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Local Government Transformation: Glimpses from the Local Finance Literature under the 1991 Local Government Code

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Although still mainly traditional in terms of local financing, local government units (LGUs) have increasingly taken advantage of the facilitating framework for revenue generation provided by the Local Government Code of 1991. LGUs are trying to improve their tax collection efficiency, as well as planning and budgeting capabilities to be abreast with modern developments in the field like computerization of tax administration and networking of offices. They have also ventured into roles which are enabling in nature along with their traditional functions as direct service provider and employer.

Introduction

Fundamental changes are now occurring in the way national governments structure their economy and instruments of governance. These changes are also affecting local governments. The global trend towards decentralization and democratization, the rise of civil society, and the increasing globalization of national economies with the resulting competitive pressure it spawns are some of the changes swirling around local governments. These changes are forcing a reexamination and transformation of the role of local government.

The changes mentioned earlier are happening at a time when the political and administrative context for local governance in the Philippines is being reshaped by a new Local Government Code. Almost five years had passed since the Code was enacted and became effective. During that phase, much has happened by way of "doing decentralization" (Romero 1977) — functions and responsibilities had been devolved, personnel had been transferred, funds had been turned over and disbursed, and structures at the local level had been reorganized. Now is an opportune time to keep track of the progress that was achieved, and even of transformations that might have occurred. Are there glimpses of transformation in the way local governments conducted themselves as a result of the devolution process?

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This article is a particular attempt to keep score of the decentralization process, focusing on local finance. It seeks to keep tab of what has happened in local finance since the Code took effect through a review of relevant literature between 1992 and now. The emphasis on local finance is due mainly to the significant place it occupies in discussions on and the outcome of decentralization.

The Role of Local Government

It would be useful to situate the review of developments in local finance within the framework of the role of local government. The traditional role of local government has been that of a direct service provider and employer (Legaspi 1996a). In recent years, however, there is a growing discussion of the *enabling* nature of local government; a new way of looking at local government as a facilitating, entrepreneurial institution. The concept of an *enabling authority*, however, has come to mean many things—from a laid back local state, to an institution seeking to open the local economy and administration to market forces through privatization or contracting out of services, to one with broader powers to act in behalf of the community interest (Hollis *et al.* 1992). However defined, the enabling authority seeks to "meet the needs of the community in the most effective way" (Hollis *et al.* 1992), be it through a mixture of direct service provision and private market involvement, or through community participation.

The traditional role of local government mirrors a state-led view of development. This means that the task of service delivery is the primary responsibility of local governments. It is the local government which marshals the resources and creates the necessary organization and apparatus for the delivery of services in a legally determined territory. To carry out these services, local governments generate revenues from taxation and other levies. Such revenue-generating powers are delegated by the national government to the local government unit as part of the latter's position as an instrumentality or agent of the State. The national government also provides funds in the form of transfers and grants to the local governments in order to support the functions and responsibilities being performed by these units in its behalf.

The enabling local government is a recent concept which complements the idea of decentralized governance. It recognizes that the local governmental organization may not be the most effective instrument in achieving development. It is aware of the existence of other institutions and the possible contribution that they could make.

An enabling government is aware that it is not self-sufficient, not only in terms of resources, but also in terms of technical and coordinative capabilities. Because of such awareness, it may establish and maintain relationships with different institutions in pursuit of defined goals. The relationship could be in the form of contracts for the private delivery of specified services under specified standards, or it may involve the provision of private financing for projects to be directly delivered by the local government unit. It may treat residents or constituents not merely as clients, but also as customers or as active participants in governance. The enabling local government is also an entrepreneurial local government. The entrepreneurial local government implies a local institution that is oriented towards local economic development in its operations. It recognizes risks and resource constraints as manageable conditions that can be minimized by appropriate strategies. It knows how to promote its advantages and unique product characteristics, and is guided by policies that would facilitate economic development in its area.

The desired direction under a decentralized system of governance is for local governments to become more and more of the enabling authority. In the area of local finance, this would mean looking outward for revenue sourcing, taking advantage of the private capital market, or employing cost-recovery schemes, among others. Are local government units (LGUs) headed toward this direction under the framework of the 1991 Local Government Code?

Anticipating the Code's Impact

Early studies on local finance under the 1991 Local Government Code focused on the possible changes it might bring to the fiscal health of local government units. Manasan (1992b) analyzed how some of the provisions of the Code would affect the financial position of LGUs, the match between the increase in internal revenue allotment (IRA) and the cost of devolved functions, and the distribution of IRA across different levels of LGUs. In another study, Cuaresma (1995) posed the question of whether LGUs could financially cope with the expanded functions and responsibilities transferred to them. These studies observed that while LGUs stood to gain from the Code's implementation, such gains would come automatically. The impact of the Code, according to Manasan (1992a), would depend partly on the changes in the statutory tax rate and the legal tax base; the composition of the tax base of LGUs; and the buoyancy of the tax base. Local governments also need to flex their muscles by exercising their taxing powers according to the new provisions of the Code; revising their existing revenue codes to take advantage of the new tax rates; imposing new taxes on previously untaxed economic activities; revising the schedule of market values of their real property tax (RPT); and by revamping their tax administrative machinery (Manasan 1992a; Cuaresma 1995).

As the process of decentralization gradually became embedded in local administration, the focus of literature shifted to developments and issues in one or several key aspects of local financing, namely: local taxation, internal revenue allotment and alternative sources of financing. It will be noted that the issues and concerns raised in the initial years of the Code's implementation were indicative of a traditional local government in the process of adjusting to inevitable change.

Internal Revenue Allotment (IRA)

Local development initiatives were often financed out of the regular revenue sources of local governments, mainly through taxes and levies. They were augmented by sources external to the local government, such as the Internal Revenue Allotment. Because more often than not, regular tax revenues were inadequate, many local governments had to depend largely on their share of the IRA to support their programs.

Initial apprehensions on the outcome of the devolution process highlighted the local governments' concern on the sufficiency of IRA for the devolved functions and the personnel devolved to them. They were also worried about the uncertainty of receiving their estimated IRA shares (ARD 1992; Local Government Center 1995). Concerns were also raised on the equality of sharing among levels of LGUs, particularly between provinces and cities, as well as the responsiveness of the criteria used (i.e., population, land area, and equal sharing) to the funding needs of poorer LGUs (LGC-DSE 1996).

Manasan's study (1995) of the early years of the Code noted the substitutive effect of IRA on local tax revenue mobilization. This was consistent with the observation reported in the 3rd Rapid Field Appraisal (September 1993) that the LGUs' reliance on the IRA for their financial requirements was taking their focus away from more efficient tax collection and innovative ways of generating revenues. Case studies done by the Local Government Center of the University of the Philippines (LGC-UP) for the same period (1992-1993) also indicated a dependence on IRA, particularly among poorer LGUs (Legaspi 1996a). Discussion is still ongoing on the amount of IRA needed to cover the true costs of devolved functions. Meanwhile, IRA has assumed the role of being the main source of revenue for LGUs (see ARD 1996; Manasan 1995; Cuaresma and Ilago 1996).

IRA performance in relation to local tax revenue mobilization has led to a proposal to restructure its distribution formula. The proposed formula would include a maintenance-of-effort factor (Manasan 1995) that would serve as an incentive for LGUs to maintain or improve on their local revenue generation efforts. A related proposal was to develop a sharing system that would be responsive to "net fiscal capacities," that is, allocating IRA based on the gap between the potential tax revenues and the expenditure requirements (Manasan 1995). Meanwhile, IRA sharing among various LGU levels has led provinces to propose a reduction of the share of cities; the argument being that provinces bear the greater burden and costs of devolution due to the type of services transferred to them. This matter has yet to be resolved to the satisfaction of both LGU levels, as cities believe there are no cogent reasons to amend the distribution formula (LGC-DSE 1996).

Local Taxation

While IRA has become the major source of revenue of LGUs, local taxes have remained as the major contributor to locally generated revenues. Among these taxes, the real property tax (RPT) is the main local source.

Because of RPT's enormous importance in the local revenue structure, several studies focused their attention toward its improvement (Manasan 1995; Cuaresma and Ilago 1996; Tan 1993). These studies recognized the significant potential of RPT, but noted that this was restrained by several factors: underdevaluation of properties due to infrequent assessment valuations; ineffective system of monitoring and evaluation; lack of political will in enforcing collection through legal means; and inadequate records management and records keeping. Some of the constraints remain to be addressed fully until now. The last rapid appraisal of decentralization (ARD 1996) observed that the system of RPT assessment and collection remains cumbersome and excessively complex such that efforts to improve performance by conventional methods "cannot overcome the system's inherent shortcomings" (ARD 1996).

For non-property taxes, a major constraint cited was the determination of gross receipts, which serves as the tax base for the collection of the business license tax. In the case of the other local taxes, there are inadequate systems and procedures on assessment, collection and enforcement (Manasan 1995; Cuaresma and Ilago 1996).

The concerns and issues on IRA and local taxation show a local government oriented toward its traditional role, grappling with uncertainties as it tries to match regular funding sources with new responsibilities and tasks. Its response thus was to look inward to improve its structure and organization—the classic case of a public bureaucracy reexamining its systems and procedures, to reform it, and to achieve the desired efficiency or productivity.

The constraints mentioned above were not considered insurmountable. Notable improvements were observed. The 2nd RFA (January 1993) reported that many LGUs either passed or were in the process of adopting new local revenue ordinances, preparing new schedule of market values for RPT, and reassessing real property values. By the 4th RFA (June 1994), LGUs demonstrated increasing interest in computerizing tax systems and in networking offices involved in tax administration. Cities such as Cebu and Naga showed more than just interest: they embarked on a computerization program in their respective areas which enabled them to increase their annual regular income. The programs also enabled the city governments to practice information or data-based decisionmaking (*Innovations* 1994 and 1996). The 5th RFA (1995) noted the increased efforts of LGUs to generate funds locally, implement their new local tax codes, and auction delinquent properties. In the municipality of Binangonan, Rizal, the local government was able to increase its tax revenues — from ₱17.44 million in 1992, to ₱32.39 million in 1993 and to ₱41.31 million in 1994 — by going backwards to the basics of a no-nonsense tax collection campaign. Described as personalized, innovative, and "gently coercive," the campaign involved the inventory of all existing business establishments, including ambulant vendors and previously unregistered businesses, and the organization of the data into a computerized database; a dialogue between local officials and the business taxpayers; and the support of pressure groups such as the Church and concerned citizens' groups (*Innovations* 1995). In the most recent RFA report, a slight decline in the IRA's share of total revenue since 1993 was noted among a number of cities and provinces, alongside a gradual increase in locally generated revenues (ARD 1996).

Alternative Sources of Local Financing

Under the Code, alternative mechanisms exist to supplement LGU revenues and to fund desirable local development projects — through credit financing, Build-Operate-Transfer (BOT) schemes, and privatization of basic services. As nontraditional approaches to financing, they stress the limit of "self-sufficiency" of local governments under the traditional role perspective. These methods invoke the participation of non-local government sectors in the matter of funding, service delivery, or both, and are thus associated more with the enabling, entrepreneurial type of local government.

Historically, credit financing and bond flotation had been available to local governments even prior to the Code. But, as it was in the past and now under the Code, LGU access to credit financing and bond flotation is not yet fully tapped, according to the study by Lanto *et al.* (1995). Their study stressed that the absence of a clear-cut credit policy framework and well-defined relationships and roles among players in the LGU credit markets hinders the full development of LGU credit markets. The study further noted that many LGUs still rely on traditional sources of revenue such as the IRA, local tax collections, and grants.

Several constraints were identified. Among these were the lack of awareness by LGUs of available credit facilities, as well as the lack of information by financial institutions of the LGUs' creditworthiness. The information flow between LGUs and financial institutions was reportedly stymied by the lack of formal business relations between the two. Another issue raised was that COA's restriction of LGUs to hold deposits in private banks prevents the latter from developing insights on the peculiarities of development financing (Gruschinski *et al.* 1997). Other constraints cited focused on the weak capabilities of LGUs, such as the loan repayment capacity, and the project management quality and executive ability of LGUs (Llanto *et al.* 1995). A report from the Asian Development Bank (ADB) observed that the low level of both local funds and local resource generation made LGUs unable to access or pay for international loans (Cariño 1997). The Llanto study further identified several constraints: collateral and loan safeguards and credit risks; type and viability of project to be financed; regulatory framework affecting LGU deposits and bond issuance; short political tenure of LGU officials; manner of private sector participation in LGU credit markets; and the appropriate role for the Municipal Development Fund. The ADB report also cited political issues in resource generation and loan repayment, the lack of mechanism for direct lending to LGUs, and the lack of national government guarantee for LGU loans as constraints in development financing (Cariño 1997).

Bond float as one of the alternative mechanisms for local financing was evaluated by Saldaña (1992). His study examined the impact of regulations on municipal bond performance and prospects through a comparison of the regulatory framework under Presidential Decree (PD) 752 and the Code. In his assessment, Saldaña noted that the market for LGU securities has been underdeveloped due to the restrictive regulatory structure and the low level of awareness of LGUs of the availability and requirements of security financing. Financial institutions, on the other hand, are not familiar with the evaluation of LGUs' financial condition, and thus could not provide effective advisory assistance to LGUs. The work of Llanto *et al.* also mentioned several constraints specific to bond float, namely: the LGUs' lack of familiarity with procedural requirements; their lack of skilled personnel; the issue of marketability of long-term debt instruments; absence of LGU bond rating system; and restrictive regulations on bond marketing and administration.

These constraints notwithstanding, LGUs have increasingly shown interest and are now more aware of nontraditional sources of funding. Several LGUs have availed of loans for economic infrastructure projects, such as the municipalities of Muñoz, Nueva Ecija and Bangued, Abra. Others have floated bonds like the cities of Dumaguete, Legazpi, Naga, Cotabato and Baguio. Even a municipality in the lower income-class such as Sto. Domingo, Nueva Ecija has been innovative enough to also float bonds. The first local government to experiment with BOT schemes was the city of Mandaluyong. Using the scheme, the city was able to build a modern public market worth ₱405 million and with potential revenues of ₱10-20 million yearly. The cost for the city government was minimal, if not zero (Pardo 1996; *Innovations* 1994). Such efforts have not gone unnoticed. The municipality of Victorias, Negros Occidental became one of the top ten *Galing-Pook* awardees in 1995 for demonstrating how a bond float could be harnessed for its low-cost housing project. The BOT experiment of Mandaluyong city was likewise recognized in 1994.

Some local governments have also experimented with cost-recovery mechanisms despite the political risks. In the town of Malalag, Davao del Sur, health services are delivered by the municipal government under a socialized scheme which requires payment by clients of a fixed service charge. A family with an annual income of ₱15,000 would have to pay 25 percent of the fixed service charge; those with annual income over ₱15,000 up to ₱50,000 would have to pay the full service charge (*Innovations* 1996). In the city of Olongapo, solid waste management is efficiently carried out, but households have to shell out from ₱10 to ₱20, and business establishments from ₱30 to ₱300, to enjoy such professional service (*Innovations* 1994).

Confronting Other Concerns

Both faces of local government — the traditional and the enabling — have to contend with other concerns as LGUs try to measure up to the demands of a decentralized administrative system. For example, the Code allows LGUs to have a just share from national wealth arising from the exploitation of natural resources in their areas. However, LGUs continue to experience problems in getting their share. There is no reliable system of calculating and allocating LGUs' share, and LGUs complain that national agencies have not been particularly helpful (ARD 1995, ARD 1996).

Aside from these, LGUs have to face the issue of unfunded mandates. These are laws and statutory requirements enacted by the national government which LGUs are forced to comply with, even if their sources of funding are not clearly identified or provided (LGC-DSE 1996).

The alternative course of inter-local cooperation as a means of financing development projects is yet to be fully maximized. Under an enabling authority, inter-local cooperation could be an effective strategy in local financing especially for projects that require massive investments, transcend political boundaries, and have spillover benefits.

Towards a New Framework

As the system of decentralization becomes more institutionalized, maintaining the quality of functions and level of services requires substantial financing which local governments may not be able to raise through traditional, regular sources. A proposed policy framework for LGU credit financing is bared by the Department of Finance to assist local government units in accessing other sources of financing. In essence, the proposed framework could contribute to the desired shift towards the enabling authority. It encourages and redirects local government initiatives toward the private market, eventually restructuring the mix of financial support that can be raised between the traditional ones and the alternative, private-source funding.

The framework is based on the Department's appraisal of three problem areas in local financing. These are the limited role of private capital markets in LGU development finance; the lack of creditworthiness of LGUs which hinders them from accessing private funds; and the restraint among banks and local government units from financing social and/or environmental projects (Gruschinski *et al.* 1997).

The proposal identifies a complementary role between government financial institution (GFIs) and the Municipal Development fund (MDF) in the development of a viable municipal credit system. It envisions that eventually, more creditworthy LGUs will access private sources of capital. In the interim, the GFIs will lend principally to creditworthy LGUs that still cannot tap the private capital market, while the MDF will focus its financing on less creditworthy LGUs and to social and/or environmental projects. The GFIs will also develop co-financing schemes as well as project referral schemes with private financial institutions, and provide technical assistance on project and financial management to LGUs. The MDF, on the other hand, will provide technical assistance to LGUs to enable them to access GFI credits.

Conclusion

From traditional, direct provider of services to an enabling authority—that is the premised direction of local governments as they are transformed by the process of decentralization. The literature indicates, however, that the local government in the Philippines is harnessing and exploring both roles. In the area of local financing, local governments have shown both traditional and enabling features. Local governments are still traditional, in the sense that they continue to be the main provider of services, using regular sources of financing, but taking advantage of the more facilitating framework for revenue generation provided by the Code. But there is a positive difference. As a traditional public organization, they have responded by looking into their internal structures to improve on their efficiency in tax collection and administration, planning and budgeting. They are now more challenged and are now venturesome to modernize their systems and to try out other strategies to improve their efficiency. Illustrative of these are the cases on computerizing tax administration and networking of offices.

Within the traditional organization, there are attempts to become an enabling institution. This paper has noted cases of local governments embarking on innovative ways of financing the delivery of public services. It is not just the alternative ways of financing which invite attention. The more significant implication is the readiness of local governments to factor in risk and uncertainty in their financing decisions and to submit to a form of discipline. These are readily apparent in the cases of local governments which have contracted loans, floated bonds, or ventured into build-operate-transfer schemes. The policy framework, as recognized in the literature, is not fully conducive to these nontraditional forms of local financing. That there are local governments which are willing to raise capital within this framework shows a changing disposition towards risk and uncertainty, and a desire to become not merely a traditional, but an enabling local government.

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