Strengthening the Fiscal Performance of Philippine Local Governments

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LOCAL GOVERNMENT
FINANCE IN THE
THIRD WORLD

A Case Study of the Philippines

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Strengthening the Fiscal Performance of Philippine Local Governments
by ROY BAHL

One might question the feasibility, if not the wisdom, of strengthening local government fiscal performance in the Philippines. It has been pointed out that even in the face of a national government policy favoring fiscal decentralization, local government fiscal performance did not improve during the 1970s. Despite strong policy declarations, fiscal decentralization is not occurring. In light of this history, does it seem possible that more policy changes will promote a growing local government sector? Another major issue is that, compared to the entire economic structure and development strategies of the Philippines, local government finances appear to be almost negligible. Thus, does it make sense for the government to give a high priority to the improvement of local government financial performance?

Neither of these issues, it seems to us, can defeat the enthusiasm or possibility for strengthening local government fiscal performance in the Philippines. In terms of the feasibility, it should be recognized that changes in the local government financial system can take place in a context of considerable strength. First, the basic system of local government is fundamentally sound. To be sure, there are changes that need to be made, but the administrative procedures, assessment practices, budget format, authorization to borrow, and the like suggest a more workable system than is seen in many other countries of similar income level. The central problem in the Philippines has much less to do with the structure of the system than with the implementation of the system. Second, the quality of public administration seems quite good by comparison with that in many
other developing countries. This impression is particularly strong in the case of assessors and treasurers.

Furthermore, the central government's stated objective of strengthening the role of local government in the financing and delivering of public services is a correct priority and should remain at the center of these reforms. The benefits of decentralization are well recognized and consistent with goals of the national plan: to induce local governments to mobilize more revenues, to stimulate infrastructure/economic development expenditures by local governments, to improve the financial management and accountability aspects of local government finances, and to provide local governments with an adequate and dependable source of revenue.

This study of local government finances has led to a suggested program of reform and new initiatives in five areas: financial management and budgeting, local taxation, the allotment programs, the use of public enterprises, and the use of credit financing. Ironically, a major prerequisite to strengthening the financial performance of local governments is a strengthening of the central government's ability to administer and control local government finances.

LOCAL GOVERNMENT BUDGETING, FINANCIAL MANAGEMENT, AND EXPENDITURE MANDATES

It quickly becomes clear to anyone working on local government finance in the Philippines that two important bottlenecks to increased revenue mobilization and to a more efficiently functioning local government sector are inefficiencies in the local government budgeting/financial management process and the substantial restrictions placed on local government expenditures by the central government.

Budgeting and Financial Management

To the outsider, 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. 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. While some degree of flexibility is desirable in any managerial
context, the provision for numerous supplemental budgets in the Philippines surely leads to less efficient overall planning of fiscal affairs. The practice of permitting numerous supplemental budgets should be discontinued. The elimination of supplemental budgets and the general improvement of local budgeting practices will call for training of local budget officers, a more rigorous budget approval process at the central government level, and a new set of instructions regarding local government budget preparation and execution.

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 and lists proposed capital projects. However, in the financial review process there is to be a coordination of the annual budget and the CIP. We could find little evidence that these improvements had been implemented or that they had contributed to improved fiscal planning. Until annual budgeting is improved and made an integral part of the financial management process, there is little likelihood that capital budgeting can be effective. Nevertheless, if additional use of credit financing and an increased focus on capital spending by local governments are part of future plans, well-designed capital budget statements will be essential. Capital budgets, in specified form and including financing plans, should be a general requirement for larger local governments and certainly for all of those borrowing for capital projects. Again, this means that the MOB, MLGCD, MOF, and lending institutions must have the staff necessary to scrutinize the capital budget submissions and certify their acceptability.

Coordination of Central Government Controls

The local fiscal management function is overseen by at least four different arms of the central government. While there may be considerable rationale and even need for this division of labor, it must be recognized that such fragmentation imposes costs. Different ministries have different priorities, which leads to 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. The central government seems to have decided that local fiscal activities must be highly controlled, yet by not coordinating
the control of fiscal affairs, the government is losing one of the significant advantages of centralization. At the very least, techniques and practices of the primary central agencies involved in aspects of local government financial affairs (Ministry of Finance, Ministry of the Budget, Ministry of Local Government and Community Development, and the Commission on Audit) should be reexamined periodically to ensure that their review processes are not at odds with each other or with overall central government objectives.

Expenditure Mandates

The centralized orientation of local financial management is nowhere more evident than in the various restrictions placed upon localities in terms of what they can or must budget for certain functions. This practice enhances the direction the central government can give, but it also markedly reduces the discretion that local governments have in determining the size and makeup of their budgets. We estimate that about 40 percent of the typical local government budget is so constrained. These constraints raise two problems. The first is that if local governments do not control all of their budgets, they can be held that much less accountable for their fiscal performance. For example, because their budgetary discretion is limited, local governments may have to accumulate substantial balances and thus may be less willing to increase their own tax effort. The granting of more local autonomy by easing some of these restrictions is a strategy that may well lead to more resource mobilization and capital spending by local governments.

The second problem relates to the methods by which the expenditure mandates are imposed. One of the simplest, albeit at times misguided, methods to ensure that particular objectives are pursued is to require local governments to spend certain amounts on specific activities. The more or less uniform application of such rules to over 1,600 diverse local government units further complicates the situation and is unlikely to lead to an optimal allocation of resources. If these mandates are to be retained, each should be reviewed in terms of whether the intended objectives are being attained and whether reform is necessary. In particular, the following should be examined:

1. Is an amount as much as 18 percent of general revenues still necessary for recovering INP costs and is a uniform 18 percent
requirement an equitable way of spreading the INP financing burden?

2. The statutory contingency reserve of 2 percent of general revenues should be replaced by a contingency fund. This fund could be specified in size as a percent of total General Fund revenues, but the government needs to establish criteria for determining the size of this fund.

3. The statutory transfer to the Infrastructure Fund may no longer be necessary in light of potential increases in the Specific Tax Allotment and should be reconsidered.

4. The required 20 percent of the BIR Allotment earmarked for development expenditures may be an inefficient practice. The evidence suggests that the 20 percent is as likely to wind up in cash balances as in capital expenditures. Moreover, there is the question of why 20 percent?

We cannot say where a review of these mandates will or even should lead—some of the possibilities depend on changes in the allotment system and others depend on broader objectives of government policy.

**Cash Balance Accumulations**

Some municipal governments have been accumulating substantial cash balances and unappropriated surpluses. As purely liquid cash, these resources cannot be used for development purposes by either the public or the private sector. This problem is partially addressed by other policy directions suggested in this study, namely, a credit financing scheme and the untying of some local funds from central mandates. Nevertheless, improved cash management techniques need to be implemented to maintain a minimum level of purely idle reserves. The issue should be brought under further study and a manual should be prepared describing standard procedures. A proper consideration of this issue, however, must await a decision on the proposal to create and capitalize a specialized local government credit authority.

**THE REAL PROPERTY TAX**

The structure of the property tax in the Philippines is sound and the quality of assessors and assessment practices impressive. On the other hand, the revenue performance has suffered from a poor record
of enforcement. This trend can be reversed and the property tax made a more effective method of mobilizing domestic resources—but only if the central government takes some important steps.

The first step is to accept the fact that increasing the effectiveness of the local government property tax will mean raising overall tax burdens. The second is to initiate vigorous legal actions against delinquent (and often influential) taxpayers. Third, the central government must coordinate several ministries' activities to improve property tax administration. A fourth step is to recognize that some central government investment in improving the tax will be required. Finally, there is need to create a set of incentives and penalties to induce more active local participation in property tax improvement programs.

To be sure important administrative and management improvements have to be made at the local government level, but in the highly centralized Philippine system, the most important reforms must be initiated by the central government. This research has led to recommendations for change in the following six areas.

**Structural Reform**

The current practice of assessing certain higher valued improvements at a higher rate than land imposes a penalty on some property investments. This practice is at odds with the government's objective of promoting the mobilization of local resources for capital investments. Moreover, although fractional assessment may be viewed as a method of enhancing the equity of the property tax, it is not an especially effective means of doing so. It would be beneficial to abandon the practice of fractional assessments, that is, to begin assessing all improvements at the same percentage rate, regardless of their value.

Exemption of government-owned properties, religious properties, low valued properties, and "favored industries" tends to erode the real property tax base of local governments. These properties utilize services provided by local governments, and though they may confer employment benefits on the local area, they also confer national benefits. Moreover, the decision to provide the exemptions, and the designation of eligible firms in the case of pioneer firm exemptions, are matters of central government tax policy. In the case of government properties, a system of payments to local governments in lieu of property taxation would well be instituted. In the case of pioneer industry exemptions, there should be a serious reconsideration of
eligibility. In many instances the pioneer industry exemption may no longer be called for and may be, in fact, an unnecessary relinquishment of local government resources.

Increased Intensity of Use

In comparison with many other developing countries, and in comparison with other taxes in the Philippines, the property tax is not heavily used. By law, the basic property tax rate is limited to 1 percent of assessed values in municipalities and provinces and 2 percent in cities, with an additional 1 percent designated to the SEF. When fractional assessments on land and improvements are taken into account, the effective rate for the two funds combined is unlikely to exceed 1 percent of market value. If underassessment and collection problems are considered, the actual effective rate is even lower. The ratio of tax collections to assessed value was less than 1 percent in the reassessment years of 1974 and 1979 (0.7 and 0.9, respectively).

While better implementation will contribute to an increased property tax effort, an increase in the legal rate ceiling would also seem appropriate. Limits on the basic rate of 1.5 percent for municipalities and provinces and 3 percent for cities would provide some needed amount of flexibility for local governments. The option to exceed the present rate limit might be restricted to those communities with "acceptable" collection rates and those which are tax mapped. The proposed 50 percent increase in maximum rates, together with the recommended elimination of fractional assessments, would greatly increase the overall revenue potential of the property tax.

Holding land out of productive uses may be rational from the standpoint of an individual landowner but it imposes serious social and economic costs on society. Application of the idle lands tax as it is currently constituted under Philippine law would be a socially beneficial policy. It would increase property tax revenues, but its more important contribution would be to improve the efficiency of land use and penalize speculation. Implementation is the major bottleneck. Local governments will make use of the idle lands tax but only if the central government sees the merit in this tax and mandates its use. If idle lands taxation is part of an increased emphasis on taxing large landowners and delinquents, and if firm directives are sent from MOF, provincial and local officials will be more likely to implement the tax.
Some structural reforms in the existing idle land taxation legislation, however, are called for. The National Tax Research Center has recommended that the idle lands tax rate be increased to 6 percent and also that the tax be broadened to include smaller parcels, especially in urban areas, and that while a grace period before development be given to persons acquiring idle lands, subsequent transfers should not be allowed any grace period. These are sound recommendations.

While a large proportion of local government spending is devoted to services generally available to all residents, many construction-type projects are quite location-specific. In such cases, the use of a special assessment imposed upon the landowners who benefit most directly from the project is justified and desirable. These "special assessments," when used in the place of general tax revenues, free local government revenues for other uses. Very possibly this could be linked to the use of credit financing. For example, lending authorities might provide favorable terms for projects whose cost recovery is partially guaranteed through the use of special assessments. Special assessments are important fiscal instruments in many developing countries and could be important in the Philippines.

Tax Mapping and Records Management

The virtues of tax mapping are generally accepted, and the idea of having complete parcel identification and ownership information has few foes. The problem is that the costs of tax mapping have become too high to overcome the inherent short-time horizon that characterizes most political decisions. The issues, then, are how to mobilize more resources for tax mapping, how to improve the efficiency of tax mapping practices, and how to induce more enthusiastic local participation and some local financing.

More central government funding should be allocated for tax mapping loans via the MOF revolving fund and for staffing to increase the MOF capability to distribute and monitor these loans. Less than 20 percent of local governments have even begun tax mapping, and the process is not going very far on a P50 million revolving fund. By combining these programs of the MLGCD and MOF, it may be possible to provide initial seed money on a grant basis and the remainder on a loan basis. Moreover, if loan repayments are deferred, the obstacle of local governments having to make substantial initial
contributions might be removed and more local participation might be induced.

Additional incentives should be provided by the central government in order to induce more local government participation in tax mapping. This could be done in two ways: by providing more initial seed money to reflect the higher cost of mapping and to cover a larger share of the initial cost; and by lowering interest costs and deferring repayment on the loan-financed portion. The capitalization of the revolving fund will suffer from the stretched-out repayment, but this could be partly offset by increased central government contributions and the infusion of grant assistance from international agencies. Additionally, it might be beneficial to allow the use of a share of allotments earmarked for infrastructure expenditures for covering the local government portion of tax mapping costs.

The problem of inefficient record keeping and management remains. In the long run, a more satisfactory method must be developed to ensure that as the ownership of parcels is transferred, the property tax rolls are adjusted. Because total reliance upon the parties to the transaction leaves too much to chance, the central government must take steps to ensure that recorders of deeds, issuers of building permits, and surveyors relay all transactions and other relevant information to the assessor’s office. These communications are already required (PD 464), so all that is necessary is the imposition of proper incentives or penalties by the central government to ensure that this information transfer is carried out. Not to do this is to compromise the sustainability of the tax mapping achievements.

Addressing the Land Reform Program

There is no question but that the land reform program in the Philippines has complicated the administration of the real property tax. Because records are inadequate, it is not clear where tax liability lies, whether and how the tax might be collected from former tenants, and what to do about back taxes owed by former owners. The blame for the problem can be rightfully shared by many parties—former tenants and owners, MAR, and local finance officials—but the basic problem seems to be with the system.

The case of long-delinquent tenants requires special consideration. The objective is to integrate these new landowners into the taxpaying population as soon as possible, rather than to penalize them for not having paid property taxes since 1972. This goal could be attained
partly through a tax amnesty on a portion of past due taxes, but this amnesty should not be advertised or granted until a method to assess and collect taxes in land reform areas is established.

Obviously, completion of the tax mapping process in reform areas will help, but until mapping is completed, property taxes should be included in the annual payment by tenants to the Land Bank. While this would require a basic change in the relevant statutes, it would greatly improve the likelihood of compliance with the tax, albeit with some increase in administrative costs.

The central government needs to make a concentrated effort to inform new owners of their legal responsibilities to pay property taxes, of the potential benefits to be had from the increased government revenues, and of penalties to be faced for failing to comply. The MAR, MLGCD, the co-ops and the barangays are information-dissemination channels that could be used. Local assessors and treasurers must be encouraged, if not pressured, to gain an understanding of the administrative processes involved in land reform. Interagency dialogues between local representatives of the MAR and the treasurers and assessors, as well as explanatory manuals, would assist both groups in gaining an understanding of their mutual problems.

Assessment and Reassessment

Philippine assessment practices seem reasonable and appropriate, and there does not seem to be the same dire shortage of assessors that plagues local governments in so many developing countries. There are, however, two major problems with the current triennial reassessment cycle. First, it requires complete reassessments of all properties at a single point in time, thus adding to the overall costs of administering the tax. This peak loading of the work means that it is necessary to hire large amounts of casual labor at particular times during the cycle and also increases the likelihood of errors in administrative performance. Second, taxable values experience large incremental jumps once every three years and then are relatively flat during the interim period. The local government must anticipate slow growth in property tax revenues during the interim period while taxpayers experience large single year increases in tax bills. The result is a lowered willingness to comply with the tax and/or pressures for rate reduction.

Two changes in the assessment system might be considered. First, each jurisdiction should be divided into three parts, with each part
formally reassessed every third year. This would help avoid the peak workload problem and also would provide a buoyancy to the property tax system since approximately one-third of the tax base would be revalued annually. Second, the increases in tax liability on individual properties should be phased in over the three-year period. In this manner the taxpayer would realize that tax liabilities would be increasing during the next three years but in no single year would the entire increment be felt.

**Collection Efficiency**

The largest single problem with property tax administration in the Philippines is tax collection. Efforts centered on this problem will have the largest and quickest payoffs and should concentrate on coordinating the collection of various taxes, ensuring that taxpayers do not become delinquent, and collecting previous years’ taxes.

One way of ensuring taxpayer compliance is to require that taxes owed on a parcel of property be paid before the owner is allowed to transact other business with the government. The current statute already contains this idea in requiring that the previous owner must show proof of payment of past due taxes before a deed is issued to a new owner. Another opportunity is to require businesses to show proof of property and business license taxes before a mayor’s permit is issued.

No one enjoys paying taxes. Yet efforts to lower compliance costs and to show the taxpayer that compliance with the tax is in his self-interest can lower the resistance. These aspects of the tax collection process suggest that efforts be continued to allow the taxpayer to comply with the law at the lowest possible cost and to educate the taxpayer concerning his legal liabilities. Both of these initiatives can be effectively carried out at the barangay level. Sending tax collectors to the barangay can help reduce compliance costs. More use of barangay-level campaigns designed to show residents the direct benefits they might gain from compliance with legal statutes, and more use of the barangay captains in the campaigns and in the collection process would also be effective measures.

Despite their political unpopularity, the legal remedies for collection of delinquent taxes must be aggressively enforced by the central government. All other good efforts notwithstanding, the property tax collection record will not improve dramatically until the central government makes it clear that the consequences of delinquency and
Strengthening the Fiscal Performance

Evasion will be serious. The central government should initiate a well-publicized attack on delinquents, focusing initially on larger delinquents. The extreme remedies, sale of land or personal property at public auction, should be emphasized.

Local assessors might also be induced to push the use of extreme remedies. The provincial treasurer could provide a monetary inducement to municipalities such that those jurisdictions collecting the greatest proportion of past due taxes would, in effect be allowed to maintain use of around 60 to 70 percent of the delinquent tax received rather than the legal 45 percent. This may provide sufficient incentive to a local political leader to accept the acrimony generated by the auction of delinquent properties. Barangay captains might be given a share (for example, 5 percent) of all delinquent taxes they are able to collect, in the case of smaller taxpayers.

Another necessary change in the treatment of tax delinquencies is to increase the penalty rates. The current maximum of 24 percent after one year is insufficient in the inflationary environment of the Philippines. An increase of 3 percent per month in the penalty rate and its extension for an additional two years would not seem inappropriate. Finally, and especially in smaller rural areas, the use of public knowledge of delinquency, such as posting of delinquent taxpayers’ names, could provide a nonmonetary yet effective incentive for compliance.

THE BUSINESS LICENSE TAX

The business license tax (BLT), which yields more than the property tax for many Philippine jurisdictions, has good potential as a local government revenue source. There are two possible routes to reform, altering the current administration and structure of the tax or replacing it with a shared central government general sales tax. There would seem to be more wisdom in the former approach at the present time.

The legal structure of the business license tax suffers from no serious defects with respect to its equity, neutrality, or income elasticity of yield, but the necessary administrative machinery to achieve these goals may be beyond the capabilities of many jurisdictions. The principal administrative difficulty lies with the determination of the tax base—gross receipts. Local governments do not have the staff to assess this base, hence most business taxpayers self-report. This makes the BLT, in effect, a voluntary payment where understatement of
gross receipts is more likely the rule than the exception. In the case of larger businesses that do produce financial statements, interpreting and verifying the accuracy of such records are beyond the current capabilities of many local government administrations.

It is feasible that all businesses above a threshold size be required to produce records of their past year's business. To ensure that these records can be interpreted, training programs could be instituted in each province to train designated business tax collectors in the rudiments of business accounting. The central government would do well to underwrite the training cost of these collectors and a share of their annual salaries for the first three years. Business tax collectors might also be charged with the task of reorganizing the BLT roll and monitoring the relationship between payment of the BLT, the property tax, and the mayor's permit.

Rate structure reform is necessary to improve the yield and growth in the BLT. Present rates are quite low on average and are lower for large than for small firms. This regressive structure could be improved with a flat rate set at a level 10 percent higher than the average rate currently levied on larger businesses. The differential rates among types of businesses, however, should be retained. Such a policy should yield a substantial revenue increase.

Inasmuch as record keeping is minimal among small businesses, a flat annual charge would be suitable; however, this charge should be indexed in some manner to the general level of inflation. This reform would permit an easy administration of the tax while still ensuring a certain amount of income elasticity in this component of the BLT.

THE ALLOTMENT SYSTEM

There is a substantial difference between the Philippine grant system that exists in the statutes and the one that is actually practiced. A first positive step would be for the central government to establish and stay with a grant system and avoid ad hoc, year-to-year adjustments. In this context, the structure of the grant system should be rethought and appropriately reformed. Possible reforms fall in four areas: combining the various grant components into a consolidated allotment system; providing incentives to stimulate the mobilization of additional local revenues; providing incentives and financial resources to stimulate development spending; and rethinking the proper role of the barangay in financing and delivering local government services.
Consolidating the Allotment Programs

The present allotment system, which includes the BIR Allotment, the Specific Tax Allotment, and the National Tax Allotment, is unduly fragmented and does not well serve the fiscal decentralization objectives stated at the beginning of this chapter. A consolidated allotment system could be created in place of these components. At 1979 statutory funding levels for each program, such a consolidation would imply an amount equivalent to about 30 percent of BIR collections (with the BIR basis lagged three years). Whatever share of BIR revenues is chosen, however, should be adhered to rigidly.

The consolidated BIR Allotment, in keeping with the percent distribution of the current system, should earmark as much as two-thirds of the grant for the Infrastructure Fund. This policy would protect the more stimulative features of the Specific Tax Allotment and the objective of promoting capital expenditures.

A full distribution of these grant funds may be more than local governments can absorb, at least in the short run. A full distribution in 1979 would have been about twice the actual distribution, and because two-thirds are earmarked for capital projects, one possibility is that local government cash balances could increase. Although more research is necessary on the absorption capacity of local governments, their problems with preparing and implementing projects are well known. If local governments cannot easily absorb this increased flow of grant funds, the objective of mobilizing more local resources might be helped in other ways. In this regard a share of the grant could be held back to capitalize and subsidize a local government credit authority.

A need to tie the Specific Tax Allotment to petroleum tax revenues no longer exists, and there are a number of good reasons to change the basis for this grant program. The funds are presently used for much more than road and bridge construction and maintenance—hence, it is not possible to justify petroleum taxes as a benefit charge to road users. Moreover, because petroleum taxes are specific rather than ad valorem, revenues from the Specific Tax Allotment do not grow in response to GNP or inflation but because of increases in the petroleum tax rate. This raises the most substantial problem with the basis for the Specific Tax Allotment—discretionary petroleum tax actions are guided more by energy policy than by local government financial needs. It makes little sense to tie local grants to energy policy—the potential windfall gains to the local sector from increased specific tax rates in the past two years attest to this.¹
Mobilizing Additional Local Revenues

The current formula distribution system does not provide a major inducement for increased revenue mobilization. Two changes in the system would help. First, some measure of tax effort could 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 for their fiscal performance. Second, the allotment distribution might be amended to provide other incentives for improving the capacity of local governments to assess and collect property taxes. Allotments earmarked for economic development expenditures should be available for coverage of the local share of tax mapping costs. Likewise, the allotment might be used to cover the partial cost of an additional property tax clerk (for a specified short period) to deal with a backlog of record-keeping problems.

Stimulating Economic Development Expenditures

Many of the suggested reforms lead to increased spending for capital projects by making more resources available. The objective of more capital spending, however, raises the specific question of what incentives might be provided to redirect general revenues to capital projects. One effective incentive seems to be the earmarking of a share of the allotment to the Infrastructure Fund. A second, and potentially much more powerful, technique is to encourage the use of credit financing by eligible local governments.

Barangay Problems

The time is right to assess definitively the role of barangays in the local finance system. Some of the increased barangay involvement is beneficial and clearly should be retained; for example, the 10 percent property tax share for barangays serves many useful purposes. The merit of some other programs and their cost calls for reevaluation. Although it is clear that more input at the barangay level can improve the decision-making process markedly, it is unclear whether the barangay unit is capable of providing the requisite technical or financial planning and management. The barangay unit has not been studied here in any detail. It might be observed, however, that the present practice of earmarking 12.4 percent of the total BIR and
Specific Allotment may be a great deal of financial support for a unit of government whose ability to absorb funds is quite limited. It would be unfortunate for the barangay shares to be dropped, but that eventuality should be studied carefully.

LOCAL GOVERNMENT PUBLIC ENTERPRISES

A more widespread use of local government public enterprises (LGPEs) would be consistent with the fiscal decentralization objectives of the central government and with the goal of increased revenue mobilization. Although the use of LGPEs is provided for in Philippine law, the practice has been largely restricted to markets, and the financial success record has been spotty. The limited use of LGPEs might be traced to a number of factors: limited possibilities for cost recovery, inadequate central government incentives to induce local governments to use the enterprise form, management and administrative problems, and inadequate provision for capital financing. More generally, there seems to be an ambiguity at the central government level about whether LGPEs should be providing a service at subsidized rates or selling a service to recover full costs. The central government could remove some of these ambiguities with a clear policy statement about its goals for the use of local government enterprises and about the operating autonomy that will be given. This statement should distinguish clearly between enterprises that serve social purposes and those that are more purely commercial ventures.

This research suggests that local enterprise activities can be financially viable, that they can be an effective way to mobilize additional resources, and that management and administrative problems can be overcome. What is most needed is for the central government to regulate and monitor firmly the design stage, granting maximum pricing and operational autonomy, reforming the accounting system so that costs and profitability can be more accurately measured, and finding a way to assist in the provision of adequate capital financing.

Public Markets

Most market operations can cover variable costs and some can also cover capital costs, but without capital subsidies, full cost recovery would not appear likely for many. The critical factor seems to be size of the market, with smaller markets that lie in the commuting
range of larger markets being particularly disadvantaged. Public policy for market enterprises cannot be formulated only on the basis of the few case studies carried out here; however, four fundamental problems and reform possibilities did emerge in the course of this research: accounting and measurement needs, revenue policy, cost and volume considerations, and credit policy.

Resolving the problems of accurately measuring the cost of enterprise activities is an essential first step in rationalizing the role of public markets in the system of local government finance. The existing accounting system falls short of answering this need in two important respects. The first problem arises because of the special circumstances of small governments. Levels of market activity require heavy work efforts on market days and very little work effort at other times. Thus, either the market plantilla must be supplemented by the efforts of other government employees during peak times or the regular market work force is assigned other tasks on nonmarket days. Moreover, since a full administrative staff cannot be justified, management tasks such as accounting, personnel management and the like are performed by personnel whose plantilla assignment is in other departments. Under either condition, it is unlikely that personnel costs would (or even could) be prorated among market and other accounts in a way that actually reflects the uses of an employee’s time. In effect, any monitoring of the financial success of small markets may be ruled out.

What might be done about this problem? The prorating of personnel costs in small areas would be difficult, imprecise, and possibly not worth the effort. Indeed, the very difficulty of separating the enterprise activities may be telling one that the enterprise form is just not a good idea for very small jurisdictions. The public market may be much more a general government function in smaller than larger jurisdictions.

The second accounting problem has to do with the measurement of capital costs. Because capital costs are “lumpy” and capital facilities are long-lived, cash outlays do not give a reasonable estimate of the annual cost of using up the resources embodied in a facility. These costs would be better reflected in annual depreciation reserves that, when accumulated during the lifetime of the facility, would provide for its replacement. An approximation of this amount, which we have used in this analysis, is the annual payments on a loan of amount sufficient to cover the cost of reconstructing the facility. The central government would do well to adopt a standard practice in
accounting for the annual capital costs of local government market facilities.

An important barrier to full cost recovery has to do with pricing policy, that is, prices are set too low and revised too infrequently. This practice is partly due to a concern with the cost of foodstuffs and other necessities to low income groups, and partly due to the fear of lowering stall occupancy rates. Our view is that this reasoning is not well founded except, perhaps, in the case of some small markets. First, market stalls are usually all rented. Second, the evidence suggests that market revenues could be increased with little effect on the prices of goods sold in the market. Local governments should be encouraged to increase market fees and to make regular fee revisions in line with rising costs of operation.

The capital-intensive nature of public markets works against smaller markets by keeping their per capita (and presumably per unit) costs high. Our analysis has indicated that these efficiencies become effective when markets service a population of about 40,000. This is not to say that municipalities with larger populations will necessarily realize these efficiencies, for they may not if they fall within the service area of a larger market. Rather, it implies that the technology of market operation is a barrier against the profitability of small markets.

In sum, the key to the profitability of public markets seems to be volume. Our findings suggest two important barriers to market profitability, both of which are related to volume. The first is a lack of access between municipalities and their hinterlands. The policy implication is that road projects that link urban areas with their rural hinterlands should have an important positive effect on public markets, especially larger markets. Second, they suggest that markets of larger municipalities dominate those of smaller nearby municipalities. This competition places smaller markets at a disadvantage and thus constitutes a barrier to their financial success.

In establishing a credit policy for public markets, what might be reasonable expectations? Our sample suggests that recovery of current cost may be expected, but recovery of full capital costs would be less common. Public markets are income generating, but if costs are measured correctly, many will not be completely self-financing. Credit policy might include two features: (1) Capital subsidies could be provided in the form of lower interest costs than the present 14 to 18 percent, and (2) loan maturities could be extended to match better the expected life of market facilities.
Commercial Ventures

The study of four commercial ventures of the Bulacan provincial government suggests that there are good possibilities for local government commercial ventures and that the management constraints may not be so great as one might expect. A number of lessons emerge from the Bulacan experience, particularly in the areas of project design and review, pricing policy, management autonomy, and proper accounting.

Concerning project design and review, the Bulacan experience makes a good case for central government involvement in the planning stage for private ventures. One issue that arises here is the need for external review of whether or not the proposed undertaking has reasonable prospects for financial success. The other relates to whether this type of local government investment ought to be undertaken without review and approval in terms of coordination with the goals of the national economic development plan. If financing is from internal sources, a MOF or MLGCD signoff on the feasibility study should also be required. The establishment of a review procedure and standards for financial feasibility studies would facilitate project planning.

The second issue is more problematic. One could argue effectively that for purely business ventures, the central government should give the local governments maximum discretion in project selection. Only where the project must be justified partly on grounds of providing social benefits should normal central government review and signoff occur.

Pricing decisions should be made by local governments because preferences and economic conditions vary from one community to another. Nationally prescribed price schedules, such as slaughter fees, are changed infrequently and in any case may be unsuitable for some local governments. Furthermore, for some enterprises, pricing autonomy may spell the difference between failure and success. Where the objective of commercial ventures is solely to raise funds for the local government, then the central government should give maximum incentive for local governments to achieve this goal. For purely commercial enterprises, there should be no restrictions on the level of profits that may be earned or on the disposition of these profits.

Regarding management autonomy, many lessons can be learned from Bulacan’s management of less traditional public enterprises. A major ingredient for “success” appears to be the ability of the enter-
prise to function as a private firm. With the exception of the Galeria, the enterprises have been run with some form of private sector participation—management contracting for the slaughterhouse and Convention Center and operating contract for the Cafetorium. In addition, and again with the exception of the Galeria, which operates as a regular government department, the Bulacan enterprises have resorted to various labor-cost saving mechanisms that are largely unconventional by government standards. It appears, therefore, that business enterprises should be given flexibility in terms of hiring and wage determination and in terms of general operating decisions.

Lastly, accounting reforms should be considered. Proper measurement of profitability is a requirement if management is to be held accountable for its efficiency and if subsidies provided to the enterprise are to be detected. To improve overall decision making, to generate a more cost-conscious management behavior, and to facilitate performance monitoring of the enterprise, some structural changes in existing government accounting practices are envisioned. These include adopting a system of enterprise accounting that includes depreciation (or consumption of fixed capital) in the product accounts; requiring the measurement and accounting of all forms of subsidy—either explicit (capital subsidy, statutory transfer, grants) or implicit (tax exemptions, preferential loan subsidy); and the maintenance of a separate set of accounts for the enterprise which records transfers to and from any government funds (General, Infrastructure, Trust, Sinking, Fiduciary, and so on).

INCREASED USE OF CREDIT FINANCING

One important barrier to increased capital formation by local government and to increased participation in "income-generating" projects is the high start-up cost of constructing the capital facility. The government has taken steps to remove this barrier by making loans available to local governments through DBP, the Land Bank, and GSIS, but participation levels are low.

It is apparent that substantive changes must be made in the present system if local governments are to be encouraged to undertake credit-financed projects. Essentially, there are two options: to rectify the problems of the present system by pursuing changes in current policies, procedures, and practices; or to propose a bolder solution—the creation of a new, specialized entity. Although neither approach is without problems, we think the weight of the evidence
favors the establishment of a new, specialized credit facility for local governments. The rationale is that project planning, appraisal, and management assistance are so critical to the credit financing process that technical staffs experienced in the different fields of public sector investments must be maintained by the institution.

The organization of such a new authority should pose no great problems. Although the matter requires some careful study, one could envision an authority established by law and governed by a board of directors, comprising both representatives of central ministries involved in local government affairs and local government officials, and with its chairman appointed by the president. Specifically, the board could consist of the ministers of the budget, finance, local government and community development, economic development, and human settlements, and the governor of the Central Bank. An equal number of government representatives might be appointed with equal representation from provincial, municipal, and city governments. The director or internal manager could be appointed by the president, based on the recommendation of the board and with the approval of the Ministry of Finance.

The major drawback to this proposal is the problem of funding. Ultimately the central government is going to have to invest in this activity if it is to be successfully used in inducing local governments to generate more revenues. On the other hand, this funding may not require new allocations of funds to local governments. In fact, with some reallocation of resources already earmarked for the local government, it would be possible initially to capitalize a specialized local government credit authority. It is important to note that the choice of a financing source involves far more than simply finding the pesos. It should be made on a basis of fulfilling the government's ultimate reasons for wanting to increase local government use of credit financing: to stimulate the undertaking of capital projects, to encourage the initiation of income-generating projects, and to stimulate local government tax effort. The objective, in sum, is to design a credit authority financing scheme that promotes these three objectives while diverting funds from other local government activities.

Firm estimates of capital requirements, necessary initial and continuing appropriations, and operating costs of the authority require a detailed financial study, but we can estimate only very roughly the magnitudes of funding involved. Capitalization could come from two sources. The first is an annual share, perhaps 10 to 20 percent, of the proposed Consolidated Allotment. This financing
source presumes, of course, that the government begins distributing the full allotment. The second source is approximately P200 million of the balances held in banks by local governments, which might be exchanged for share capital in the authority. There are two other potential sources of funding. One is the annual barangay shares of the allotments, and the other is funding from external donors, such as the U.S. Agency for International Development. With external funding it should be possible to allocate some proportion of loanable funds, at subsidized rates, to low income jurisdictions or for “social” projects that might not otherwise qualify.

To stimulate borrowing and tax effort to support capital projects, a change from present lending policies is called for. The strategy is essentially to lower the “price” of borrowing. The interest rate should be set to vary inversely with the amount of cash equity a local government has in the project and to lengthen the maturity of loans to more accurately reflect the economic life of the asset being financed. The authority should consider funding some capital projects that are non-income generating but that may enhance the performance of the local economy. Interest rate subsidies could also be provided for local government loans. The size of these subsidies, however, will be heavily dependent on the method of capitalization chosen.

THE COSTS AND BENEFITS OF REFORM

The costs of any comprehensive program of reform should be weighed against the potential benefits to be received. On the cost side of this program, there is the initial and perhaps continuing outlay required of the central government and the loss of some control by the central government over local government finances. On the benefits side there is the potential for increased revenue mobilization by local governments, more efficient fiscal operations of local governments, increased capital project activity, decentralized government fiscal activity, and a stronger local government sector in the long run. Whether the costs outweigh the benefits depends on the probabilities for success of this program and on the importance placed on local government financial reform by the central government. One thing is sure: A piecemeal reform, such as one that leaves out the incentive elements, is likely to generate costs without benefits. But to try to reform local finances at no cost, by not providing the funding for inducements or for increased ministry staffing, generates little improvements.
The costs of this reform program are enumerated, insofar as is possible, in Table 7.1. The major cost is associated with the full distribution of the allotment system (exclusive of barangay shares). At 1979 levels (the latest year for which we can make an estimate), this change would amount to about P1 billion. In 1982, the level of the undistributed share will depend on the recent growth in the BIR basis, petroleum tax revenues, and discretionary government decisions. In any case, it will be considerably greater than P1 billion. Careful study will be required to update the undistributed amounts, but one might guess that a sum roughly equivalent to 30 percent of the lagged BIR basis could fund most of the initiatives suggested here. In one sense this expenditure is a cost only if the outlay needs exceed the undistributed portion, as the present allotment system is already earmarked for the local government sector.

At present there is insufficient information with which to estimate the other costs implied in Table 7.1. The cost of supplementing the MOF revolving fund for tax mapping depends on a number of factors: how much the government wants to push tax mapping, whether an integration between the MOF and USAID/MLGCD program can be worked out, and whether the MOF staff is shored up to accommodate an increased volume of tax mapping activity. Doubling the size of the revolving fund would add measurable support to tax mapping efforts.

If local government finances are to be strengthened within the highly centralized Philippine system, the size and expertise of the central government agencies that monitor and control local finances must be strengthened. It is almost axiomatic in the Philippine case that the center must be strengthened if the local sector is to be strengthened. Additional personnel and training in tax mapping, budget preparation and review, financial analysis, and governmental accounting are essential to the efforts proposed here. A government appropriation of as little as P2 million spread over the next five years for capacity building would go a long way toward strengthening the operations of local government. Supplementary funds for this purpose might also be sought from external sources.

Another proposal that would require additional central government funding is the cost sharing for a business tax collector, although the cost should be rather small. For illustration, assume two such collectors per province and assume that the government bears (a) an initial training cost of P5,000 per collector, (b) a salary and benefits


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<th>Reform Action</th>
<th>Funding</th>
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<tr>
<td>1. Consolidated allotment program</td>
<td>There should be a full distribution of the authorized BIR, Specific Tax, and National Tax allotments. At 1979 levels, this would imply distribution of $1 billion, more than was actually the case.</td>
</tr>
<tr>
<td>2. Local government credit authority</td>
<td>To be capitalized with a share of the Consolidated Allotment and the cash deposits of local governments in banks. Other potential sources are external funding and the barangay shares of the allotment.</td>
</tr>
<tr>
<td>3. Supplementing MOF revolving fund for tax mapping and providing additional staff to review mapping proposals</td>
<td>New central government funding; merger of USAID/MLGCD with MOF revolving fund would provide further support.</td>
</tr>
<tr>
<td>4. Supplementing MOF/MOB/MLGCD staff for a. tax mapping b. budget review c. training local officials in (a) and (b) and business tax collection and monitoring d. monitoring design phase for local government public enterprises e. Reforming accounting system for local government public enterprises</td>
<td>New funding from central government; merger of MLGCD program with MOF revolving fund would provide further support for (b).</td>
</tr>
<tr>
<td>5. Cost sharing for local business tax collector for three years</td>
<td>New central government funding.</td>
</tr>
<tr>
<td>6. Payment in lieu of property tax on government properties</td>
<td>New central government funding.</td>
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</tbody>
</table>
cost of P14,000 per collector per year, and (c) a central level supervisory cost of P50,000 per year. The total three-year cost would be about P3 million.

Finally, there is a proposal for payment in lieu of property taxes on government property and on some government-granted exemptions. A rough estimate from sample data on Iloilo and Albay suggests that about 10 percent of total assessed values are exempt. If half of these exemptions are covered under this proposal, the annual cost to the government would have been about P40 million in 1979.

Obviously, these estimates are rough, but they give some idea that the cost of this program is not unmanageable. In 1979, the cost of this program would have been less than 3 percent of total central government expenditures. By comparative standards, the program may be affordable—the level of tax effort in the Philippines is low. But more to the point is whether the benefits of such a reform program warrant these expenditures.

Benefits

This reform program brings two kinds of potential benefits. The first is improvement of the efficiency of local government operations

<table>
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<tr>
<th>Reform</th>
<th>Effect</th>
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<tr>
<td>1. Form a review office to deal with interministerial conflicts concerning local government finance.</td>
<td>1. Increased revenue generation, improved expenditure and managerial efficiency.</td>
</tr>
<tr>
<td>2. Eliminate the practice of supplemental budgets.</td>
<td>2. Increased efficiency in local government expenditures.</td>
</tr>
<tr>
<td>3. Require capital budgets of larger local governments.</td>
<td>3. Improved fiscal planning.</td>
</tr>
<tr>
<td>4. Eliminate fractional assessments in real property taxation.</td>
<td>4. Will remove property tax disincentive to real property investments.</td>
</tr>
<tr>
<td>5. Instigate a program of phased reassessment of property values.</td>
<td>5. Improved taxpayer compliance.</td>
</tr>
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TABLE 7.2

Programs to Increase the Efficiency of Local Government Operations
TABLE 7.3
Incentive Programs to Increase Local Government Revenue Mobilization

<table>
<thead>
<tr>
<th>Reform</th>
<th>Response from Local Government</th>
</tr>
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<tbody>
<tr>
<td>1. Earmark 60 percent of Consolidated Allotment for Infrastructure</td>
<td>1. Stimulate economic development expenditures; increase revenue</td>
</tr>
<tr>
<td>expenditure expenditures.</td>
<td>generation.</td>
</tr>
<tr>
<td>2. Permit use of Infrastructure share of Consolidated Allotment for</td>
<td>2. Increase revenue generation from real property tax.</td>
</tr>
<tr>
<td>covering some portion of local share of tax mapping cost and a share</td>
<td></td>
</tr>
<tr>
<td>of the cost of a property records clerk.</td>
<td></td>
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<tr>
<td>3. Introduce a tax effort component into the Consolidated Allotment</td>
<td>3. Increase local government tax effort.</td>
</tr>
<tr>
<td>formula.</td>
<td></td>
</tr>
<tr>
<td>4. Increase the size of the MOF revolving fund for RPTA improvement;</td>
<td>4. Increase real property tax collections and administrative</td>
</tr>
<tr>
<td>provide additional MOF staffing to support these loans; and relax the</td>
<td>efficiency.</td>
</tr>
<tr>
<td>terms of repayment.</td>
<td></td>
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<tr>
<td>5. Merge or coordinate the MOF and MLGCD tax mapping programs and</td>
<td>5. Increase tax mapping activity.</td>
</tr>
<tr>
<td>provide greater incentive grants for tax mapping.</td>
<td></td>
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<tr>
<td>7. Variable interest rate program and lengthened maturities for local</td>
<td>7. Stimulate spending for income-generating projects; increase</td>
</tr>
<tr>
<td>government credit financing.</td>
<td>revenue effects.</td>
</tr>
<tr>
<td>8. Increase penalty rate for property tax delinquency; barangay</td>
<td>8. Increase property tax collections.</td>
</tr>
<tr>
<td>campaigns.</td>
<td></td>
</tr>
<tr>
<td>delinquents.</td>
<td></td>
</tr>
<tr>
<td>10. Reduce earmarking and restrictions of local government budget</td>
<td>10. Increase local government revenue effort.</td>
</tr>
<tr>
<td>allocations:</td>
<td></td>
</tr>
<tr>
<td>a. Eliminate transfer to Infrastructure Fund</td>
<td></td>
</tr>
<tr>
<td>b. Review 18 percent INP requirements</td>
<td></td>
</tr>
<tr>
<td>11. Encourage idle lands taxation and special assessments.</td>
<td>11. Increase local government revenue effort and stimulate capital</td>
</tr>
<tr>
<td></td>
<td>spending.</td>
</tr>
<tr>
<td>government public enterprises.</td>
<td></td>
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</tbody>
</table>
(Table 7.2). In effect, these improvements can be had without the major reforms described above and with little cost, although an increase in the budget review capabilities of the MOF/MOB would be essential. This part of the reform program can result in an improved ability of local governments to deliver services and manage their affairs, but it falls short of achieving government objectives in other areas. It does not provide incentives for the local governments to mobilize additional revenues, to spend more for capital purposes, or to improve their capacity to accommodate future expansions in their fiscal activities. These objectives are served by the second component of this reform program.

The potential benefits described in Table 7.3 are more in the areas of increased revenue generation and capital spending. Twelve areas are listed where the incentives provided should induce local governments to increase tax effort and capital expenditures, although it is not possible to estimate the extent of the increase. Moreover, in some cases the benefits are long run.

FUTURE RESEARCH

With respect to needed reform, the research reported in this book has perhaps raised as many questions as have been answered. On the other hand, much has been learned about local government financing in the Philippines and much of the experience may be transferable. Furthermore, the general direction of the reforms proposed is consistent with government policy and all are administratively and financially feasible. This momentum could be built on with a further research effort in three areas: analysis of the financial performance of local governments from a nationwide sample; working out the implications of specific reforms, particularly in the case of the proposed Consolidated Allotment and credit authority; and determining data needs for tracking and monitoring local government finances.

This analysis of fiscal performance and behavior has been carried out largely on a sample of four provinces and needs to be extended to a nationwide sample. For some questions, such as measuring the stimulative effects of the allotment system and measuring tax effort, an analytic framework has been developed but requires further testing before it can serve as a firm basis for policy changes. In other cases, such as our discovery of surpluses and cash balances, the question arises as to how widespread the phenomenon is. Finally, in some areas of inquiry, such as the fiscal structure and performance of
market enterprises, the sample was too small to expose regularities that may exist.

The second important research task is to work out the specific details of some of these reform suggestions. For example, the case for a local government credit authority seems persuasive to us, but there is much to be done in working out the details of organizing and operating such an authority. Similarly, we know that a different kind of allotment system based on local matching requirements would stimulate greater local tax effort and we believe that a Consolidated Allotment system would have great merit. To design such a system would entail a significant amount of effort.

Finally, there is an important research need in the area of improved local government fiscal data. If the local government sector is to grow in importance in the Philippines, its performance will have to be understood and monitored. The producing of annual, timely data on local government finances is a requirement. The monthly reports to the MOF and the annual COA data could serve as the basis of an annual "census of local government finances." However, given the state of municipal accounting practices, detailed design work would be a first step. Our opinion, based on working with these data, is that such an undertaking is feasible. The analysis of the four provinces is evidence, we hope, of the valuable uses to which such data might be put.

NOTES

1. There is a similar problem with the BIR basis, but the parallel is really not so close. Both BIR collections and local finance needs bear some relationship to income growth and inflation.

2. Field research that found substantial local government potential at the barangay level is reported in Buenaventura M. Villanueva, "A Study of the Competence of the Barrio People to Conduct Barrio Government," Ph.D. dissertation, University of Southern California, 1959.