(E_i - \bar{E}) = 0.19$. All of this may be attributed to local actions, as the average property tax effort in the province is the same as the national average. To describe this above-average performance, we construct an effort index (I_i) from

$$I_i = \frac{E_i}{\bar{E}_p} \quad (1.2)$$

for each municipality. An index greater than 100 indicates a tax effort performance above the provincial average. In the case of Pavia, in Iloilo, for example, the property tax effort index is 168, which is quite high.

On the other hand, the municipality of Tabaco in Albay makes a property tax effort of 0.07, which is 0.21 below the average national effective rate, that is

$$E_i - \bar{E} = -0.21 \quad (1.3)$$

We may attribute 0.16 of this to the generally lower property tax effort in the province, that is

$$\bar{E}_p - \bar{E} = -0.16 \quad (1.4)$$

Furthermore, Tabaco exerts a low effort even within the context of its low taxing province, that is

$$E_i - \bar{E}_p = -0.05 \quad (1.5)$$

Thus, Tabaco's effort index is a relatively low 58, and the average Albay index is an even lower 43.

The index and relative effort for business taxes can be interpreted in an analogous way. Computing such indexes for each tax source provides an opportunity to assess the reasons for a high/low effort and to examine tradeoffs in the intensity of use of business and property taxes.²³ Let the total effective rate (E) be equal to the sum of the effective rates for property taxes (E_1), business taxes (E_2), and other taxes (E_3). Hence, for the i th jurisdiction in province p

$$E_i = E_{1i} + E_{2i} + E_{3i} \quad (1.6)$$

Define

$$E_{1i} = \frac{T_{1i}}{Y_i} = r_{1i} \quad (1.7)$$

and

$$\bar{E}_{1p} = \left(\frac{\bar{T}_{1p}}{Y_p} \right) = \hat{r}_{1p} \quad (1.8)$$

and define r_{2i} , r_{3i} , r_{2p} , and \hat{r}_{3p} similarly.

Now actual tax yield in the i th municipality (T_i) is

$$T_i = r_{1i}Y_i + r_{2i}Y_i + r_{3i}Y_i \quad (1.9)$$

and potential yield (\hat{T}_i) is

$$\hat{T}_i = \hat{r}_{1p}Y_i + \hat{r}_{2p}Y_i + \hat{r}_{3p}Y_i \quad (1.10)$$

The index of tax effort I_i , then, is

$$I_i = [E_i/\bar{E}_p] 100 = \frac{r_{1i} + r_{2i} + r_{3i}}{\hat{r}_{1p} + \hat{r}_{2p} + \hat{r}_{3p}} 100 \quad (1.11)$$

and

$$I_i - 100 = \frac{r_{1i} - \bar{r}_{1p}}{\Sigma \bar{r}_{1p}} + \frac{r_{2i} - \bar{r}_{2p}}{\Sigma \bar{r}_{2p}} + \frac{r_{3i} - \bar{r}_{3p}}{\Sigma \bar{r}_{3p}} \quad 100 \quad (1.12)$$

The first term in equation (1.12) may be interpreted as the contribution of the property tax to an above- or below-average tax effort index, and the second and third terms to the business and other tax contributions, respectively. Returning to the examples of Pavia in Iloilo and Tabaco in Albay, we may calculate these components of overall tax effort. The results show that Pavia's high effort is due to an above-average performance for all taxes (Table 1.10), which may indicate a generally strong local tax administration. Tabaco offsets a below-average property tax effort with a very high business tax effort. This finding suggests that the commercial/industrial sector is easily taxed, perhaps because of the presence of a few large firms or a generally stronger commercial base; this case might have reduced the pressure to increase property tax effort. Malinao, a poorer municipality in Albay, makes a very low tax effort in total and for each tax, although business tax effort accounts for most of its poor performance.

Do these results provide any clues as to what community characteristics lead to variations in tax effort? To begin exploring this question we have computed the simple correlations between the tax

TABLE 1.10

**Illustration of Calculation of Components of Tax Effort:
Pavia, Iloilo, Tabaco, Albay and Malinao, Albay**

	Pavia	Tabaco	Malinao
Effort index (I_i)	257	126	52
($I_i - 100$)	157	26	48
Deviation of index from provincial average ($J_i - 100$) that can be attributed to:			
Property tax	36 (23%)	-12 (-46%)	-7 (-15%)
Business tax	100 (64%)	+41 (158%)	-31 (-65%)
Other tax	21 (13%)	-2 (-7%)	-10 (-21%)

Source: Computed by authors.

effort indexes and per capita income, urbanization, and population for the municipalities in each province as well as for the sample of cities (see upper panel, Table 1.11). For the provinces taken separately there is a consistent negative relationship between per capita income and tax effort. This result suggests that within a province, those jurisdictions with a larger income base tax relatively less of it than do lower income municipalities. On the other hand, total local taxes and especially business taxes are positively related to the relative share of income earned from nonagricultural sources—manufacturing, retail, and wage incomes.

There is a plausible explanation for these seemingly mixed findings. Given that these jurisdictions are predominantly rural in nature, the findings concerning per capita income and nonagricultural shares of income may reflect the fact that farms are exempt from business taxes and that the RPT is not easily collected from the agricultural sector. With respect to the latter, absentee ownership, controlled below-market prices, inadequate assessment and records, land reform, and the physical problems of getting the tax collected are some of the important impediments. If nearly all jurisdictions in a province are predominantly rural in nature (as is especially true in Albay and Sorsogon), the higher incomes in some cannot be “captured” by the tax system—thus the negative correlations.

Most obvious from the charter city analysis is the lack of association between these demographic/economic characteristics and tax effort, although larger cities or cities with stronger nonagricultural economic bases make a greater business tax effort.

The bottom panel of Table 1.11 provides a different perspective regarding tax effort in municipalities in the pooled sample by correlating the effective tax rates (T_i/Y_i) with socioeconomic characteristics. Given the differential average effective tax rates across the four provinces, it is not surprising to find the rather strong positive association between total taxes and both urbanization and nonagricultural incomes. The municipalities of Bulacan are probably a strong influence on this result.

The evidence here suggests that local government taxes in the Philippines are urban taxes. Business tax effort is higher where there are higher levels of per capita nonagricultural income and urbanization. The pattern of property tax effort is less clearly seen from these relationships, perhaps because the pattern is more complicated than can be picked up by simple, zero-order relationships.²⁴ The major consistent finding is that where per capita income is high—and especially if a large share of this income is earned in the agricultural sector—property tax effort will be low.

TABLE 1.11

**Simple Correlations of Municipal and City Property and
Business Tax Effort Indexes and Effective Tax Rates
with Socioeconomic Variables, 1977**

Province	Simple Correlations with Tax Effort Indexes ^a			
	Per Capita Income	Population	Urban Population ^b	Nonagricul- tural Share of Income ^c
Albay				
RPT index	-.690	-.334	.336	-.412
Business tax index	-.184	.176	.404	.567
Total	-.417	.121	.258	.048
Bulacan				
RPT index	-.174	-.312	-.116	.173
Business tax index	.211	-.173	.263	.540
Total	-.006	-.308	.020	.261
Iloilo				
RPT index	-.266	-.054	-.221	-.304
Business tax index	-.335	-.056	.135	.374
Total	-.358	-.089	-.124	.092
Sorsogon				
RPT index	-.824	-.096	.039	.064
Business tax index	-.282	.460	.664	.439
Total	-.469	.300	.688	.262
Four Provinces				
RPT index	-.258	-.111	-.085	-.018
Business tax index	-.183	.015	.205	.201
Total	-.281	-.065	.069	.109
Cities				
RPT index	-.090	-.094	-.031	-.091
Business tax index	.179	.425	.191	.313
Total	.027	.179	.267	.146
Simple Correlations with Effective Tax Rates				
Four Provinces				
RPT rate	-.084	-.081	.032	.222
Business tax rate	.016	.112	.354	.456
Total tax rate	-.073	-.010	.224	.387

^aSee Table 2.5 for significance levels.

^bUrban population in 1975 as a proportion of total population.

^cManufacturing, retail, and wage income as a proportion of total income.

Source: Annual Report of the Commission on Audit on Local Governments, 1977.

Measuring Tax Effort: A Digression

The results above treat a high effective tax rate as a high tax effort because of an assumption that all income generates the same level of taxable capacity. Yet we have learned from the above that effective tax rates tend to be larger where urbanization rates and per capita nonagricultural income are higher. We speculated that this is due in part to a generally more advanced stage of development and a greater taxable capacity. Where taxable capacity is high, we may expect a higher effective tax rate, and it is improper to attribute all of an above-average tax performance to "effort," to a greater willingness to pay.

To correct for this we have constructed a tax effort model in the traditional form used in cross-country studies.²⁵ If taxable capacity varies not only with income level but with per capita nonagricultural income (NY_p), urbanization (U), and population size (P), we may estimate

$$T/Y = f(NY_p, U, P) \quad (1.13)$$

where T/Y = total local taxes as a percent of personal income.

Under this approach the fitted relationship, if considered adequate, could then be used to measure an "expected tax capacity," $(\hat{T}/Y)_i$, based upon the values of the independent variables in the i th municipality. The actual effective rate, $(T/Y)_i$, could then be compared with this expected level to form a new tax effort measure, EE_i , defined as

$$EE_i = \frac{(T/Y)_i}{(\hat{T}/Y)_i} \quad (1.14)$$

Rankings of municipalities can then be made on the basis of the EE_i index reflecting whether a jurisdiction is capturing its taxable capacity, where the latter is based upon its own economic characteristics.

Two different forms of the relationship between socioeconomic variables and $(T/Y)_i$ have been estimated, with the results shown in Table 1.12. The first set of regression results shows per capita nonagricultural incomes to be significantly related to effective tax rates (measured as total local taxes per P1,000 of personal income), whereas neither urbanization nor population is significant. The second regression suggests that variations in effective tax rates are closely

TABLE 1.12

Ordinary Least Squares Regression Results: Effective Tax Rates
Related to Local Socioeconomic Characteristics

Model	Intercept	Percent Urban	Per Capita Non-agricultural Income	Population (1,000s)	Dummy Variables			R ²	F
					Albay	Iloilo	Sorsogon		
1	3.301 (2.60)*	1.846 (.62)	8.782 (3.62)*	-.052 (1.56)				.17	6.53*
2	8.711 (3.72)*	1.569 (.53)	4.466 (1.59)	-.061 (1.73)	-3.840 (2.09)†	-3.855 (2.44)†	-5.077 (2.66)*	.24	4.76*

Note: Tax rates measured as the ratio of total local taxes to personal income (in P1,000).

*Significant at less than the 0.01 level.

†Significant at less than the 0.05 level.

Source: Computed by authors.

related to province-specific factors. Three dummy variables have been introduced to delineate among the four provinces (Bulacan is used as the standard of comparison). Under this formulation none of the three economic variables is significant, while each of the dummy variable coefficients is. This finding suggests an underlying difference in local taxation that depends more on regional levels of development or perhaps provincial government operations than on particular characteristics of the localities.²⁶

Several possibilities may explain these results. One grows out of the centralized nature of local tax administration. The role of the provincial treasurer may be so dominant that it swamps the influence of local economic conditions on tax effort and results in no systematic variability in tax effort across jurisdictions within a single province. Another possibility is that the independent variables used here are too crude to pick up subtle differences in stages of development, which account for differences in tax efforts. And a third is that basically random local forces, such as an active municipal mayor, have greater influence on taxing behavior than do the more traditional economically-based variables.

Cash Balances and Surpluses

The question of fiscal health can also be studied by considering trends in the annual surplus/deficit and in the accumulated cash position of local governments. One possibility is a pattern of continuing deficits, exhausted reserves, and general insolvency. Although this scenario is not unknown in developing countries, it fails to describe the situation in the Philippines, at least in the four provinces studied here.

Cash Balances

Municipalities can hold cash either in their own treasuries or in a trust fund administered by the provincial treasurer. Generally, the amounts held locally are minimal—no more than is necessary for the day-to-day operation of the government.²⁷ To study movements in the cash position of municipalities, COA data are not adequate. Therefore, information was gathered from site visits to a small number of municipalities in the provinces of Iloilo, Bulacan, and Albay.²⁸ The results of these case studies are summarized in the first two sets of columns in Table 1.13. The first set of columns shows the General Fund balance as a percent of General Fund income for 1977-79. The

TABLE 1.13

Cash Balance and Surplus Position, Selected Municipalities and Cities

	General Fund Cash Balance as a Percent of Revenue			General Plus Infra- structure Fund Cash Balance as a Percent of Total Revenue			General Fund: Unappro- priated Surplus as a Percent of Revenue			General Plus Infra- structure Fund Unappro- priated Surplus as a Percent of Revenue		
	1977	1978	1979	1977	1978	1979	1977	1978	1979	1977	1978	1979
Iloilo												
Dingle	45.5	26.8	9.6	47.5	41.9	26.1	23.7	8.9	14.3	19.5	11.4	14.3
Dumangas	65.0	72.0	66.0	69.0	92.0	80.0	30.0	41.0	34.0	35.0	41.0	34.0
Guimbal	93.5	85.7	85.3	96.3	89.9	113.9	90.3	18.0	18.6	123.1	31.2	18.6
Passi	61.4	133.4	146.0	65.4	126.9	141.1	33.2	9.4	51.4	33.1	19.4	51.4
Pavia	46.8	41.8	42.2	48.1	55.9	44.6	30.9	39.2	9.3	33.9	41.4	9.3
Tigbauan	22.9	21.8	17.0	32.8	30.8	30.3	10.9	13.5	17.7	27.6		17.7
Albay												
Camalig	0.4	0.2	6.4	0.3	0.0	14.5	0.2	7.5	NA	3.2	9.0	NA
Libon	0.5	14.3	4.4	9.7	36.8	22.1	0.2	3.7	NA	8.6	17.9	NA
Malinao	7.8	14.4	2.4	8.9	13.8	7.4	5.4	9.3	6.6	16.2	20.6	7.3
Tabaco	37.3	46.5	51.5	36.0	48.1	47.9	0.1	1.2	NA	0.5	2.4	NA

Bulacan

Balagtas	0.08	7.14	0.67	5.61	0.12	4.54	1.64	4.31
Baliwag	3.15	21.00	3.94	17.81	1.07	6.32	1.19	5.14
Malolos	38.43	35.91	40.32	36.64	5.81	17.79	6.53	17.16
Obando	34.45	45.89	50.81	66.49	15.94	21.03	17.97	22.09
Sta. Maria	28.12	28.66	26.62	27.95	7.79	7.87	7.71	8.31

Total General Fund as
a Percent of Revenue

General plus Infrastructure
as a Percent of Total Revenue*

	1977	1978	1979	1977	1978	1979
Legaspi City						
Cash						
On hand	6.8	4.9	1.9	6.1	4.3	4.0
Interest-bearing	31.8	49.8	29.7	28.9	46.2	26.2
Unappropriated surplus	41.6	52.6	31.6	36.7	47.2	21.8
Iloilo City						
Cash						
On hand	3.8	27.3	12.2	4.2	25.5	9.6
Interest-bearing	23.9	9.6	8.8	50.6	9.0	6.9
Unappropriated surplus	8.3	12.6	6.9	8.0	12.4	6.2

*Infrastructure Fund "income" in 1979 was P4,234,343 in Legaspi but included a loan of P2,079,812. The loan is excluded in the computation of these percentages.

Source: Data gathered during field visits to individual municipalities.

next set gives the same information for the combined General and Infrastructure Fund positions. In each case the balances are those held in the provincial treasury.

For most municipalities studied, cash balances are quite large and have been increasing. In Iloilo, even the smallest (1977) balance, relative to revenues, is in excess of 22 percent or equivalent to more than two and one-half months of revenues. The weighted average of the six municipalities in Iloilo (weighted by the amounts of revenue) in 1977 is approximately 57 percent for the General Fund and 61 percent for the two funds combined—an amount equivalent to over half the total year's income. The Bulacan municipalities also have been holding large cash balances, a weighted average for the General Fund of 23.22 percent in 1977.²⁹ There is, however, considerable variation across the municipalities within this province. The cash position for the Albay municipalities is much less strong, although it did grow during the 1977-79 period.³⁰

Substantial levels of cash are also observed for the two chartered cities examined. Especially notable in the cash balances are the large relative holdings in the form of interest-bearing securities. In each of the three years, the stock of interest-bearing balances in Legaspi City was equivalent to nearly 30 percent of its annual flow of income (the percentage was close to 50 percent in 1978). This finding reflects the fact that, as in the case of provinces, cities are allowed to earn interest on cash balances without the approval of a higher level of government. The city of Iloilo relied less heavily on interest-bearing accounts—drawing them down between 1977 and 1978 and then holding them constant through 1979.

The cash position of these local governments is so strong that it causes some questions to be raised—most obviously, the opportunity cost associated with holding these balances. Apparently, only treasuries of provincial and city governments hold assets in the form of interest-bearing time deposits. Municipalities thus incur a real resource loss when these balances become excessive.³¹

Both efficiency and redistributive effects are associated with this policy. For municipalities there is no direct incentive to accumulate excess reserves since it does involve a resource loss. Yet the evidence suggests that, at least in some localities, this disincentive has been overcome through the strong leadership of provincial treasurers. If such is the case, there has been no resource loss associated with the policy, at least when viewed from the perspective of the entire province. However, to the extent that the interest proceeds are not redistributed to the contributing municipalities, there is a resource redis-

tribution. Such redistribution may also affect local tax compliance. If taxpayers in a locality comply with the tax laws but do not observe corresponding increases in public service quantities and qualities, they may become less willing to comply. Beyond possible alterations in the current statutory arrangements, a reasonable administrative policy would be to redistribute some portion of interest proceeds in proportion to the deposits held in the provincial treasury.

Fiscal Surpluses

Cash balances may represent a value of asset holdings by local governments, but they may not be a good measure of the discretionary funds available to local governments because some portion of this liquid wealth may already have been committed to particular purposes. A second approach to the measurement of fiscal well-being, which can take this possibility into account, is to study the trend in the surplus position of a jurisdiction. It should be emphasized that we are not talking here about an annual budgetary “surplus” measure but about the stock of cash available for general purposes. Surplus is measured as the sum of cash in the treasury plus deposits and receivables less payables.

Two different types of “surpluses” are included in the post-closing balance—appropriated and unappropriated. The former includes those funds that, while appropriated for projects, have not yet been spent. Included here are any unspent funds from the 20 percent Development Fund. Unappropriated reserves are, however, essentially free reserves and therefore provide another view of the fiscal reserves of the municipality. These discretionary funds are found in both the General Fund and the Infrastructure Fund. Their size relative to total revenue is reported in the last two sets of columns in Table 1.13 for 1977–79.

One must conclude from the data on the six Iloilo municipalities that substantial financial resources are available and not utilized. By 1979, free reserves averaged (unweighted) 32 percent of total General plus Infrastructure Fund income. While comparable averages in 1978 in Albay (12.4) and Bulacan (11.4) are lower than in Iloilo, the levels in the larger and more urbanized places—Tabaco (Albay) and Obando (Bulacan)—are quite large. The unappropriated surpluses are also very large in Legaspi City—exceeding 50 percent of General Fund income in 1978 and exceeding 20 percent of revenues in all years. The surpluses were not so large in Iloilo City, but nevertheless remained at a substantial level throughout the three-year period.

An obvious question that arises from the finding of these strong cash and reserve positions is, why? Several answers might be suggested. First, it may simply be that these jurisdictions do not "need" these resources and they truly are surplus funds. This explanation, however, does not square with stated needs for public service improvements. Second, the accumulation of balances may be due to a conservative financial management philosophy, espoused at both higher and lower levels of government. At the central government level funds are earmarked for contingency reserves and for capital formation, and, moreover, local government consumption expenditure increases are limited by law. Local treasurers may also contribute to this conservatism in spending by consciously underbudgeting. Local treasurers feel that they have some personal liability in cases of budget deficits and in any case see their performance rating as being based on the fiscal performance of their jurisdictions. It is a truism that in the financial management world, surpluses get good marks. Provincial treasurers have little incentive to revise their conservative practice, for many of these same reasons and because the interest returns on local cash balances accrue fully to the provincial treasury.

A third reason is that it may be these reserves would not accumulate if more imaginative uses of local funds were pursued. That is, there may be "needs" for additional local services, but the system for ascertaining these desires does not work effectively to reflect them in actions. If residents have no effective way of voicing their demands for public services, there is likely to be a tendency to remain with the status quo in terms of services provided rather than undertaking new policy initiatives at the local level. Fourth, and possibly most relevant, is that the kinds of spending necessary to meet the citizens' public service demands require that considerably greater amounts of resources be made available. The balances may be substantial but not by comparison with what is required, for example, to build a market.

CONCLUSION

Three general conclusions may be drawn from the preceding discussion. The first is that not only is local government financing highly centralized in the Philippines in terms of taxing authority and expenditure responsibility but centralization extends to day-to-day influence on fiscal decisions and administrative procedures. The second is that the fiscal importance of the local government sector

declined during the 1970s. Third, central government policy may have to share the blame for the failure of local governments to mobilize more resources, for the inefficiencies in local government operations, and perhaps for the wide variation in tax effort.

If increased local government participation in governmental financing is indeed a national objective, the central government may find it necessary to remove certain disincentives to more efficient local government financing and to create incentives for local governments to increase tax effort and development spending. The discussion in this chapter suggests areas where such reforms would seem called for: local budgeting and financial management practices, the central government oversight process, the relaxation of expenditure mandates, and the reduction or management of local government cash balances. We elaborate on these possibilities in Chapter 7.

NOTES

1. Jose Veloso Abueva, "Ideology and Practice in the 'New Society,'" in *Marcos and Martial Law in the Philippines*, ed. David A. Rosenberg (Ithaca, N.Y.: Cornell University Press, 1979), p. 58.

2. PD 464, Preamble, May 20, 1974.

3. This goal was stated by Virata in two recent speeches: "Financing Local Development: Policy Changes, Issues and Problems" (February 4, 1979), and "Local Government Finance: Challenges and Prospects" (no date).

4. *Budget Operations Manual for Local Governments* (Manila: Provincial and City Treasurers and Assessors Association, undated), pp. 8-9.

5. *Ibid.*, p. 8.

6. The fiscal year in the Philippines coincides with the calendar year. Prior to 1976 the fiscal year was July 1-June 30; July 1, 1976-December 31, 1976 constituted the "transition period."

7. *Budget Operations Manual for Local Governments*, p. 82.

8. A review of these issues in the United States is presented in Roy Bahl and Larry Schroeder, "Forecasting Local Government Budgets," Occasional Paper No. 38, Metropolitan Studies Program (Syracuse, N.Y.: Maxwell School, Syracuse University, 1979).

9. This arrangement was altered under PD 1375 (May 1978), when the budget review responsibility was passed to the Ministry of the Budget.

10. Jurisdictions are classified according to the amount of revenue collected.

11. This situation is similar to that facing the U.S. government, which is unable to decide what constitutes a "distressed" city. See James W. Fossett and Richard P. Nathan, "The Prospects for Urban Revival," and Roy Bahl, "The Next Decade in State and Local Government Finance: A Period of Adjustment," both in *Urban Government Finance, Emerging Trends*, ed. Roy Bahl (Beverly Hills, Calif.: Sage Publications, 1981).

12. The municipalities of Jordan, New Valencia, and San Miguel, in Iloilo Province, and Casiguran and Sorsogon, in Sorsogon Province, were excluded

from the sample because the data were not available from COA. Appendix A contains a listing of the jurisdictions included in the sample.

13. The sample was chosen with the advice of the PIDS project directors, using criteria such as accessibility, willingness to cooperate, and variation in income level, economic structure, and quality of financial administration. Some of these criteria may themselves ensure a bias.

14. Obtaining accurate income data from any census is a difficult task. It is even more difficult in rural areas of developing countries, given lower literacy rates of respondents, inadequate record keeping, nonmonetary transactions, and reluctance to divulge financial information. While we recognize the potential weaknesses in the data, they are, nevertheless, the most up-to-date and complete set of economic information available.

15. This term is slightly misleading given the methods used to classify incomes by the census. That is, respondents were asked to indicate from which of several activities (farming/gardening, livestock and poultry, fishing, manufacturing, wages) "the household derived the most income in 1975." Thus, even though only 51 percent of total income of a household may have been earned in a particular pursuit, the entire amount of household income would be classified under that activity.

16. Iloilo has a relatively lower average income level than expected. One possible explanation is the influence of national price controls on sugar and rice production, which are the major crops in Iloilo.

17. It should also be noted that 1975 populations were used to derive these per capita amounts. Hence, differential population growth from 1975 to 1977 could alter these findings slightly by understating the relative per capita amounts for the slower growing municipalities.

18. For a complete listing and discussion of these local taxes and fees, see A. Yoingco and V. Quintos, *Philippine Tax System Under the New Society* (Manila: GIC Enterprises, 1979), especially pp. 238-50 and 262-77.

19. Because of missing financial and socioeconomic data for particular variables, there is some minor variability in the sample of jurisdictions used in the several analyses performed in this and subsequent chapters.

20. While total revenue effort—the ratio of total General Fund revenues less the BIR Allotment to personal income—may be computed, it is less comparable because it includes gross revenues from enterprise activities. It is not reported here.

21. The municipal share of the property tax is only 45 percent.

22. As approximated here by the average across the 98 municipalities, since comparable personal income data were not available for municipalities across the entire nation.

23. The relative effort indexes are shown for all sample municipalities in Bahl et al., *Strengthening the Fiscal Performance of Philippine Local Governments*, Tables II-12a-II-12d, pp. II-47-II-50.

24. This possibility is explored more fully in Chapter 2.

25. See Joergen Lotz and Elliott Morss, "Measuring Tax Effort in Developing Countries," *IMF Staff Papers* 14 (1967): 478-99; Roy Bahl, "A Regression Approach to Tax Effort and Tax Ratio Analysis," *IMF Staff Papers* 18, no. 3 (November 1971): 570-612; Harley Hinrichs, *A General Theory of Tax Structure Change During Economic Development* (Cambridge, Mass.: Harvard Law

School, 1966); Alan Tait, Wilfred Gratz, and Barry Eichengreen, "International Comparisons of Taxation for Selected Developing Countries, 1972-1976," *IMF Staff Papers* 26, no. 1 (March 1979): 123-56; Roy Bahl, "A Representative Tax System Approach to Measuring Tax Effort in Developing Countries," *IMF Staff Papers* 19, no. 1 (March 1972): 87-124; Raja Chelliah, Hessel Baas, and Margaret Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969-1971," *IMF Staff Papers* 22, no. 1 (March 1975): 187-205.

26. Several other regressions were fit with both intercept and slope dummy variables, under the expectation that both the level of tax effort and its response to economic characteristics differ across provinces. The findings did not, however, bear out this expectation. We also estimated several nonlinear relationships and still could not improve the results.

27. It must be recognized, however, that this measure is of the stock of cash at a point in time (the final day of the fiscal year). This measure can change daily in response to the particular flows of revenues and expenditures in a jurisdiction.

28. The "sampling" scheme was nonrandom; no attempt was made to choose either the "best" or "worst" cases.

29. We were unable to obtain the necessary data for 1979 in Bulacan, so the most recent growth or decline in these stocks cannot be ascertained.

30. This may, however, have to do with the data displayed here—cash held in "other local treasuries." If the municipalities in Albay are not encouraged to hold cash in the provincial treasury, they may well have relatively larger holdings within their own treasuries.

31. Municipalities can earn interest on excess cash balances only with the joint approval of the provincial and municipal councils. Only in the subprovince of Guimaras did we observe this action.