MEANINGFUL DEVOLUTION

IN A NUTSHELL

- The local government units (LGUs) are in a position to know their constituents' unique development needs and deliver local services better than the national government.

- However, more than two decades since the Local Government Code has been enacted, the LGUs are still heavily reliant on fund transfers from the national government and their financial management systems remain underdeveloped.

- The administration implemented reforms to empower the LGUs so they could take on more of the national government's service delivery functions:
  - It built on the previous reform efforts and introduced the LGU PFM Program to strengthen the capacity of the LGUs in financial stewardship.
  - It implemented the Bottom-up Budgeting and other mechanisms to incentivize the LGUs to become more transparent, participative, and accountable.

- These reforms for meaningful devolution support the moves to further decentralize the government and empower the LGUs to become effective partners in development.

NG

The NG also provides additional budgetary support to LGUs for specific programs or projects.

The NG is mandated by law to allocate 40 percent* of its internal revenue taxes (i.e., IRA) to LGUs. Some LGUs also have special shares from NG revenues (e.g., sin taxes).

LGUs

Through the Local Government Code, NG devolved basic service delivery functions to LGUs, putting them in a better position to address local poverty and other concerns.

As part of their local powers, LGUs may collect local taxes and revenues. However, LGUs depend on NG's financial support for about 64 percent of their finances, as of 2014 data.**

NG

*Local Government Code of 1991
**2014 DOF-Bureau of Local Government Finance statements of receipts and expenditures of LGUs*

Because they are on the ground, the LGUs are in the best position to know the development needs of their localities and to deploy resources to meet those needs.

Scholarly work in the past half-century has established that devolving the mobilization of resources and delivery of services from the national government to LGUs improves the allocation of resources. For one, the LGUs are able to adapt public services to the unique needs of their constituents, as opposed to the national government's tendency to provide "one size fits all" solutions. Individuals may also move to local jurisdictions that provide public services according to their "tastes." Moreover, the LGUs compete with one another, thereby creating "pressure" to deliver public services efficiently. Lastly, decentralization motivates the LGUs to innovate and "adopt new approaches to public policy (Oates, 2006)."[1]

Several conditions must be met for fiscal decentralization to enable the optimal delivery of services to specific localities. The LGUs' accountabilities for managing public resources—through expenditure responsibilities, allocation of sources of revenue, inter-governmental transfers, and borrowings—must be clearly defined. "Without appropriate fiscal empowerment, the autonomy of sub-national governments cannot be substantiated and, in this way, the full potential of decentralization cannot be realized (Feruglio and Anderson, 2008)." Likewise, the LGUs must have ample capacity to fulfil their devolved fiscal management roles: from the effective collection of local revenues to the efficient utilization of funds for the delivery of services, and accurate accounting and reporting of their financial transactions.

Therefore, in order to become effective agents of development in their respective jurisdictions, the LGUs must have sufficient resources to deliver tailor-fit services to their constituents and must have the capacity in effectively deploying such resources.

TWENTY-FIVE YEARS SINCE THE LOCAL GOVERNMENT CODE

The Philippines' Incomplete Decentralization Project

> "It is hereby declared the policy of the State that the territorial and political subdivisions of the State shall enjoy genuine and meaningful local autonomy to enable them to attain their fullest development as self-reliant communities and make them more effective partners in the attainment of national goals."
>
> **The Local Government Code of 1991**
> SECTION 2 (A), "DECLARATION OF POLICY"

Almost 25 years ago, the Local Government Code (LGC)[2] was enacted to empower the LGUs to become effective instruments of local and national development.

The code devolved a number of national government mandates to the LGUs, particularly by giving them the authority to expand certain sources of revenue, such as real estate taxes and business-type income, and design their local budgets according to their local development objectives. Likewise, the delivery of local services, including local infrastructure, primary healthcare, and solid waste disposal, were assigned to the LGUs. The LGC likewise increased the share of the LGUs in the national internal revenue taxes—the Internal Revenue Allotment (IRA)—from 20 to 40 percent to provide them with the resources as a means to absorb the service delivery functions that have been devolved from the national government.[3] The code also enshrined the participation of civil society and non-government organizations as active partners of the LGUs.

However, despite the powers, opportunities, and resources at the disposal of the LGUs, their financial sustainability has remained a challenge. Data from the DOF-Bureau of Local Government Finance (BLGF) for 2009 show that provincial and municipal governments have remained highly dependent on the IRA and other shares from national revenues. On the average, provinces and municipalities are dependent on their shares in the national taxes at 79 percent and 80 percent, respectively, of their operating income, though cities have a lower dependence rate at 46 percent. This state of affairs is far from the vision of the LGC, i.e., for the LGUs to become self-reliant.

The national government undertook efforts to improve local fiscal management by strengthening its own oversight. The Department of the Interior and Local Government (DILG) introduced the Local Government Performance Management System (LGPMS), although its coverage for local government finance has been limited. Acknowledging the fragmented structure of the oversight function of the national government on local PFM, DILG, NEDA, DBM, and DOF in 2007 jointly issued guidelines[4] to harmonize local planning, investment programming, revenue administration, budgeting, and expenditure management. The said guidelines strengthened the interface between the LGUs and the national government agencies. Complementing this move, DBM updated the Budget Operations Manual (BOM) for LGUs in 2008 to inform the LGUs on new budgeting tools, make account classifications consistent with the National Government Accounting System (NGAS), clarify vertical linkages among the various levels of the LGUs, and introduce the guidelines on citizens' participation in local budgeting. In 2007, DBM, with technical assistance from the European Commission, carried out the LGU PFM Phase 1 Project[5] after realizing that no comprehensive and standard assessment on LGU financial management had been undertaken.

The IRA and other mandatory shares of the LGUs may be insufficient after all to cover their broadened mandate for service delivery under the LGC. However, additional financial support of the national government for the LGUs should be done through clear, rules-based mechanisms that are hinged on measurable criteria, rather than through political patronage. This principle was recognized by the DBCC in 2009 when it approved a Performance-Based Incentive Policy to rationalize the national government's transfers to LGUs and focus these transfers as incentives to improve local governance and service delivery (DILG, 2011).

LGUS AS STEWARDS OF PUBLIC FUNDS AND AGENTS OF DEVELOPMENT

Recent Reforms to Strengthen and Incentivize LGU PFM

> "This is an opportunity to push our agenda for meaningful devolution. Our local governance and financial stewardship initiatives... have been boosting the LGUs' ability to absorb more funds and deliver basic social and economic services—those that are currently undertaken by the national government, even if these appropriately fall under the mandate of LGUs under the (LGC)."
>
> **President Benigno S. Aquino III**
> President's Budget Message 2011

The Aquino administration sought to bring fresh momentum to the stalled devolution project through various reforms. A primary stream of such reforms is the comprehensive LGU PFM Reform Roadmap aimed at strengthening the capacity of the LGUs for financial stewardship. The development of such a roadmap entailed the difficult yet necessary task of assessing the strength of LGUs' PFM systems. The administration also introduced mechanisms that gave the LGUs incentives for implementing transparent, accountable, and participative PFM.

Setting the baseline of LGU PFM performance

The implementation of the PFM Improvement component of the EU-funded LGU PFM Project Phase 1 paved the way for the development of the LGU PFM Assessment Tool (PFMAT). Issued in 2012,[6] the PFMAT is a self-assessment, evidence-based instrument that describes the characteristics of an open and orderly PFM system. A diagnostic tool, it established indicators that measure the seven critical dimensions of performance of LGU PFM *(see box)*. The tool allows the LGUs to identify the strengths and weaknesses in their PFM systems as basis for improvement measures through their respective PFM Improvement Plans (PFMIPs).

The Dimensions of an Open and Orderly LGU PFM

1. **Policy-based Budgeting** – assesses the level of consideration or due regard given to government policy, including local development plans, when preparing the LGU's budget
2. **Comprehensiveness and Transparency** – measures the completeness of information presented in the LGU's budget and the accessibility of fiscal information to the public
3. **Credibility of the Budget** – evaluates whether or not the budget—including revenue and expenditure forecasts—is realistic and is implemented as intended
4. **Predictability and Control in Budget Execution** - determines if the LGU's budget is implemented in an orderly and predictable manner, with sufficient controls against wastage
5. **Accounting, Recording, and Reporting** – measures the adequacy of records and information produced, maintained; and disseminated for control, management, and reporting
6. **Internal and External Audit** – examines the arrangements for scrutiny of public finances and follow-up by the local chief executive and/or the local legislative council (Sanggunian)
7. **Citizens' Participation** – measures how LGUs enable Civil Society Organizations (CSOs) as partners in the formulation, monitoring, evaluation, and improvement of the local budget

The PFMAT was patterned after the PEFA Framework but with the additional dimension on citizens' participation. As an evidence-based instrument, the PFMAT was used by the LGUs in assessing their PFM systems using quantitative indicators.[7] The PFMAT uses a five-point scale from 0 (lowest) to 4 (highest). An electronic version of the PFMAT was issued and used by the LGUs in 2013.

Baseline data from the results of PFM assessments undertaken in 2012 by 550 LGUs covered by the pilot run of Bottom-up Budgeting (BuB) established that the elements of an open and orderly PFM system in LGUs were not complete, although "what exists are fully operational." The LGUs covered by the assessment garnered an overall mean score of 2.34 out of the possible highest score of 4 across all the dimensions of the PFMAT *(see Table 1).* Scoring the lowest—below the overall mean score—were policy-based budgeting; accounting, recording, and reporting; and internal and external audit (LGU PFM 2 Project, 2015).

As of mid-2015, the PFMAT has been rolled out to 95 percent of LGUs, and 53 percent of LGUs have met the PFM benchmarks, or at least an average score of 2.34 (GGAC, 2015). The assessment results using the PFMAT has become one of the conditions for an LGU to avail of funding support under the BuB.

Table 1: Baseline LGU PFM Performance: Mean Scores of 550 LGUs

Critical Dimensions of PFM System	Score	Assessment Highlights
Policy-based budgeting	1.70	• weak alignment of local development plans & local budgets • local economic enterprises not self-reliant
Comprehensiveness & transparency	2.99	• highest mean rating, though poor compliance with disclosure requirements
Credibility of the budget	2.85	• revenue forecasts less reliable as revenue codes & market values were outdated
Predictability & control	2.36	• weak tax enhancement, especially real property taxes • poor cash flow forecasting • weak procurement practices
Accounting, recording, & reporting	2.26	• poor practices in reconciling bank accounts & liquidating cash advances
Internal & external audit	1.24	• internal audit units not created • low settlement of COA disallowances
Citizen's participation	2.82	• CSO accreditation is strong but degree of CSO participation is low

A comprehensive roadmap for the reform of LGUs up to 2022

In 2012, the government (DOF-BLGF, DILG, and NEDA), with the support of the European Union, commenced Phase 2 of the LGU PFM Project. Through this phase, a rapid assessment of the state of the LGUs' PFM was conducted using the results of the PFM assessment of the 550 LGUs in 2012. A series of consultations with LGU officials was held to validate the results. These inputs were used in developing the LGU PFM Reform Roadmap, which was issued in 2015.[8]

> "When we were starting with the implementation of LGU PFM 2 Project, there was no strategic plan for LGU PFM reform, the improvement measures being implemented at that time were introduced separately and at times in an overlapping manner by the national government agencies, among other fundamental issues. Now, after rolling out the LGU PFM Reform Roadmap and Implementation Strategy, we have identified the various structures, systems, and tools to assist LGUs in strengthening their PFM systems and enticing CSO participation in the local budget process."
>
> **Director Julian Ll. Pacificador, Jr.**
> DBM REGIONAL OFFICE IV-A

The LGU PFM Reform Roadmap seeks to address two key PFM issues that beset the LGUs: the perennial challenge of attaining fiscal sustainability and sound expenditure management; and the weak LGU PFM systems, which are partly due to poor coordination between the LGUs and the oversight agencies, as well as among the oversight agencies themselves. The roadmap, thus, guides the LGUs in strengthening their PFM systems and assists the national government oversight agencies to enhance their support for the PFM reforms implemented by the LGUs. It also seeks to help development partners identify possible entry points to provide support for the LGU PFM reform efforts in the country.

The roadmap groups reform interventions into four clusters *(see box)* and outlines the policy tools or interventions that address the issues identified by stakeholders. The roadmap also outlines the targeted outcomes at the end of three years for three successive terms (i.e., 2016, 2019, and 2022) and the indicators to measure the extent of accomplishment of these outcomes. The roadmap is accompanied by an Implementation Strategy to provide the specific action plan and identify the risks in accomplishing the roadmap and the measures to mitigate such risks (LGU PFM 2 Project, 2015a).

"In a short period of time the implementation of the Roadmap has made impressive gains (LGU PFM 2 Project, 2016)." In particular, the convergence among oversight agencies has been strengthened through the establishment of Regional Inter-Agency Teams to support the LGUs in crafting and implementing their PFMIPs. Noteworthy likewise is the release of the Handbook on the Participation of CSOs in the Local Budget Process.

Highlights of Accomplishments of the LGU PFM Roadmap

- Linking Budget Planning to Policy Priorities
  - Regional Inter-Agency Teams for LGU PFM established
  - PFMAT and PFMIP institutionalized through the BuB and a DBM LGU Policy Unit
  - Guide for the Preparation, Review, Monitoring, and Updating of the Comprehensive Development Plan and Local Development Investment Plan enhanced
- Developing Reliable and Predictable Budgets
  - Development of LGU Integrated Financial Tools (LIFT) commenced
  - Manuals on budget operations, revenue mobilization, treasury operations, assessment examination monitoring, and real property appraisal reviewed and updated
  - Performance Standards for Local Treasurers and Assistant Treasurers issued
- Integrating Transparency and Accountability
  - Handbook on CSO Participation in the Local Budget Process issued
- Holding Managers to Account
  - Internal Audit Manual for LGUs produced
  - Revised Chart of Accounts for LGUs issued by the CoA
  - New budget performance monitoring and evaluation framework adopted

Source: LGU PFM 2 Project (2016)

> "Most LGUs still face the challenge of fiscal sustainability, particularly in raising sufficient funds and effectively managing their resources. The introduction of performance-based downloads addressed the LGUs' need for further support, while also incentivizing the regular assessment of PFM systems and implementation of improvement measures. Thus, at the same time as we are helping LGUs, we are institutionalizing the culture of constant improvement and strengthening of PFM systems."
>
> **Director Leila Magda G. Rivera**
> DBM PUBLIC EXPENDITURE MANAGEMENT BUREAU

Incentivizing LGUs' adoption of PFM

The administration, through DILG, introduced the Performance Challenge Fund (PCF) in 2010 to incentivize the LGUs to adopt good governance standards. The PCF was introduced together with the Seal of Good Housekeeping (SGH), which is awarded to the LGUs that comply with the policy of fully disclosing budget and financial information, have no adverse audit opinions, comply with the Procurement Law, and implement measures against red tape. In 2014, the SGH was enhanced to the Seal of Good Local Governance, which expanded the assessment of the LGUs' performance: the core areas of Good Financial Housekeeping, Social Protection, and Disaster Preparedness; and the essential areas of Business-Friendliness, Peace and Order, and Environmental Management.

The PCF incentivizes the LGUs that attain the SGH or the SGLG[9] through counterpart funding for capital investment projects of the LGUs:[10] those that support the attainment of the Millennium Development Goals (MDGs), pursue local economic development, support disaster risk reduction and management, and boost ecological solid waste management. After an initial allocation of P500 million in the 2011 Budget, the PCF was increased to more than P1 billion in the 2016 Budget. As of end-2015, the PCF has funded 2,183 projects, of which 1,945 (89 percent) have been completed (DILG, 2016). The details of these projects and their status have been made available online by the DILG through its PCF website (http:pcf.dilg.gov.ph).

> "The direct release mechanism exemplified the Aquino administration's resolve to speed up infrastructure development particularly, rural road network thereby increasing economic activities in the countryside and also developing the capability of LGUs in implementing big ticket infrastructure projects."
>
> **Director Alfonso B. Bedonia, Jr.**
> DBM REGIONAL OFFICE VI

The Bottom-up Budgeting (BuB) process, which was introduced in 2012, likewise serves as a mechanism for the LGUs—specifically cities and municipalities—to access more resources for development projects if they meet good governance standards, such as the SGH, the self-assessment under the PFMAT, and the development of a PFMIP. In recent years, the government has allowed the LGUs with the right capacity and that meet higher governance standards to implement BuB-funded projects. More importantly, however, the BuB incentivizes the LGUs to engage the local CSOs and grassroots organizations in their jurisdictions, considering that projects will not be funded if these are not identified through an open and participative process. In 2016, the administration started the pilot run of Barangay BuB to give barangays access to additional resources on the condition that they engage local organizations and meet good governance conditions *(see Citizen's Participation in the Budget Process).*

> "What is good now is that we are not looking at personality-based but policy-based, which means the (programs) are looking at our capacities and commitment to good governance. The partnership of the local governments and the national government looks at how to make the resources more felt at the grassroots level."
>
> **Bataan Governor Albert S. Garcia[11]**
> BATAAN GOVERNMENT

The administration recently created a facility for provinces to access additional resources for the implementation of provincial roads: the Konkreto at Ayos na Lansangan at Daan Tungo sa Pangkalahatang Kaunlaran (KALSADA).[12] With an initial allocation of P6.5 billion in the 2016 Budget,[13] the facility supports the rehabilitation and upgrading of provincial roads that are consistent with their respective Provincial Road Network Development Plans (PRNDP). The program builds on the Provincial Road Management Facility project implemented in 2007 by the DILG, the Australian DFAT, and 10 pilot provinces. The KALSADA expands the support to 73 provinces that meet good governance conditions and social development benchmarks. The funding was distributed to the provinces based on these metrics as well as their performance in completing road projects funded by the Special Local Road Fund.[14] Provinces are also required to report the status of projects to the national government regularly through the Open Roads Portal (http://openroads.gov.ph).

TO FURTHER EMPOWER THE LGU

Meaningful Devolution Requires a Strong LGU PFM

> "Perhaps more than anything, this administration has defined meaningful devolution in two ways. One, we have a clear baseline of the capacities of LGUs along defined pillars of governance and public fiscal management. The LGU PFM project for municipalities aided by the BuB and the KALSADA program for provinces. Barangay BuB has also, for the first time, given us a clear baseline and database of the capacity of all 42,036 barangays. Two, these same programs have put performance standards in place based on national and international norms of fiscal openness and effectiveness."
>
> **Assistant Secretary Maxine Tanya M. Hamada**
> DBM BUDGET PERFORMANCE MONITORING AND EVALUATION GROUP

The administration sought to give the Philippines' 25-year-old devolution project a boost through the reforms that strengthened the PFM systems of the LGUs and provided incentives for their adoption of good governance standards.

Are these efforts succeeding? These reforms are still in the infancy stage: notably, the LGU PFM Reform Roadmap was introduced only in 2015, and to be completed by 2018. Many of its important components are therefore still in the pipeline: the harmonization of performance-based incentive mechanisms for the LGUs; the installation of an ICT-based system for the LGUs' financial management; and the LGUs' full implementation of the manuals that were recently issued by the oversight agencies of the national government.

> "The PFM teams of DBM ROs witnessed the slowly-changing paradigms in local financial management after the initial round of assessment. Implementation of the PFMIPs however, remain to be a challenge. Most PFMIPs are ambiguous and generalized statements formulated 'for compliance purposes' and therefore difficult to monitor and measure; Local Chief Executives are not completely supportive even if the Plans bear their signatures; concerned Department Heads do not exert effort to oversee the implementation of corrective and preventive measures. Nevertheless, sound LGU PFM systems must be pursued to complement the good governance advocacies at the national level."
>
> **DBM Assistant Director Maria Fe D. Jagna**
> DBM REGIONAL OFFICE XI

Strengthening the performance-based mechanisms for the LGUs indicates the need to continue and further strengthen the PCF, the BuB, and the KALSADA as mechanisms to incentivize LGUs that truly meet good governance standards. Moreover, based on the mean PFMAT scores in 2013, a lot of work needs to be done in strengthening the capacity of the LGUs to link development plans with their budgets, make cash availability predictable, comply with procurement laws, reconcile accounts in a timely manner, strengthen internal audit, and act on adverse audit findings of the COA.

Local resource mobilization is especially challenging: BLGF data as of 2014 show that, on the average, provinces and municipalities are still 80 percent dependent on the IRA and other mandatory shares from national government revenues; while cities are 44 percent dependent. Evidently, not much has changed since 2009 on this aspect of the LGU PFM. In response to this chronic issue, the LGU PFM Reform Roadmap outlines policy actions as a means to improve the capacity of the LGUs to generate revenues: from strengthening their capacity to assess and collect real property taxes to ensuring the viability of local economic enterprises.

Moving forward, these reforms should help further empower the LGUs as "more effective partners in the attainment of national goals," as the LGC was envisioned, through greater capacity to take stewardship of their local finances and greater accountability to their constituencies.[15]

NOTES

[1] About half a century ago, Oates (1972, as cited in Oates, 2006) defined the Decentralization Theorem, as follows: "For a public good—the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or for the respective local government—it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of any output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions."

The four arguments for fiscal decentralization as cited here are based on the "basic elements" identified in a working paper by Oates (2006) of how, based on "traditional theory," decentralization improves the allocation of resources in the public sector. The working paper itself revisits the "traditional" or "first generation" theory of fiscal decentralization in light of new evidence and the emergence of a "second generation theory."

[2] R.A. No. 7160, enacted on October 10, 1991

[3] Additionally, LGUs receive special shares from national government revenues, including those from tobacco excise taxes, the expanded VAT, royalties from the extraction of natural resources (e.g. oil, gas, and mining), the collections of special economic zones, among others. LGUs also receive allocations from the National Budget, such as from the Priority Development Assistance Fund *(see End of Pork as We Know It)*, the Local Government Support Fund, and transfers from national government agencies for the implementation of programs and projects.

[4] Joint Memorandum Circular (JMC) No. 1, "Guidelines on the Harmonization of Local Planning, Investment Programming, Revenue Administration, Budgeting, and Expenditure Management," issued on March 8, 2007.

[5] The LGU PFM Phase 1 Project was introduced as part of the Technical Assistance for the Health Sector Policy Support Program of the European Commission to the Department of Health. The Project covered 16 provinces.

[6] Promulgated by the DBM via Local Budget Circular No. 101 on October 12, 2012.

[7] Generally, the assessment is based on a three-year set of data to allow for abnormal situations outside the control of the local administration.

[8] DBM-DILG-DOF-NEDA JMC No. 2015-1, "Adoption of the Local Government Units Public Financial Management Roadmap and Implementation Strategy," issued on February 24, 2015.

[9] SGH until 2014, then SGLG from 2015. For the latter, LGUs must meet the three "core" criteria and at least one of the "essential" criteria to qualify for the PCF.

[10] Such capital investment projects must be included in an LGU's Annual Investment Program (AIP) and funded out of the Local Development Fund or 20 percent of its IRA (DILG, 2011).

[11] From an ULAP Press Release on the occasion of the upcoming 25th anniversary of the LGC in January 2016 (http://ulap.net.ph/index.php/en/program-updates/news-updates/484-lgus-push-for-key-local-governance-reforms-in-line-with-the-local-government-code-25th-anniversary)

[12] Roughly translated as "Concretized and Quality Pavements and Roads Towards Inclusive Development"

[13] Under the Local Government Support Fund

[14] This Fund, a Special Account in the General Fund (SAGF), is financed through the Motor Vehicle User's Charge *(see Budget Integrity and Accountability)*

[15] While it is not the intention of this article to elucidate on how the shift to federalism can be pursued, it is noteworthy that the literature on fiscal decentralization does not discount the possibility of "fiscal federalism" being implemented in a unitary system. Still, it may be possible for "fiscal federalism" reforms, in tandem with the continued implementation of LGU PFM reforms, to be implemented in preparation for the eventual shift to a federal system of government. The so-called "second generation theory" on fiscal federalism may also be instructive in designing further reforms. For instance, Weingast (2007) identifies possibilities for engineering reforms, including decentralizing in steps—"with the first step allowing one or a small number of regions the power to reform 'one step ahead'"—so that their success could be used to demonstrate the benefits of decentralization.