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LOCAL REVENUE ADMINISTRATION PROJECT

MAXWELL SCHOOL

SYRACUSE UNIVERSITY

Strengthening the Fiscal Performance of Philippine Local Governments: Analysis and Recommendations

Local Revenue Administration Project
The Maxwell School of Citizenship and Public Affairs
Syracuse University

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Report submitted to Philippine Institute for Development Studies Research Group on Local Finance: Dean Raul De Guzman and Director Angel Yoingco, Co-Chairmen.

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PREFACE

After more than a year's work on this project, we have come to understand the considerable difficulties of stimulating the fiscal development of local governments in the Philippines. The problems in this area are formidable and complex and we do not even begin to have all of the answers. But we think we might have a few. Our principal conclusion is that the local government system in the Philippines, centralized though it may be, can be made to work quite effectively. The goals of increased revenue mobilization, increased capital project activity, greater local government participation in expenditure delivery and decision-making, and a more efficient management of local affairs are definitely attainable.

The plan we suggest to reach these goals is based on four premises. First, because the system is so highly centralized, the really important reforms must be initiated at the Central Government level. Second, and for the same reason, it is necessary to strengthen the capacity of the Central Government to manage and monitor local government affairs before the local government sector can be strengthened. Paradoxically, the first step toward governmental fiscal decentralization is to invest in strengthening the management capacity at the center. Third, local government fiscal behavior may be influenced in important and desirable ways through the use of financial incentives. Finally, one should not expect all things from every reform measure, i.e., if these reforms could lead toward the objectives listed above, quite a lot will have been accomplished.

To bend such a reform package to address other goals, e.g., the redistribution of income, is to run the risk of accomplishing nothing.

This report is organized in three parts. In Part One, we consider local financial management, taxation, and the Allotment System. In Part Two, the feasibility of local government public enterprises is studied, and in Part Three we take up the question of credit financing. Every chapter concludes with recommendations but these are directions for reform rather than a complete working out of the detail. An Executive Summary is included, but this cannot be substituted for a full reading of the analysis in the text.

This report is a joint effort. Professor Schroeder and I collaborated on the first five chapters, Professor Greytak and Mr. Diokno prepared chapters six, seven and eight, and Professor Hubbell had primary responsibility for chapters nine and ten. I also had a hand in the preparation of chapters six through ten, and along with the principal authors am willing to accept responsibility for whatever errors or misstatements are made.

The task we undertook was enormous, far more so than we realized at the onset of this work. Certainly we would not have accomplished this much without a great deal of help and cooperation. USAID-Washington funded this effort through a cooperative agreement with the Maxwell School, Syracuse University. USAID-Manila initially invited our participation, provided any service we requested to facilitate our getting the work done, and demanded only that we be responsive to the needs of the government of the

Philippines and the PIDS Study Group. Neither USAID-Washington nor USAID-Manila saw draft versions of this report and we have no idea whether or not they share these conclusions, opinions, or recommendations.

The great amount of field work described in the next several hundred pages suggests that we have many, many goverment officials to thank for their time and interest. In particular, we would like to acknowledge our debt to Dean Raul DeGuzman of the University of the Philippines, Director Angel Toingco of the National Tax Research Center, and Director Lorinda Carlos of the Ministry of Finance. Without their help this work could not have been done, and without their unfailing good humor and patience the whole experience would not have been so pleasant. The conclusions and analysis here, however, do not necessarily reflect their views.

Our underpaid and overworked graduate assistants did their usual good job in preparing the data and handling a number of other, equally unpleasant tasks. Finally, our secretarial staff--Esther Gray, Jeanne McGrath, Cindy Antrim, and Cheryl Wood--did the splendid job that we have come to expect from them.

Despite all this help and advice, my colleagues and I must accept responsibility for whatever errors remain.

Roy Bahl
May, 1981

GLOSSARY OF ACRONYMS

ARC	Agrarian Reforms Code
ASEAN	Association of South-East Asian Nations
BCLP	Local Barangay Committee on Land Production
BIR	Bureau of Internal Revenue
BLT	Business License Tax
CIP	Capital Improvement Program
CLT	Certificate of Land Transfer
COA	Commission on Audit
CPI	Consumer Price Index
DBP	Development Bank of the Philippines
DCF	Discounted Cash Flow
EO	Executive Order
FY	Fiscal Year
GAR	Gross Annual Revenue
GF	General Fund
GNP	Gross National Product
GOP	Government of the Philippines
GSIS	Government Service Insurance System
HACC	Hiyas Agro-Commodities Center
HBCC	Hiyas ng Bulakan Convention Center
ICLC	Internal Centre for Local Credit
IF	Infrastructure Fund
IMF	International Monetary Fund
INP	Integrated National Police
IRR	Internal Rate of Return
LBP	Land Bank of the Philippines
LDC	Less Developed Countries
LGPE	Local Government Public Enterprises
LOI	Letter of Instruction
LWUA	Local Water Utilities Administration
MAR	Ministry of Agrarian Reform
MLGCD	Ministry of Local Government and Community Development
MOB	Ministry of the Budget
MOF	Ministry of Finance
NAS	National Accounting Service (NEDA)
NCSO	National Census and Statistics Office
NEA	National Electrification Administration
NEDA	National Economic and Development Authority
NPV	Net Present Value
NTRC	National Tax Research Center
PACTAA	Provincial, City & Municipal Treasurers and Assessors Association
PD	Presidential Decree
PIDS	Philippine Institute for Development Studies
PNB	Philippine National Bank
PVB	Philippine Veterans Bank

RA	Republic Act
RDCs	Regional Development Councils
RDIP	Regional Development Investment Program
RFC	Rehabilitation Finance Corporation
ROP	Republic of the Philippines
RPT	Real Property Tax
RPTA	Real Property Tax Administration
SEF	Special Education Fund
SSS	Social Security System
STA	Specific Tax Allotment
STP	Social Time Preference
USAID	U.S. Agency for International Development
UPCPA	University of the Philippines College of Public Administration

STRENGTHENING THE FISCAL PERFORMANCE OF PHILIPPINE LOCAL GOVERNMENTS: ANALYSIS AND RECOMMENDATIONS

EXECUTIVE SUMMARY AND RECOMMENDATIONS

It is a clear objective of Philippine government policy to strengthen the finances of local governments and to decentralize the provision of public services. Yet the local government sector in the Philippines has been declining in relative importance. Total local government expenditures fell from 18 percent of Central Government expenditures in 1969 to 11 percent by 1979; those financed from own revenue sources fell from 9 to 7 percent of Central Government expenditures over this same period; and there was no growth in per capita real local government spending. It seems pretty clear that the trend of the 1970s was increased fiscal centralization and that the mobilization of additional resources by local governments has come to a halt.

Why has the relative and absolute size of the local government sector not been increasing? And how did such a decline occur at a time when so many new initiatives were being taken to strengthen the local sector? One explanation is conscious Central Government policy. The 1970s were years of great social change in the Philippines, the effects of worldwide recession and the energy crisis had to be dealt with, and there was the continuing need to mobilize domestic resources for development. As a result of these pressures, there were claims on Central Government resources which may have temporarily had higher priority than the need to strengthen local

government finances. An important consequence of this state of affairs was that the distributions of BIR and Specific Tax Allotments were held well below the originally authorized levels, and very little of the National Tax Allotment and Barangay Allotment shares was distributed.

A second explanation is that the Central Government has not gone far enough in supporting its own initiatives for increasing local government taxing and spending, or perhaps it has not gone about things in the right way. Specific problem areas come quickly to mind: the grant system is not designed to make local governments accountable for their fiscal actions or to stimulate them to increase their own tax effort, revenue earmarking may unnecessarily dilute local government expenditure choices and dampen the willingness to tax, too little Central Government support may have been given to local government tax administration and enforcement, and the possibilities of leveraging local revenues with borrowing for capital financing has not been encouraged. Such problems fall under a heading of inadequate penalties and incentives to draw out a more substantial local government participation.

A third set of explanations are the management and administrative shortcomings and the conservative fiscal management bent of local governments, which have held back innovation and growth. Here one may point out that tax collection is a major problem, local fiscal planning is all but nonexistent and local governments have not really begun to take full advantage of the legal taxing and borrowing avenues open to them.

In truth, local government in the Philippines has not grown because of some combination of these factors. The first barrier might be removed

by government's ability to focus more on the development of the local government sector in the 1980s, and the second and third by structural and administrative reforms. The question on the table is what specific policy measures will strengthen local government finances? One thing is clear: the major initiatives must be taken at the Central Government level. This is because local government in the Philippines is very much a centrally controlled operation, not just in terms of taxing authority and expenditure responsibility, but also in terms of the day-to-day influence on fiscal decisions and administrative procedures. The ultimate intent of government policy may well be for local governments to mobilize more resources for development purposes, but the Central Government must take the lead in formulating programs and providing a setting in which this response may be drawn out. The reform plan we suggest here is one of Central Government action and local government response, and it relies much more on incentives than on punitive measures.

The cure for this problem of a slow growing local government sector will not be painless, therefore all proposed reforms will be objectionable to some corners. In general, one or more of three problems are common to virtually every reform measure that we have proposed below. First, some financial outlay will be required of the Central Government. In effect, the government must invest now in the local government finance system to make it more revenue productive in the future. Second, virtually every change in local fiscal structure will generate interministerial conflicts, or at least new needs for coordination. Resolution of these conflicts is politically unpleasant, but is a need that is

at the very heart of strategies to improve local government finances. Finally, the goals of creating a more responsible and responsive local government system and a more equitable distribution of income are not always compatible. We would urge that local government financing reforms not be guided primarily by immediate income distribution objectives. There are much better ways to deal with income redistribution and, in general, setting many diverse objectives for local government financial reform is to run the risk of achieving none of them. In this connection, it is very important to recognize the difference between improving the lot of the poorest citizens--which many of these reforms will do--and improving the lot of the poorest governments, which may not be a feasible objective for the present.

These major constraints to reform noted, it should be recognized that changes in the local government financial system in the Philippines will take place in a context of considerable strength. First, the basic system of local government--given its high degree of centralization--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, etc., suggest a more workable system than we have seen in many other countries of similar income level. The 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.

These advantages are important. They suggest that the objective of strengthening local finance in the Philippines--stimulating local governments to mobilize more resources, improving public services, and increasing development spending--can be achieved.

Our 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. The key to a successful reform, as we see it, is a complete overhaul of the Allotment system, including a full distribution of entitlements to local governments, and the creation of a more effective vehicle for local government credit financing.

Local Government Budgeting, Financial Management and Expenditure Mandates

It quickly becomes clear to anyone working on local government finance in the Philippines that important bottlenecks to increased revenue mobilization and to a more efficiently functioning local government sector are (a) inefficiencies in the local government budgeting/financial management process and (b) 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, since 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.

There have been attempts 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. Moreover, 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 the future is to see additional use of credit financing and an increased focus on capital spending by local governments, well-designed capital budget statements will be essential. *Capital budgets, in specified form and including financing plans, should be a general require-*

ment 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 surely imposes costs. Different Ministries have different priorities which lead to conflicts in the directives and requirements given to local governments. Because of these conflicts and the sheer time cost of complying with these requirements, local government fiscal management is almost certainly 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. *In the long [illegible], 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 Municipal Audit--should be re-examined periodically to insure that the various processes are not at odds with each other or with overall Central Government objectives. We recommend the creation of a high level interagency task force to look into this question and to define the scope of concern for the Review Office. NEDA and/or the Office of the President would be a likely location for such an office.*

Expenditure Mandates

The centralized orientation of local financial management is no more strongly evident than in the various restrictions placed upon localities in terms of what they can or must budget for certain, specified functions. While this practice, in theory, enhances the direction which the Central Government can give, it markedly reduces the discretion which 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, i.e., because their budgetary discretion is limited, local governments may have to accumulate substantial balances and they may be less willing to increase their own tax efforts. 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 insure that particular objectives are pursued is to require that local governments spend certain amounts on specific activities. The more or less uniform application of such rules to over 1600 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:

(a) Is an amount as much as 18 percent of general revenues still necessary for recovering INP costs and is distribution of the costs as the same percent of general revenues in every jurisdiction an equitable way of spreading the INP financing burden?

(b) 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.

(c) 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.

(d) 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? If it is to be retained, tax mapping costs should fall within the allowable use of these funds.

We cannot say where a review of these mandates will or even should lead, since some of the possibilities depend on whether the reforms suggested for the Allotment system are accepted. We would expect in any case that a substantial relaxation of Central budgetary controls might occur.

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 recommendations 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. *We recommend that the issue be brought under study and that a manual 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 practice is 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 can be made a more effective method of mobilizing domestic resources, but only if the Central Government takes some important and perhaps overdue steps. The first 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 force a coordination among several Ministries to the end of improving property tax administration. A fourth important step is to recognize that some Central Government investment in improving the tax will be required, i.e., fixing the property tax will not be a costless exercise. Finally, there is need to create a set of incentives and penalties to induce a more active local participation in property tax improvement programs.

To be sure there are important administrative and management improvements to be made at the local government level, but in the highly centralized Philippine system, the really important reforms and implementing actions must be initiated by the Central Government. Our research has lead to recommendations for change in six areas:

(a) reform in the tax structure
(b) more intensive use of taxes on property
(c) tax mapping and records management
(d) accommodating the special problems of land reform
(e) changes in reassessment practices
(f) improvements in the collection process.

Structural Reform

The current practice of assessing certain higher valued improvements at a higher rate than land imposes a tax penalty on some property investments. This practice is at odds with the government objective of promoting the mobilization of local resources for capital investments. Moreover, while 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. *We recommend dropping the practice of fractional assessments, i.e., 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 and are not influenced by local governments. *In the case of government properties, we would recommend a system of payments to local governments in lieu of property taxation. In the case of pioneer industry exemptions, we would recommend a serious reconsideration of the pioneer status of certain firms.* In many cases the pioneer exemption is no longer necessary and amounts to an unnecessary giveaway of local government resources.

Increased Intensity of Use

By comparison with many other developing countries, and by comparison with other taxes in the Philippines, the property tax is not heavily used. By law, the basic property tax rate is limited to 1.0 percent of assessed values in municipalities and provinces and 2.0 percent in cities, with an additional 1.0 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 1.0 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 1.0 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, we would also recommend an increase in the legal rate ceiling. Limits on the basic rate of 1.5 percent for municipalities and provinces and 3.0 percent for cities would provide some needed amount of flexibility for local governments. The option to exceed*

the present rate limit should 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 levy.

Holding land out of productive uses may be rational from the standpoint of an individual landowner but imposes serious social and economic costs on society. *Application of the idle lands tax as it is currently constituted under PD 464 (as amended) is therefore a socially beneficial policy and we recommend its use.* It will increase property tax revenues, but its more important contribution will be to improve the efficiency of land use and penalize speculation. 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 idle land taxation 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. *We would concur with these 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 up 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. *We recommend that the Central Government encourage the use of Special Assessments.*

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. We would make recommendations in four areas.

First, more Central Government funding will have to 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 ₱50 million Revolving Fund. *We further recommend a fuller use of the USAID-financed grant program for RPTA improve-*

ments as a method to mobilize more resources for tax mapping. We fully support the recommendations of the Holland-Wasylenko-Bahl Report which calls for an integration of the MLGCD-USAID and MOF programs under the MOF. By combining these programs, it may be possible to provide initial seed money on a grant basis and the remainder on a loan basis. Moreover, if payments on the latter 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 must be provided by the Central Government to induce more local government participation in tax mapping. *This should 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.* This easing of cost constraints may be sufficient to provide the incentive necessary to bring about more tax mapping. 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 USAID grant assistance.

Fourth, there is need for more on-site technical assistance in tax mapping techniques and procedures. A training capability in tax mapping will have to be developed in MOF, and/or expanded in MLGCD.

The biggest problem with these recommendations, of course, is cost. The MOF Revolving Fund and the USAID grant funds are important resources, but still not enough. Additional local resources have to be coaxed out with a set of incentives, and Central Government contributions--at least

to beef up the MOF staff--will have to be made. *We would recommend allowing the use of a share of Allotments earmarked for Infrastructure expenditures for covering the local government portion of tax mapping costs.* Certainly an investment in the apparatus necessary to raise property taxes in the future is a justifiable development-oriented expenditure.

While tax mapping can go a long way toward sorting out the problem of inefficient record-keeping and management, additional steps are necessary. The MOF is nearing approval of a revised manual for RPTA and the MOF and MLGCD have given far more study to the records management question than we have. We would offer only a suggestion about one important element of reforming the records management function. In communities which are not tax mapped, duplicate records are a major problem. In communities which are tax mapped, steps must be taken to prohibit duplication of records from taking place. Until a more satisfactory solution can be reached, cross-checking for duplicates by hand is likely to be the only method by which incorrect or duplicate entries will be found. The investment in a property tax clerk for this job would have a substantial payoff, and the use of Allotment revenues to cover a proportion of costs would seem appropriate.

In the longer run, a more satisfactory method must be developed to insure that as the ownership of parcels is transferred, the property tax rolls are adjusted. Since total reliance upon the parties to the transaction leaves too much to chance, the Central Government must take steps to insure that recorders of deeds, issuers of building permits and surveyors relay all transaction and other relevant information to the assessor's office. Since these communications are already required under PD 464,

all that is necessary is the imposition of proper incentives or penalties by the Central Government to insure 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 Problem

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, local finance officials--but the basic problem would seem to be with the system. While there are many "excuses" for the poor record of non-compliance, the relevant question now is what might be done.

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. *We recommend a tax amnesty on a portion of past due taxes.* This amnesty should not be advertised or granted until a method to assess and collect taxes in land reform areas is established.

The MAR and Bureau of Lands should be encouraged to speed the completion of the mapping process in reform areas. *To help overcome the financial constraints to this completion, a partial cost recovery via surveyor's fees should be considered.*

We further recommend that, until mapping is completed, property taxes 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 should direct that concentrated effort be made to inform new owners of their legal responsibilities to pay property taxes and of the potential benefits to be had from the increased government revenues, and penalties to be faced for failing to comply. The MAR, MLGCD, the co-ops and the barangays are natural information dissemination channels that should 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, and explanatory manuals, would be of great assistance to 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. Not only does this peak loading of the work mean that it is necessary to hire relatively large amounts of casual labor at particular times during the cycle,

but such peaking makes it more likely that errors will creep into the effort. Second, taxable values experience large incremental jumps once every three years and then are relatively flat during the interim period. This has a disadvantage for both the public sector and the taxpayer. 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.

To deal with these problems, we would recommend two changes in the assessment system. *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 associated with the current system and would also provide a bouyancy to the property tax system since approximately one-third of the tax base would be revalued annually. *Second, we would recommend that the increases in tax liability on individual properties 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. This, in turn, should have a beneficial effect upon property taxpayer compliance.

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 be concentrated in three areas: coordination of collection of various taxes, efforts to insure that taxpayers do not become delinquent and efforts aimed at 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 before a deed be issued to a new owner, the previous owner must show proof of payment of past due taxes. *Another opportunity that we recommend, is to require businesses to show proof of property and business license taxes before a Mayor's Permit is issued.* The MOF should direct a wider use of this practice.

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 (1) allow the taxpayer to comply with the law at the lowest possible cost and (2) 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 and is a strategy we recommend. We also recommend 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.*

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 evasion will be serious. *The 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 say 60-70 percent of the delinquent tax take rather than the legal 45 percent. This may provide sufficient incentive to a local political leader to accept the heat associated with sale at auction of some delinquent properties. Barangay captains might be given a share (e.g., 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 reached after one year is insufficient in the current inflationary environment of the Philippines. *We recommend that the penalty rate be increased to 3 percent per month and be extended for an additional two years.*

Finally, especially in smaller rural areas, the use of public knowledge of delinquency, e.g., posting of delinquents taxpayers' names, could provide a non-monetary, yet effective, incentive for compliance.

The Business License Tax

The business license tax, which yields more than the property tax for many Philippine jurisdictions, has good potential for increasing the mobilization of local government resources. While there are two possible routes to such reform--altering the current administration and structure of the tax or replacing it with a shared Central Covernment general sales tax--we see more wisdom in the former approach at the present time.

The legal structure of the business license tax (BLT) 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 which do produce financial statements, interpreting and verifying the accuracy of such records is beyond the current capabilities of many local government administrations. *We recommend that all businesses above a threshhold size be required to produce records of their past year's business and, so as to insure that these records can be interpreted, that training programs be instituted in each province to train designated "business tax collectors" in the rudiments of business accounting. We further recommend that the Central Government 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 BLT, property tax, and Mayor's Permit. This very natural way of increasing compliance will serve the purpose of increasing local government resource mobilization, hence would be a well placed Central Government incentive.

Rate structure reform is necessary to improve the yield and growth in the BLT. Present rates are quite low on average and they are lower for large than for small firms. *We recommend replacing this regressive structure 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.* Our admittedly crude estimates would suggest that such a policy might yield a substantial revenue increase.

Since record-keeping is minimal among small businesses, *we would recommend a flat annual charge; however, this charge should be indexed, in some manner, to the general level of inflation.* This would permit an easy administration of the tax while still insuring 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 reform need is for the government to establish and stay with a grant

system and back away from ad hoc, year-to-year adjustments. In this context, the structure of the grant system should be rethought, and appropriately reformed.

These reforms must be based on a considered set of objectives--i.e., to reask the question "what is to be accomplished?" Our opinion is that the Central Government's present objective--strengthening the role of local government in the financing and delivering of public services--is the correct priority and should remain at the center of these reforms. Consistent with this general goal are four important subobjectives: (a) to induce local governments to mobilize more revenues, (b) to stimulate infrastructure/economic development expenditures by local governments, (c) to improve the financial management and accountability aspects of local government finances and (d) to provide local governments with an adequate and dependable source of revenue. By restructuring the grant system to provide appropriate incentives, these objectives can be achieved. There will, however, be costs to such a program: much less focus can be given to equalizing the financial capacity of local governments, and the Central Government will have to give up its flexibility to make ad hoc changes in the amounts distributed.

We recommend reforms in four areas:

(a) a combining of the various grant components into a consolidated Allotment system

(b) the provision of incentives and financial resources to stimulate development spending

(c) the provision of incentives to stimulate the mobilization of additional local revenues

(d) a rethinking of the proper role of the barangay in financing and delivering local government services.

Consolidating 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 objectives stated above. The National Tax Allotment, a discretionary fund which has not been fully used, should be abolished as a separate Allotment. It may have served a purpose once, but would no longer appear to contribute to government objectives.

There is no longer a need to tie the Specific Tax Allotment to petroleum taxes. Indeed, 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 no longer possible to justify petroleum taxes as a charge to beneficiaries. Moreover, because petroleum taxes are specific rather than ad valorem, revenues from the Allotment do not grow in response to GNP or inflation. The growth in the Specific Tax Allotment has come about in recent years 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 more guided by energy policy than by local government financial needs. It makes very 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]

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[1] One might want to point out that there is a similar problem with the BIR basis, but the parallel is really not so close. BIR collections and local finance needs both bear some relationship to income growth and inflation.

These considerations bring us to a recommendation that a consolidated Allotment system be created in place of the BIR, Specific Tax and National Tax Allotment programs. At 1979 statutory levels for each program, this implies 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 held to rigidly. The partial distributions of recent years have defeated many of the objectives of the grant system.

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

We suspect that a full distribution of these grant funds may be substantially more than local governments can absorb, at least in the very short-run. A full distribution in 1979 would be about twice the actual distribution, and since two-thirds are earmarked for capital projects, one possibility is that local government cash balances could increase. Though more research is necessary on the absorptive 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 we would recommend holding back a share of the grant to capitalize and subsidize a local government credit authority.* (This proposal is discussed in some detail below.)

Mobilizing Additional Local Revenues

As it presently stands, the formula distribution system does not provide a major inducement for increased revenue mobilization. *To address this shortcoming, we recommend two changes in the system. First, some measure of tax effort should be introduced into the distribution formula.* This could provide a substantial reward for increasing tax collections, and it might also increase the accountability of local governments for their fiscal performance. *Second, we recommend that the Allotment distribution 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 partially cover the cost of an additional property tax clerk--for a specified short time period--to deal with a backlog of record-keeping problems.*

Stimulating Economic Development Expenditures

Many of the reforms suggested above lead to increased spending for capital projects, in that they make more resources available. The objective of more capital spending, however, raises the specific question of what incentives might be provided to redirect more general revenues to capital projects. *One incentive is simply to earmark a share of the Allotment to the Infrastructure Fund--a practice we recommend continuing. A second, and potentially much more powerful, technique is to encourage the use of credit financing by eligible local governments.* We develop a recommendation for a local government credit authority below.

Barangay Programs

The time is probably right to reassess the role of barangays in the local finance system. Some of the increased barangay involvement is beneficial and clearly should be retained, e.g., the 10 percent property tax share for barangays serves any number of useful purposes. The merit of some other programs, and their cost, would seem to call for a reevaluation. While it is clear that more input at the barangay level can improve the decision-making process markedly, it is equally clear that the barangay unit is capable of very little technical or financial planning or management. We have not studied the barangay unit in any detail. However, the present practice of earmarking 12.4 percent of the total BIR and Specific Allotment seems a great deal of financial support for a unit of government whose ability to absorb funds is quite limited. *We are not prepared to recommend that the barangay share be dropped, but we would recommend that this eventuality be studied.*

Local Government Public Enterprises

A more widespread use of local government public enterprises (LGPEs) would be consistent with the decentralization objectives of the Central Government and with the goal of increased revenue mobilization. Though the use of LGPEs is provided for in Philippine law, the practice has been largely restricted to traditional activities such as markets, and the financial success record has been spotty. The limited use of LGPEs might be traced to a number of factors: (a) limited possibilities for cost recovery,

(b) inadequate Central Government incentives to induce local governments to use the enterprise form, (c) management and administrative problems, and (d) inadequate provision for capital financing. More generally, there seems to be an ambiguity at the Central Government level about whether a LGPE should be providing a service at subsidized rates or selling a service to recover full costs. *We recommend that the Central Government remove some of these ambiguities by making 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 differentiate clearly between enterprises which serve social purposes, e.g., public markets, and those which are more purely commercial ventures.

Our analysis has been limited to quite a small sample--11 local government market undertakings and 4 commercial type ventures--and so our conclusions are rather more like hypotheses and our recommendations more like suggestions that ought to be pursued. Some of these conclusions and recommendations, we think, will stand the tests of further analysis on a broader sample. In general, our view is that local enterprise activities can be financially viable, that this may 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 take a firm hand in regulating and monitoring 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. We emphasize

the rather substantial differences between using the enterprise form to deliver a service such as water or markets, and creating an enterprise for a commercial undertaking. Government policy should be different toward two types of enterprise.

All local government services, and all types of private business are not amenable to public enterprise financing and delivery. The good or service must be marketable, there should be some possibility of relating price to production costs, and separate management and accounts should be possible. A substantial cost recovery should be possible in all cases and a full cost recovery in the case of commercial ventures. In Chapter VI we have outlined those local services which we see as reasonable candidates.

Public Markets

Most market operations can cover variable costs and many can also cover capital costs, but without capital subsidies, full cost recovery would not appear likely for many. The critical difference would appear to be size of the market, with smaller markets that lie in the commuting range of larger markets being particularly disadvantaged.

Public policy cannot be formulated on a basis of a few case studies, as were carried out here, however, fundamental problems and directions for reform did clearly emerge in the course of this case study. In addition to the "small area" problem, we would classify these as accounting and measurement needs, revenue policy, cost and volume considerations and credit policy.

The Small Area Problem. In some cases, small public markets will not make it as financially viable public enterprises. Their operating costs are relatively high because of the diseconomies of small scale operations; their pricing policies are constrained by the fear that shoppers and vendors may shift to nearby larger markets; their volume is limited by their own small population and their inability to draw substantially from their hinter-

land population; and their ability to make use of credit financing is limited. Even their capacity to keep proper accounts is sorely limited.

This line of reasoning leads toward a conclusion that the enterprise form is not suitable for small municipalities. The question arises then, how small is too small? A much more inclusive sample than this will be necessary to provide an answer. It is another of those issues that needs more research.

Accounting Problems. 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. Before one can pass judgement on the merits of subsidies or pricing adjustments, he must understand the extent to which true costs are being covered. The existing accounting system falls short in two important respects. The first problem arises because of special circumstances of small governments. The levels of market activity are such as to 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 workforce is assigned other tasks on non-market 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 which 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 us 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. Since 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 which, 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. This is but one approach to measuring capital costs, and there are others. *We recommend that the Central Government move to adopt a standard practice in accounting for the annual capital costs of local government market facilities.*

Revenue Policy. One important barrier to full cost recovery has to do with pricing policy, i.e., 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 by more frequent increases in market rental rates and fees, and that this could be done with little effect on the prices of goods sold in the market. Moreover, we see no reason why low income persons would suffer disproportionately from such increases. *We recommend that local governments be encouraged to increase market fees and to make regular fee revisions in line with rising costs of operation.*

Economies of Scale. The capital intensive nature of public markets works against smaller markets by keeping their per capita (and presumably per unit) costs high, i.e., there appear to be economies of scale in the operation of public markets. Our very limited and very crude analysis has indicated that these efficiencies become effective when markets service a population of around 40,000. This is not to say that municipalities with populations above this level 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.

Barriers to Profitability. The key to the profitability of public m[illegible] seems to be volume. Our findings have suggested two important b[illegible]ers 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 which link urban areas with their rural hinterland may 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.

Credit Policy. In establishing a credit policy for public markets, what might be reasonable expectations? Our limited 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. What might be done?

First, we recommend that markets should be permitted and encouraged to increase stall rental fees, and to institute a program of regular revisions. Second, capital subsidies should be provided in the form of lower interest costs than the present 14 to 18 percent. Third, loan maturities should be extended to better match the long life of market facilities. Both of the latter possibilities are taken up in Chapter X below.

Commercial Ventures

We have carried out a case study of four commercial undertakings by the Bulacan Provincial Government: a Galeria for cottage industry products, a restaurant, a convention center, and a slaughterhouse. Our estimates are that when capital costs are taken into account only the slaughterhouse is a profitable undertaking. The aggregate financial effects of these four undertakings depend on the assumptions made in estimating capital costs and future revenue flows. In the best case, the provincial government

will cover all costs and add a total suplus of ₱2.6 million (1980 pesos) to its General Fund during the life of the four projects. In the worst case, it will "cost" the province nearly ₱8 million to fully cover depreciation and make up for the lost rate of return on the ₱10.2 million in original investment. In no case did we take account of indirect effects, e.g., the possibility that the Galeria might stimulate cottage industry activity or that the Cafetorium might dampen the business of other local restaurants.

This work has led us to a conclusion that there are good possibilities for local government commercial ventures and that the management constraints may not be so great as one might expect. However, since risks are high, Central Government involvement and oversight will be necessary. Local governments need to be given latitude to identify business enterprise possibilities and freedom to operate them in an efficient manner. This would seem to call for little Central Government interference or regulation. But the issue is not so simple because local enterprises may also have regional or national implications. Moreover, in a system so centralized as the Philippines, the Central Government has a vested interest in all local government finance matters.

In this context, there are a number of lessons from the Bulacan experience that may be useful in the more general formulation of policy for local government commercial ventures. Four particularly important areas are project design and review, pricing policy, management autonomy, and proper accounting.

Project Design and Review. The Bulacan experience makes a good case for Central Government involvement in the planning stage for private ventures. Two issues arise here. The first is the need for external review of whether or not the proposed undertaking has reasonable prospects for financial success. The second 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.

Three of the four Bulacan enterprises are likely to be a drain on general revenues of the provincial government. It is not coincidental that a financial feasibility study was not made for any of these undertakings. If Central Government policy is to encourage business enterprise activity, it must also encourage effective planning and design. If capital funding is obtained from loans, the feasibility study will be part of the loan application. *If financing is from internal sources, a MOF or MLGCD signoff on the feasibility study should also be required. We would recommend such a review procedure, and the establishing of standards for financial feasibility studies.*

The second issue is more problematic. On the one hand, local government opportunities for business ventures are likely to vary, and all areas ought not be restricted to set types of undertakings. If the primary purpose of a business undertaking is to turn a profit and if it can pass the test of a feasibility study, it is immaterial whether or not it meshes with government investment priorities. If, on the other hand, the project also has social goals and does not cover all costs, it should conform with

national and local investment priorities. *We recommend that for purely business ventures, the Central Government give the local governments maximum discretion in project selection. Where the project must be justified partly on grounds of providing social benefits, normal Central Government review and signoff should occur*

Pricing Policy. Considering that local preferences and economic conditions vary from one local community to another, it would seem reasonable to leave pricing decisions to the discretion of local governments. Nationally prescribed price schedules, e.g., slaughter fees, are infrequently changed and in any case may be improper for some local governments. For some enterprises, pricing autonomy may spell the difference between failure and success. *We, therefore, recommend autonomy in pricing policy for all commercial-type ventures.* Not to give this flexibility is to deny the basic idea that local governments could operate as firms with respect to some of their activities.

The objective of commercial ventures is to raise funds for government, i.e., to make profits, and the Central Government should give maximum incentive for local governments to achieve this goal. *For purely commercial enterprises we recommend no restrictions on the level of profits which may be earned or on the disposition of these profits.*

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 enterprise 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 which are largely unconventional by government standards.

Public enterprises of a commercial nature should be assured political and economic autonomy. Once the objectives and production targets have been explicitly specified, the day-to-day operation of the enterprise should be left to the enterprise manager. *We recommend that business type enterprises of local governments be given flexibility in terms of hiring and wage determination and in terms of general operating decisions.*

Accounting Reforms. On the basis of our case study analyses, one issue has become clear: proper measurement of profitability will be required if management is to be held accountable fo. its efficiency and if subsidies provided to the enterprise are to be detected.

To improve overall decision-making, generate a more cost-conscious management behavior, and facilitate performance monitoring of the enterprise, we recommend structural changes in the existing government accounting practices. Among other things, the following measures should be considered:

- *Adopt a system of enterprise accounting that includes depreciation (or consumption of fixed capital) in the product accounts.*

- *Require the measurement and accounting of all forms of subsidy--either explicit (e.g., capital subsidy, statutory transfer, grants) or implicit (e.g., tax exemptions, preferential loan subsidy).*

- *Call for the maintenance of a separate set of accounts for the enterprise. Transfers to and from any Government Funds (General, Infrastructure, Trust, Sinking, Fiduciary, etc.) should be recorded.*

The Increased Use of Credit Financing

One important barrier to increased capital formation by local governments, 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 there have been relatively few takers. Over the five year period from 1976 to 1980, the three authorities combined underwrote only 180 projects totalling ₱573.5 million. In other words, only about one out of every ten local jurisdictions had a project loan approved during this five year period, and by 1980, total loans had fallen to a level equivalent to just slightly more than 2 percent of gross revenues of local governments. Moreover, the 1980 figure for total outstanding balances of ₱415.1 million is some ₱158.4 million less than the total for the five year period, which suggests that the rate of loan repayments is outpacing the growth of new loans, i.e., the trend is in the direction of even less use of credit financing.

In light of the government's desire to encourage local government borrowing for income-generating projects and the many initiatives it has taken in that direction, it is important to understand why so few local

governments have sought credit financing. Our data analysis, field interviews, and case studies have lead us to five explanations:

(a) Local governments do not have the experience or technical expertise to prepare the feasibility studies or other documents required for a loan application.

(b) There is a fragmented system of loan financing that mitigates against lenders establishing specialized staff to provide technical assistance to local governments.

(c) There is a complex set of compliance procedures which both frustrates local officials in their pursuit of loan financing, and seriously delays the lender's approval of acceptable projects.

(d) A combination of conservative application of the "net paying capacity" requirement, loan maturities that are far shorter than asset life, and what are seen as high interest rates have disqualified some local governments and discouraged others from applying.

(e) Some elected local officials and treasurers have a very conservative fiscal attitude and tend to favor pay-as-you-go financing.

In light of these problems, it is apparent that rather substantive changes must be made in the present system if local governments are to be encouraged to undertake credit-financed projects. Essentially, the options are (a) to rectify the problems of the present system by pursuing changes in current policies, procedures and practices, or (b) 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 tips in favor of the establishment of a new, specialized credit facility for local governments.* Our basic reason for recommending this option 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. It is doubtful, in our opinion, that the support would be forthcoming at the level required without the establishment of a specialized facility.

The organization of such a new authority should pose no great problems. Though the matter requires some careful study, one could envision an authority established by law and governed by a Board of Directors, comprised of 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, and Economic Development (NEDA), Human Settlements and the Governor of the Central Bank. An equal number of local 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 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 sector, it will be possible to initially 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:

(a) to stimulate the undertaking of capital projects
(b) to encourage the initiation of income generating projects
(c) to stimulate local government tax effort.

In a nutshell, the objective is to design a credit authority financing scheme which 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 will obviously require a detailed financial study, hence we can but suggest the magnitudes of funding involved. *We recommend capitalization from two sources. The first is an annual share, perhaps 10-20 percent, of the proposed consolidated Allotment.* This presumes, of course, that the government begins fully distributing the Allotment. *The second source is approximately ₱200 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 an external donor. *We would recommend attempting to revive the USAID proposed support for a development bank, if it could be agreed that the primary purpose of the effort is to strengthen local government rather than to provide subsidies to low income governments.* With external funding, however, 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. *We recommend that the interest rate be set to vary inversely with the amount of cash equity a local government has in the project, to lengthen the maturity of loans to more accurately reflect the economic life of the asset being financed, and that the authority consider funding some capital projects which are non-income generating but which may enhance the performance of the local economy. We also recommend interest rate subsidies for local government loans.* The size of these subsidies, however, will be very much dependent on the method of capitalization chosen.

The Costs and Benefits of Reform

The costs of this reform program might be weighed against the potential benefits to be received. On the costs side 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, the more efficient fiscal operations of local governments, increased capital project activity, decentralized government fiscal activity, and for the long-run, a stronger local government sector. 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. We can say with some confidence, however,

that a piecemeal reform, e.g., one which leaves out the incentive elements, is likely to generate the costs without the benefits. On the other hand, to try to reform local finances at no cost, by not providing the funding for inducements or for the increased Ministry staffing, will generate little improvement.

Costs

The costs of this reform program are enumerated, insofar as is possible, in Table ES-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 would amount to about ₱1 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 ₱1 billion. Some careful study will be required to update the undistributed amounts, but we would 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 is a cost only if the outlay needs exceed the undistributed portion, since the present Allotment system is already earmarked for the local government sector.

It will require a great deal more study to estimate the other costs implied in Table ES-1. The cost of supplementing the MOF Revolving Fund for tax mapping will depend on a number of factors, e.g., how much the government wants to push tax mapping, whether an integration with the USAID/MLGCD program can be worked out, whether the MOF staff is shored up to accommodate an increased volume of tax mapping activity. A doubling of the size

TABLE ES-1

FUNDING REQUIRED FROM CENTRAL GOVERNMENT SOURCES

Reform Action	Funding
1. Consolidated Allotment Program	There should be a full distribution of the authorized PIR, Specific Tax, and National Tax Allotments. At 1979 levels, this would imply distributing $1 billion more than was actually the case.
2. Local Government Credit Authority	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 (USAID) and the barangay shares of the Allotment.
3. Supplementing MOF Revolving Fund for tax mapping, and providing additional staff to review mapping proposals.	New Central Government funding; merger of USAID/MLGCD with MOF Revolving Fund would provide further support.
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	New funding from Central Government; merger of USAID/MLGCD program with MOF Revolving Fund would provide further support for (b).
5. Cost-Sharing for Local Business Tax Collector for three years.	New Central Government funding.
6. Payment-in-lieu of Property tax on government properties	New Central Government funding.

of the Revolving Fund would add measurable support to tax mapping efforts.

If local government finances are to be strengthened in a context of the highly centralized Philippine system, the size and expertise of the Central Government agencies which 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 all essential to the efforts proposed here. A government appropriation of as little as ₱2 million spread over the next 5 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 such as USAID and the World Bank.

Another proposal which would require additional Central Government funding is the cost sharing for a business tax collector. The cost should be rather small. For purposes of illustration, assume two such collectors per province and assume that the government bears, (a) an initial training cost of ₱5000 per collector, (b) a salary and benefits cost of ₱14,000 per collector per year, and (c) a central level supervisory cost of ₱50,000 per year. The total three-year cost would be about ₱3 million.

Finally, there is a proposal for payment-in-lieu of property taxes on government property and on some government granted exemptions. We have a rough estimate from our sample that about 10 percent of total assessed values are exempt. Since this estimate is derived from data in Iloilo and

Albay, we might suppose it to be representative of the non-Manila portion of the Philippines. If half of these exemptions are covered under this proposal, the annual cost to the government would have been about ₱40 million in 1979.

Obviously, these are the roughest of estimates but they give some idea of the cost of this program. The costs suggested here would seem quite minimal. In 1979, the cost of this program would have been less than 3 percent of total Central Government expenditures. By comparative standards, such a program is 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 warrants this kind of expenditure.

Benefits

This reform program brings two kinds of potential benefits. The first are the improvements in the efficiency of local government operations, shown in Table ES-2. In effect, these improvements can be had without the major reforms described above and with little cost, though 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 falls short of achieving government objectives in other areas. It does not provide incentives for the local governments to mobilize additional revenues, 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 fiscai activities. These objectives are served by the second component of this reform program.

TABLE ES-2

PROGRAMS TO INCREASE THE EFFICIENCY OF LOCAL GOVERNMENT OPERATIONS

Reform	Effect
1. Form a review office to deal with interministerial conflicts concerning local government finance.	1. Increased revenue generation, improved expenditure and managerial efficiency.
2. Eliminate the practice of supplemental budgets.	2. Increased efficiency in local government expenditures.
3. Require capital budgets of larger local governments.	3. Improved fiscal planning.
4. Eliminate fractional assessments in real property taxation.	4. Will remove property tax disincentive to real property investments.
5. Instigate a program of phased reassessment of property values.	5. Improved taxpayer compliance.
6. Make more use of barangay campaigns.	6. Improved taxpayer compliance.
7. Accounting reforms for local government public enterprises	7. Increased efficiency in local government operations.

The potential benefits described in Table ES-3 are more in the areas of increased revenue generation and capital spending. We have listed 12 areas where the incentives provided should induce local governments to increase tax effort and capital expenditures, but it isn't possible to estimate what the increase might be. Moreover, in some cases the benefits are quite long-run, e.g., to encourage tax mapping and improved property tax record-keeping now is to invest in the basis for an improved property tax effort in the future.

Conclusions: Next Research Steps

We recognize that this research has but scratched the surface of the local finance issue in the Philippines. With respect to needed reform, we have perhaps raised as many questions as we have answered. On the other hand, much has been learned about local government finance in the Philippines, and the general direction of the reforms proposed here are consistent with government policy and all of these reforms are at least administratively and financially feasible. We would urge building on this momentum 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 and intergovernmental relations.

TABLE ES-3

INCENTIVE PROGRAMS TO INCREASE LOCAL GOVERNMENT REVENUE MOBILIZATION

Reform	Response from Local Government
1. Earmark 60 percent of Consolidated Allotment for Infrastructure expenditures.	1. Stimulate economic development expenditures; increase revenue generation.
2. Permit use of Infrastructure share of Consolidated Allotment for covering some portion of local share of tax mapping cost and a share of the cost of a property tax records clerk.	2. Increase revenue generation from real property tax.
3. Introduce a tax effort component into the Consolidated Allotment formula.	3. Increase local government tax effort.
4. Increase the size of the MOF Revolving Fund for RPTA improvement; provide additional MOF staffing to support these loans; and relax the terms of repayment.	4. Increase real property tax collections and administrative efficiency.
5. Merge or coordinate the MOF and USAID tax mapping programs and provide greater incentive grants for tax mapping.	5. Increase tax mapping activity.
6. A cost sharing program for a Local Business Tax Collector.	6. Increase business tax collections.
7. Variable interest rate program and lengthened maturities for local government credit financing.	7. Stimulate spending for income generating projects; increase revenue effects.
8. Increase penalty rate for property tax delinquency; barangay campaigns.	8. Increase property tax collections.
9. Vigorous Central Government action against property tax delinquents.	9. Increase property tax collections.

TABLE ES-3 (CONT.)

Reform	Response from Local Government
10. Reduce earmarking and restrictions of local government budget allocations: a. eliminate transfer to Infrastructure Fund b. review 18 percent INP requirements.	10. Increase local government revenue effort.
11. Encourage idle lands taxation and special assessments	11. Increase local government revenue effort and stimulate capital spending.
12. More flexibility in pricing and disposition of surplus for local government public enterprises.	12. Increase local government revenues.

This analysis of fiscal performance and behavior has been carried out largely on a sample of four provinces, and it would not be prudent to base policy changes on so limited a sample. This analysis badly needs to be extended to a nationwide sample to see if the results will stand up. In some areas, e.g., 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 basis for policy changes. In other cases, e.g., the finding of surpluses and cash balances, the question arises as to whether this is commonplace or a quirk of the four provinces we chose for study. Finally, in some areas of inquiry--for example, the fiscal structure and performance of market enterprises--the sample was much too small to enable us to pick up regularities that may exist.

The second important research task is to work out the specific detail 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 detail 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 believe that a Consolidated Allotment system would have much merit. However, we have not even begun the detailed design of such a system.

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 monitored and understood. This will require the producing of annual, relatively timely

data on local government finances. 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, the state of municipal accounting practices being what they are, some detailed design work will be a first step. Our opinion, based on working with these data, is that such an undertaking is feasible. The analysis produced above for the four provinces is evidence, we would hope, of the valuable uses to which such data might be put.

A possible action by the Central Government is to appoint a high level working group to direct and coordinate research and policy formulation in this area. Should this happen, we would urge that these three suggestions be on the agenda.

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CHAPTER I

INTRODUCTION

The objective in this research is to develop a strategy for improving the fiscal performance of local governments in the Philippines. "Fiscal performance" in this report is taken to mean the mobilization of more local resources for local financing purposes and the more efficient use of available local revenues.

How can local governments be induced, or coerced, into improving fiscal performance, i.e., what set of incentives and penalties might be used as instruments? An enumeration of these instruments is what we mean by developing a "strategy." As will be quickly recognized, this strategy will require a partnership between the Central and local governments. This is because the Philippine system of local government is quite highly centralized. While many improvements can be made with straightforward adjustment of certain local government fiscal practices, most reforms will require Central Government action. Indeed, an assessment of the constraints to improved local revenue administration leads one quickly to the intergovernmental grants (Allotment) system and to the problems associated with earmarking local government revenues and mandating certain local government expenditures.

This report is presented in three parts. In Part One, we focus on local government budgeting practices and on the traditional channels for increasing revenues--taxation and intergovernmental relations. In Part Two, we study the potential for local government public enterprise financing and in Part Three, the possibilities for increased use of credit financing of long-term projects.

In most of this report, we have followed the rather standard approach of identifying objectives of government policy, problems and constraints to achieving these goals and analysis of reform options. Along the way we have included a great deal of descriptive material, particularly about how the local finance system operates in the Philippines. We felt this was essential to establishing a common frame of reference with local analysts involved in the larger PIDS effort. It should be noted, however, that not only foreign consultants have need to record their understanding of how the system works. In the Philippines, as in most countries, there is not a clear, written statement of how the system of local finances actually works and no single office seemed to have a complete view. Our piecing together of various elements of the system--gathered from interviews in many different offices, data analysis and a reading of the laws--is by no means complete, but it might be a reasonable beginning. As we will note again below, there is need for a text on the structure and practice of local governance and finance in the Philippines. This work might provide a useful start in that direction.

Because of the usual time and resource constraints and because of the mandate we were given, the scope of this report is limited in several respects. First, we have purposely excluded the local governments of Metro Manila because GOP interest in this study had to do with strengthening the finances of other local governments in the country. Yet Manila's primacy is such that it may lead other local governments in fiscal and budgetary reforms. Moreover, Manila competes with other local governments

for funds and personnel, creating interdependencies that probably should not be overlooked. On the other hand, Manila's size, economic dominance, stage of development, national capital status and special place in the local government system make it a unique situation; i.e., fiscal reforms that answer Manila's problems may not be easily transferable to other local governments in the country.[1]

Second, our treatment of the local government sector is somewhat uneven in that we have paid more attention to municipalities than to cities and provinces. This wasn't a completely arbitrary decision. There are many more municipalities, their revenue mobilization efforts are thought to be generally poorer than those of cities and there seems to have been less work done on the fiscal problems of municipalities. Moreover, a World Bank-financed study is in process of studying the fiscal system of five secondary cities.[2]

A third limitation is the scope of our more detailed field work and empirical analysis. In various parts of this analysis, case studies of representative local governments have been carried out in Albay, Bulacan, Iloilo and Sorsogon Provinces. Where financial accounts were scrutinized below the detail given by the Commission on Audit (COA), sample jurisdictions were drawn from these Provinces. A nationwide, random sample would have been better for some purposes, but was simply too expensive. The four

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[1]A summary of local finance structure and practice in Manila is provided in NTRC, Overview of Metropolitan Manila Public Finance, Vol. III in the Metro Manila Public Finance Series (Manila, 1977). Recommendations for altering its revenue structure are contained in another volume in that series, Highlights of the Proposed Metropolitan Manila Revenue Code (Manila, 1978).

[2]Cebu, Davao, Iloilo, Bacolod and Cagayan de Oro.

Provinces chosen here were on a basis of income level and some preliminary notion about the quality of their financial management.

Fourth, we have not delved into the day-to-day problems of fiscal administration which plague local governments. Some of these issues are covered in the forthcoming PIDS study, some are covered in ongoing revisions of real property tax administration in the Ministry of Finance, and others are under study by various USAID and World Bank teams. In light of this much effort, it seemed appropriate to concentrate our efforts relatively more on structural issues.

Part One

Improving Local Government Revenue Effort and Expenditure Efficiency

CHAPTER II

LOCAL GOVERNMENT STRUCTURE, FINANCIAL MANAGEMENT, AND FISCAL CONDITIONS

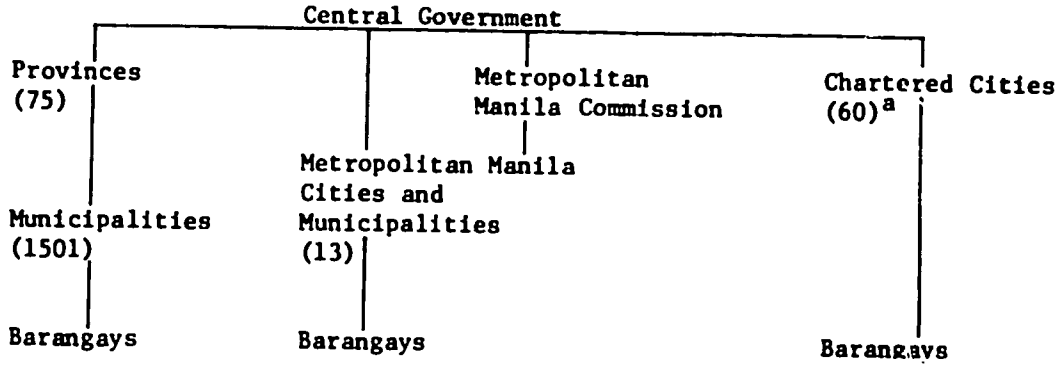
Most of this report is concerned with whether the Philippine system of local government works. Common sense dictates that evaluation of the system be based on an understanding of how the system is *supposed* to operate. In this Chapter we begin by reviewing the structure of local government and financial management practices. This brings us to a first set of financial management and budgeting problems which hamper the efficiency of local government operations. We then turn attention to the matter of "uncontrollability" of the local budget in order to assess the extent to which local governments can be held accountable for what appears to be a poor fiscal performance. In the latter part of the chapter the spending and taxing patterns of a sample of local jurisdictions are reviewed and some evidence is provided on wide variations in local government tax effort, on some inefficiencies in cash management practices, and on an identification of some important obstacles to increased resource mobilization.

Local Government Structure

The government structure in the Republic of the Philippines (ROP) is highly centralized with the National Government selectively delegating powers to its several lower governmental bodies--provinces, cities, municipalities and barangays (or barrios). The basic structural organization is diagrammed in Figure II-1.

FIGURE II-1

THE STRUCTURE OF LOCAL GOVERNMENTS IN THE PHILIPPINES



[a]Including cities in Metropolitan Manila.

While the 1959 Republic Act 2264 lifted certain restrictions regarding the taxing power of municipalities and the new Constitution, Article XI, Section 5, provided new powers to localities to create their own revenue sources, this centralized orientation has been retained. Although centralization has important disadvantages--lo . autonomy and, perhaps, initiative may be thwarted--it has the important management advantage of allowing the Central Government to deal with local governments which have relatively homogeneous fiscal structures and practices. The homogeneity results because most of the powers and duties and even administrative practices of local governments are prescribed centrally. Without this homogeneity, any measure of effective control over the 1500 or so local governments in the nation would be impossible.

The 75 provinces and sub-provinces in the Philippines have specific responsibilities and functions. Among the offices located at the provincial level are the governor, vice governor, provincial board, treasurer, assessor, district auditor, register of deeds, court of first instance, superintendent of schools, district engineer and health officer. The assessor and treasurer are representatives of the National Government rather than the province--a very important feature of the centralized nature of local financial administration in the Philippines. The provincial government collects taxes (some in conjunction with municipalities), constructs highways and bridges, dispenses justice and, of particular interest here, supervises the operations of municipal governments.

Each province is fully[1] subdivided into municipalities--geographic areas usually containing at least a small semi-urbanized market area. There are currently 1501 municipalities within the ROP. Each has a mayor, vice mayor, council, treasurer, secretary, justice of the peace, and since the issuance of Presidential Decree (PD) 464 (Section 90), a municipal deputy assessor appointed by the provincial assessor but with two-thirds of his salary paid by the municipality. The municipality provides some localized services including markets, certain public works such as local roads, local justice, and has some local development responsibilities. It is important to note that the chief financial officers of the municipality, treasurer and assessor, are supervised at the provincial level and therefore implicitly by the Central Government.[2]

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

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[1]There are no unincorporated areas.

[2]At the time of this research a new position of local budget officer had been created but it is not yet certain how this new position will alter local financial practices. It is clear, however, that her direct responsibility will be to the Ministry of the Budget (MOB).

The barangay (or barrio) has existed as a neighborhood unit of local government since the Colonial Spanish era. The original barrio charter was contained in Republic Act 2370 (1959) and replaced by Republic Act 3590 (the Revised Barrio Charter) in 1963. The government has recently expressed considerable interest in making more use of the barangays. They have been given increased grants, increased powers for raising revenues and increased service provision authority. Most recently the barangay has been used as a means to organize citizens for various civic purposes--a program known as "barangay brigades".

In general, then, much of the activity of the local public sector, even if not financed by the National Government, is influenced in great part by Central Government policies and directives. The barangay movement may be a move towards "taking the government to the people"; yet even its development has been largely directed from above. Indeed, as we shall show in Chapter V below, the barangay programs have indirectly led to accelerated centralization.

The Declining Local Public Sector

Local government in the Philippines has been weakening. The past decade has seen a continuing decrease in the size of the local government sector relative to that of the Central Government--from 20 percent in 1969 to less than 11 percent by the end of the decade (Table II-1). If the ratio of local expenditures *from own sources* to central expenditures is charted, the decline is from 9 percent in 1969 to 7 percent in 1979. It seems pretty clear that the trend of the 1970s was increased fiscal centralization.

TABLE II-1

CENTRAL AND LOCAL GOVERNMENT EXPENDITURE GROWTH,
SELECTED YEARS: 1969-78
(millions of current pesos)

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

[a]Estimates.

[b]Grants are excluded from Central expenditures but included in local government expenditures.

SOURCES: Budget of the National Government for Fiscal Years 1969-75, President's Budget Message, calendar year 1976-79; Commission on Audits Report's on Local Government (1969-71), Ministry of Finance, (1972-1979) as reported in Daniel Holland, Michael Wasylenko and Roy Bahl, "An Evaluation of The Real Property Tax Administration Project," Local Revenue Administration Project, The Maxwell School, (Syracuse, NY: Syracuse University, October 1, 1980), Table 3, p. 16.

Per capita local government spending did increase during the 1970s but mostly because of inflation (see Table II-2). In fact, if we adjust for increases in population and prices, there has been virtually no growth in Philippine local government spending during the last decade.

Why has the relative and absolute size of the local government sector not been increasing? Certainly a plethora of unmet local public service needs are present in every city and municipality. One possibility is that centralization of government finances is an overt policy of the Central Government, i.e., that growth in the local government sector is not being encouraged. This would not seem to be the case. In addition to Republic Act 2264 and Article XI, Section 5 of the new Constitution, there have been statements made at the Central Government level that increased local government revenues is a national priority. For example, in PD 464, Enacting a Real Property Tax Code, President Marcos noted that "this country cannot progress steadily if its local governments are not potent political subdivisions contributing their proportionate shares to national progress" and that it was imperative to local governments be able to provide "...adequate funds with which to underwrite basic and essential public services within their respective areas of responsibility."[1] Promoting local economic development through increased local revenue mobilization also has been prominently stated as a national goal.[2] Additional actions since the issuance of this decree would suggest that these goals are still under active pursuit.

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[1] PD 464, Preamble (May 20, 1974).

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

TABLE II-2

PER CAPITA LOCAL GOVERNMENT EXPENDITURE GROWTH, SELECTED YEARS: 1969-78
(in current and constant 1972 pesos)

	Per Capita Expenditure Current Pesos	Per Capita Expenditure Constant Pesos
1969	44.35	67.20
1971	27.25	29.45
1973	36.43	31.27
1975	52.34	31.36
1977	64.31	32.09
1979	78.57	31.36
Average Annual Percent Increase Between 1969-79	5.9	-7.3 (0.8)[a]

[a] 1971-1979.

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

The problem, then, would not seem to be a lack of intent. Another possibility is that other, more pressing national needs temporarily halted government progress in this area. The 1970s were years of important social and political change in the Philippines, new directions for investment were being established, and there was a worldwide recession and an energy crisis. One hope would be that the 1980s will provide more breathing space for government policy, and allow some greater concentration of the problems of strengthening local government finances.

There are other factors which explain some of the slow growth in the local government sector. The Central Government may not have gone far enough in taking steps to increase local government taxing and capital project spending or it may not have gone about things in the right way. One might begin to think about structural problems in the latter regard, e.g., the grant system may not be designed to make governments accountable or to stimulate them to increase their own tax effort, revenue earmarking may unnecessarily dilute local government expenditure choices and dampen the willingness to tax, too little Central Government support may have been given to local government tax administration and enforcement, and the possibility of leveraging local revenues with borrowings for capital financing has not been provided. Such problems fall under a heading of inadequate penalties and incentives to draw out a more substantial local government participation, and the declining local government sector may well be a reflection of these inadequacies. Indeed, an initial reaction to a reading of government policy in this regard is that there may have been too much use of the stick and too little of the carrot.

Local Government Budgeting and Financial Management

It quickly becomes clear to anyone working on local government finance in the Philippines that important bottlenecks to increased revenue mobilization and to a more efficiently functioning local government sector are (a) the substantial restrictions placed on local government expenditures by the Central Government and, (b) inefficiencies in the local government budgeting/financial management process. Reforms in tax policy, credit policy or the Allotment system simply cannot be evaluated independently of financial management practices and Central Government expenditure mandates. Certainly an understanding of the fund structure of the local government accounts and of the extent to which local governments may "control" their budgets is a necessary starting point.

Fund Structure

PD 477 (June 3, 1974) established a common fund structure for all local governments in the Philippines. Each jurisdiction has two funds--the General Fund and the Infrastructure Fund. Expenditures from the latter are to be used exclusively for the following:

1. The repair, maintenance, improvement, and construction of roads, bridges, and highways. However, in applying this fund to such uses, adequate provision shall be made for the maintenance of existing, unabandoned roads and bridges before new construction is undertaken.

2. The providing and maintaining of wharves, piers, and docks, in accordance with plans and specifications furnished by the proper national office, and for removing obstructions to navigation.

3. For subsidizing or for acquiring, operating, and maintaining means of water transportation within the province or city or between the province or city and neighboring provinces and cities or islands or to dredge rivers and provide facilities for communication and transportation by river, as well as for establishing and operating telephone systems.

4. The construction, improvement, maintenance and repair of wharves, piers and docks; plazas, parks, monuments and playgrounds; street lighting; artesian wells; irrigation systems; flood control systems; sewerage and drainage systems; and other permanent public improvements.

5. The acquisition of lands and buildings for public use.[1]

The General Fund is the source of all other spending within the local jurisdictions (other than for education). More specifically, the General Fund

> "consists of monies and resources not otherwise accruing to any other fund and shall be available for the payment of expenditures, obligations or purposes not specifically declared by law as chargeable to, or payable from, any other fund, though transfers of monies or resources therefrom to other funds of the local government for their augmentation and use may be made by proper appropriation."[2]

It should be emphasized that the distinction between the General and Infrastructure Funds is not identical to a separation into current and capital expenditures, as might seem implied from the above descriptions. Indeed, the General Fund may contain capital construction expenditures and the Infrastructure Fund obviously contains current spending for maintenance activities on roads, bridges, etc. Moreover, though expenditures in the Infrastructure Fund are generally developmental in nature, there are also economic development type expenditures contained in the General Fund. What this means is that a full accounting of development activities carried out by

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

[2] Ibid., p. 8.

local governments cannot be obtained simply by concentrating on Infrastructure Fund activities. To complicate matters further, there are substantial interfund transfers, a feature which makes an adventure of the construction of a consolidated local government budget.

The focus of this study is on these two funds, but there is a third fund administered by the local treasurers, the Special Education Fund (SEF). It is devoted exclusively to the provision of elementary level education. The National Government directly provides personnel expenditures for education, while nonpersonnel expenditures are supported from the SEF. The primary local revenue source supporting this fund is the real property tax, although in some localities periodic transfers from the General Fund to the SEF are also made.

Budgeting Problems and Issues

A number of issues, perhaps problems, have arisen in connection with this fund structure and current budgeting practices. These issues have to do with transfers between the Infrastructure and General Funds, the allowing of supplementary budgets, capital budgeting and the overall supervision of the budgetary process.[1]

Fund Transfers. While there is a statutory requirement that funds be transferred from the General Fund into the Infrastructure Fund (8 to 12 percent of General Fund net income with the exact percentage depending on the classification of the jurisdiction), additional transfers are permitted if the purpose for the transfer is clearly stated (Local Budgeting Regulations 1-74). However, sizeable increases in the petroleum excise

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

tax, the principal revenue of the Infrastructure Fund, have raised the possibility that local fiscal conditions may now require transfers from the Infrastructure to the General Fund. The Budgeting Regulations (issued in conjunction with PD 477) state that such reverse transfers are possible "...only from the unappropriated balance of the (Infrastructure) Fund and to cover exceptionally urgent needs of the local government" and with the approval of the Finance Minister.[1] The problem is that neither the earmarking of the petroleum excise tax nor the mandated General Fund transfer were thought through in terms of whether the Infrastructure Fund can, or should, absorb that large a share of local revenues. We return to this issue in Chapter V below.

Supplemental Budgets. 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. Under PD 477 there is a limitation of one supplemental budget per month (unless truly exceptional circumstances arise in which case additional supplementals may be prepared). From discussions with local officials, it appears that the one supplemental per month is indeed used (in fact at least one official interviewed bemoaned the fact that only a single monthly supplemental could be used). This practice does not stimulate serious fiscal planning for the full fiscal year, since 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 supplemental budgets in the Philippines surely leads to less efficient overall planning of fiscal affairs.

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[1] Budget Operations Manual for Local Governments (Manila: Provincial and City Treasurers and Assessors Association, undated), p. 82.

Capital Budgeting. There have been attempts 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. Moreover, 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. Neither of the motives that typically lead to an effective use of capital budgeting are present in the Philippines. The first is the need to understand the relationship between current and capital expenditure requirements, e.g., to know the annual maintenance costs associated with the construction of a new road or bridge.[1] However, if the annual budget is not used as a planning device, there will not be much interest in this question. The second usual reason for capital budgeting--the planning and scheduling of debt repayment--is not a stimulus in the Philippines because there is relatively little use of credit financing by local governments. It would seem clear that the greater use of credit financing--an issue which we take up in Part Three of this report--will require establishing some sort of effective capital budgeting process.

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

Financial Oversight Problems. Several different Central Government organizations are involved in the financial oversight of localities. This overlap is bound to create problems in the review process.

The Ministry of Finance oversees the principal local fiscal manager--the treasurer--and, until recently, also reviewed the annual as well as all supplemental budgets approved at the local level. This arrangement was altered under PD 1375 (May 1978) when the budget review responsibility was passed to the Ministry of the Budget. After a municipal budget is approved, it is sent to the provincial budget officer who then sends it--with recommendations--to the regional MOB representative for approval. While this review process considers such budgetary aspects as the reasonableness of the revenue estimates, its relationship to the capital improvement program, etc., the only grounds for outright budget veto is if it in any way conflicts with the several statutory budgetary limitations placed on localities.[1]

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

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[1]These are itemized in the "controllability" discussion below.

Finally, overall auditing of the financial affairs of local governments is carried out by the Commission on Audits of the Central Government. While not directly comparing budgeted amounts with actuals, this Commission is charged with at least measuring the financial soundness of local government units.

In essence then, the local fiscal management function is overseen by at least four different Central Government bureaucracies.[1] While there may be considerable rationale and even need for this division of labor, it must be recognized that such fragmentation surely imposes costs. Different Ministries have different priorities which lead to possible conflicts in the directives and requirements given to local governments. Because of these conflicts and the sheer time cost of complying with these requirements, local government fiscal management is almost certainly less efficient than it otherwise would be.

This overlap in the oversight function highlights a more fundamental problem. The Central Government seems to have decided that local fiscal activities must be highly controlled--the advantages of this control must be thought great enough to offset the advantages of greater local autonomy. Yet by not coordinating the control of fiscal affairs, the government is losing one of the significant advantages of centralization.

Controllability of the Local Budget

The centralized orientation of local financial management is no more strongly evident than in the various restrictions placed upon localities

[1] This does not, however, exhaust the list of Central Government agencies that have some influence over the fiscal activities of local governments. For example, the delinquent tax collection process involves the Ministry of Justice while market and slaughterhouse operations (see Part Two of this report) are influenced by decisions in at least nine Central Government agencies.

even greater effect would have been observed in Albay which, in 1979, collected approximately ₱0.697 million at the provincial government level. Using a similar assumption as above, revenues of the province would have increased by 32 percent. The data in Table III-2 show a generally slower growth in exempt than taxable values, suggesting that the opportunity cost of exemptions has been declining.

Subareal differences in the rate of increase in the property tax can be seen from the data in Tables III-3 and III-4 for municipalities in the Provinces of Iloilo and Albay respectively. While some of the differences in the growth rates are due to altered jurisdictional boundaries, one can see the rather considerable differences in these rates for the four sub-periods used. Again the extremely slow growth rates during the 1960s are apparent from the Table while the 1970-75 period is influenced by the effects of both the PD 76 and the 1974 reassessments.

Property Tax Rates and Additional Levies

Real property tax rates are limited by statute, as shown in Table III-5. The statute seems to suggest that provinces and their constituent municipalities can levy differential rates. In fact, this is not the case. Item (3) of Section 39 in PD 464 requires municipal tax rates to be approved by the Provincial Board. Moreover, property taxes collected on any parcel are divided among the province, municipality and barangay (in which the parcel is located) on a 45 percent-45 percent-10 percent basis.

TABLE III-3

PERCENT INCREASE IN TAXABLE ASSESSED VALUATION IN ILOILO MUNICIPALITIES: 1960-1979

	Municipality	1960-1965	1965-1970	1970-1975	1975-1979
1.	Ajuy (R-2)	6.1	4.2	309.7	158.0
2.	Alimodian (R-3)	38.2	5.6	207.4	63.5
3.	Anilao (R-3)	87.5	0.4	228.7	184.8
4.	Badiangan (R-3)	a	0.6	209.1	61.0
5.	Balasan (R-2)	-0.1	2.2	353.0	80.0
6.	Banate (R-2)	4.7	11.0	335.4	119.5
7.	Barotac Nuevo (R-3)	90.6	8.5	147.6	135.4
8.	Barotac Viejo (R-2)	5.9	6.8	366.9	115.7
9.	Batad (R-2)	2.6	2.7	276.9	169.6
10.	Bingawan (R-3)	b	c	353.2	53.6
11.	Cabatuan (R-3)	45.8	1.6	185.3	61.2
12.	Calinog (R-3)	69.1	-24.6	1476.2	102.5
13.	Carlos (R-2)	1.9	13.8	236.9	147.9
14.	Concepcion (R-2)	1.0	4.3	275.0	129.6
15.	Dingle (R-3)	120.5	2.3	157.3	68.6
16.	Duenas (R-3)	80.3	3.4	308.2	67.4
17.	Dumangas (R-3)	78.5	2.9	127.2	134.9
18.	Estancia (R-2)	18.2	6.1	333.4	86.8
19.	Guimbal (R-2)	7.4	10.9	266.1	89.7
20.	Igbaras (R-2)	0.3	8.2	285.3	99.4
21.	Janiuay (R-3)	9.6	7.1	237.1	68.0
22.	Lambunao (R-2)	6.5	16.8	356.2	85.9
23.	Leganes (R-3)	67.2	4.8	175.3	113.0
24.	Lemery (R-2)	2.3	4.5	331.4	147.6
25.	Leon (R-3)	52.7	5.8	161.9	81.4
26.	Maasin (R-3)	66.1	11.8	184.3	66.5
27.	Miagao (R-2)	4.1	8.9	402.1	30.0
28.	Mina (R-3)	a	-1.2	145.4	59.9
29.	New Lucena (R-3)	46.1	11.7	127.6	128.8
30.	Oton (R-3)	84.2	3.7	152.1	117.2
31.	Passi (R-3)	79.9	3.7	943.2	25.8
32.	Pavia (R-3)	62.5	10.0	240.0	232.8
33.	Pototan (R-3)	52.0	1.0	132.5	107.9
34.	San Dionisio (R-2)	2.7	12.7	160.6	215.1
35.	San Enrique (R-3)	168.8	7.0	131.4	64.6
36.	San Joaquin (R-2)	-26.3	62.0	295.5	126.9
37.	San Miguel (R-3)	46.7	3.8	139.2	79.8
38.	San Rafael (R-2)	b			132.3
39.	Sta. Barbara (R-3)	40.2	5.3	131.8	155.7
40.	Sara (R-2)	2.9	9.7	313.2	156.6
41.	Tigbauan (R-2)	-2.3	13.6	227.5	154.2
42.	Tubungan (R-2)	0.3	9.4	329.2	80.4
43.	Zarraga (R-3)	45.3	2.5	217.0	101.3
	Total	194	6.0	315.2	95.3

TABLE III-7 (CONT.)

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[a]No data for 1960.

[b]No data for 1960 nor 1965.

[c]No data for 1965.

[d]No data for 1965 nor 1970.

[e]No data for 1970.

SOURCE: Data supplied by Assessor, Iloilo Province.

TABLE III-4

GROWTH IN TAXABLE ASSESSED VALUATION IN ALBAY MUNICIPALITIES: 1960-1979

Municipality	1960-1965	1965-1970	1970-1975	1975-1979
1. bacacay	17.58	39.65	113.56	8.86
2. Camalig	15.22	29.24	164.42	41.90
3. Daraga	34.06	32.82	128.15	20.51
4. Guinobatan	1.90	24.25	140.95	-3.19
5. Jovellar	10.94	22.20	189.45	16.99
6. Santo Domingo	36.22	449.30	-20.55	15.84
7. Libon	37.69	-63.36	1509.48	235.67
8. Ligao	21.75	28.03	203.21	27.78
9. Malilipot	11.03	29.40	119.10	26.31
10. Malinao	10.58	20.18	197.61	15.99
11. Manito	13.58	38.29	143.25	43.20
12. Oas	32.47	36.42	175.00	21.48
13. Polangui	25.60	36.80	165.68	24.85
14. Rapu-Rapu	7.11	33.80	202.86	16.95
15. Tabaco	42.18	21.69	82.55	49.17
16. Tiwi	11.25	17.89	299.61	32.32
17. Pio Duran	a	42.44	109.95	14.49
Total	29.36	30.27	166.22	45.04

[a]No data for 1960.

SOURCE: Data supplied by Assessor, Albay Province.

TABLE III-5

PROPERTY TAX RATE LIMITS

Tax	Jurisdiction	Rate Tax Limits
Basic Tax[a]	Province and Municipality	1/4 to 1/2 percent
	City	1/2 to 2 percent
Special Education Fund	Province or City	1 percent[b]

[a] In addition, under PD 888, timber and forest lands have a fixed rate of 1/2 percent in both municipalities and provinces (a combined 1 percent rate) and a 1 percent rate in cities.

[b] The 1 percent rate does not, however, apply to total assessed value. Only properties with assessed valuations greater than ₱5,000 (under PD 1621) are taxable at this rate. (Note that it is not a ₱5,000 exemption, but a lower limit on taxable value.) The lower limit was raised from a ₱3,000 level as originally set in Republic Act 5447 of 1969.

SOURCE: PD 464, Section 39.

The SEF rate is a uniform 1.0 percent, but PD 464 provides that all tax revenues in excess of those collected in 1972 can be placed in the General Fund. This provision aids the revenue elasticity of the property tax for General Fund purposes but, in turn, restricts growth in the SEF. The size of SEF revenues is also limited by the exemption of all properties with values less than ₱5000. PD 464 states that "...when the entire total assessed valuation of real property situated in a province or city assessable to any one person does not exceed three thousand (altered to five thousand under PD 1621) pesos, the additional 1 percent tax herein imposed shall not be collected."[1]

The statute provides greater revenue capacity to chartered cities, presumably based on the expectation that the public service demands will be greater in more urbanized areas and on the wider range of servicing responsibilities given to cities.

Finally, the differential treatment of timber and forest lands using fixed rates provides both equity and efficiency effects. If one views the property tax as a tax on wealth, differential rates between land types cannot be justified on equity grounds. The flat 1 percent rate, which may be different from the prevailing rate for all other property types in a jurisdiction, provides an incentive to convert these lands to other uses if the basic rate is less than 1 percent and encourages continued use as forested land if the prevailing rate is greater than 1 percent. While the actual effect of these incentives may be small, it should be recog-

[1] Section 41 on PD 464, emphasis added.

nized that they are inherent in the rate system.

The rates that were imposed in 1975 are shown in Table III-6.[1] At that time all provinces and their constituent municipalities were levying the statutorily-maximum rates, whereas there was considerable variation in city rates, ranging from 0.7 percent (Tangub) to the legal maximum of 2.0 percent. The three instances of differential rates based either on property usage (Metro Manila), type of property (Palavan) or value (Bais) are not easily explained given the statement in Section 39 of PD 464 that the rate of levy is "... a uniform rate of real property tax..."

Special Levies

The basic tax and the SEF tax are not the only property-based taxes allowed under PD 464. Sections 42-46 provide the statutory basis for an idle lands tax while Sections 47-54 provide for special levies to be imposed by local governments (with Section 55 allowing the national government to impose special assessments on properties affected positively by Central Government public works projects).

Idle Land Tax. The idle lands tax is an additional levy on land not currently being utilized for productive purposes. The PD authorizes a rate of up to 5 percent for this purpose.[2] Idle lands are defined differently for agricultural and urban (city or municipality) areas. In the

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[1] We were unable to obtain a complete listing for a later year.

[2] PD 464, Section 42 as amended by PD 1446.

TABLE III-6

CITY PROPERTY TAX RATES: 1975

City	Tax Rates
Baguio	2.0%
Laoag	1.0
Dagupan	1.5
San Carlos	NA
Cabanatuan	1.5
Palayan	1.5 Land
	1.25 Improvements
San Jose	1.0
Angeles	1.0
Olongapo	1.0
Batangas	1.0
Lipa	1.0
Cavite	1.0
Tagaytay	1.7
Trece Martires	NA
San Pablo	1.0
Puerto Princesa	1.0
Lucena	1.0
Metro Manila	
Las Pinas	2.0 Commercial
Makati	1.5 Residential
Malabon	
Mandaluyong	
Marikina	
Muntinglupa	
Navotas	
Paranaque	
Pasig	
Pateros	
San Juan	
Taguig	
Valenzuela	
Legaspi	1.0
Iriga	1.25
Naga	1.00
Roxas	1.25
Iloilo	1.50
Bacolod	1.50
Bago	NA
Cadiz	1.0
La Carlota	2.0
San Carlos	1.0
Silay	1.0

TABLE III-6 (CONT.)

City	Tax Rates
Tagbilaran	1.0%
Cebu	2.0
Danao	1.0
Lapu-Lapu	1.0
Mandaue	1.0
Toledo	1.0
Bais	1.0 <₱3,000 Assessed Value
	2.0 >₱3,000 Assessed Value
Dumaguete	1.0
Canlaon	1.5
Caibayog	1.0
Ormoc	1.0
Tacloban	1.0
Pagadian	1.25
Zamboanga	1.00
Butuan	1.00
Ozamiz	1.25
Oroquieta	1.00
Tangub	0.70
Cagayan de Oro	1.00
Gingoog	1.00
Surigao	1.0
Dapitan	1.5
Dipolog	1.0
Davao	1.125
General Santos	1.125
Iligan	1.25
Marawi	NA
Cotabato	1.125

NA: not available.

SOURCE: Data supplied by MOF.

case of agricultural lands, any plot exceeding five hectares, where the uncultivated or ungrazed portion of the land constitutes more than 3/4 of the total, is defined as "idle". For urban properties, if more than 2/3 of the parcel is unutilized or unimproved, it can be certified as being idle. There are also provisions for exemptions from this land use status, e.g., if a natural disaster prevents cultivation, if there is lack of peace and order in the area or if the land, while classified as agricultural, is actually not cultivable (Section 44).

An idle lands tax raises revenue, but perhaps even more important are its beneficial efficiency effects. It is a penalty against land speculation and it encourages a more economic use of land. It follows that the tax is a necessary practice in the more urbanized areas of the country. The taxation of idle lands and the taxation of the gains from land speculations are widely practiced in LDCs.[1]

Apparently, the idle lands tax has never been used in the Philippines. The most obvious constraint is the political sensitivity to use of this tax. Large landholders tend to be very powerful in the community and this influence is often a substantial deterrent to actions by local treasurers and assessors.

Special Assessments. The special levy or "special assessment" provision of the real property tax code also has been used sparingly.[2] Special levies are essentially a form of benefit taxation where a portion of the costs

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[1] For a review, see Roger Smith, "The Effects of Land Taxes on Development Timing and Rates of Change in Land Price," in The Taxation of Urban Property in Less Developed Countries, ed. by Roy Bahl (Madison: University of Wisconsin Press, 1979), pp. 137-162.

[2] A few instances of usage of special assessments in the Philippines are provided in National Tax Research Center, "The Use of Special Assessment in Metropolitan Manila," Metro Manila Public Finance Studies (Manila: NTRC, 1977).

of particular projects, e.g., street paving, sidewalk construction, etc. are recovered from residents in the immediate area on grounds that they are the primary beneficiaries of the project. These benefits accrue in two ways: (a) direct use of the project, as in the case of a road fronting one's property, and (b) increased property values due to the higher level of public services.

Under PD 464, up to 60 percent of the cost of such projects may be reimbursed through this special levy. The tax is to be applied over a five to ten year period and differential rates can be applied to the different parcels lying within the area impacted by the project. In this manner the tax paid can be made to conform more closely with benefits received.

While special levies are used in developing countries around the world,[1] they have not been utilized extensively in the ROP. In our discussions with assessors, this lack of usage apparently does not stem from the inability of assessors to appraise the differential benefits of spatially defined projects, but instead it was felt that political pressures accounted for their non-use. The absence of implementing legislation was also cited. There is currently a project planned in Metropolitan Manila for which the special levy is to be used but has not, as yet, been implemented. In our interviews in other jurisdictions, it was stated that the special levy had never been applied. Given the extensive list of potential pro-

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[1] William A. Doebele, Orville F. Grimes, Jr. and Johannes F. Linn, "Participation of Beneficiaries in Financing Urban Services: Valorization Charges in Bogota, Colombia," Land Economics 55 (February, 1979): 73-92.

jects cited in PD 464[1] the special levy would appear to be an important potential revenue source for local governments in the Philippines.

There would be substantial advantages to making more use of special assessments, and its implementation would seem within the reach of most local governments. While the special levy is not as easily administered as is a general property tax, since it requires the estimation of benefits to be derived from a potential project, it certainly is not impossible to administer. Furthermore, we would argue that its benefits are likely to exceed these administrative costs. Important among these benefits is the feature that such levies allow the public choice system to work more effectively. When several taxpayers observe that it is to their collective benefit to undertake and finance a project, the special levy allows them to do so without having to influence a broader base of policy-makers to allocate General Funds to the project. The final project is much more likely to correspond to the demands of the beneficiaries than when decision-making is by those less intimately associated with the project.[2] Another advantage is that the use of such levies may increase the general level of compliance with the property tax since it will still be collected as a part of the general property tax system.

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[1] The PD provides for use of the special levy for the following projects: "laying out, opening, constructing, straightening, widening, grading, paving, curbing, walling, deepening or otherwise establishing, repairing, enlarging, or improving public avenue, roads, streets, alleys, sidewalks, parks, plazas, bridges, landing places, wharves, piers, docks, levees, reservoirs, waterworks, water courses, esteros, canals, drains and sewers." (Section 47).

[2] There is one caveat that should be inserted here: if the project yields substantial external benefits (costs), the use of the special levy may result in less (more) than optimal size of the resulting project. Thus, one should not expect the special assessment to be of use in financing all development projects.

Finally, it is quite possible that the use of the special assessment can be helpful in promoting economic growth since such growth-oriented projects as roads or streets, canals, sewers etc., can contribute to more efficient commerce or improved productivity.

Collection of the Real Property Tax

The property tax is levied against the owner of property as of January 1 of each year. Billing must occur by January 31 and payment can be made in four equal installments--on or before March 31, June 30, September 30 and December 31. The taxpayer may choose the installment option without interest or penalty. Furthermore, under LOI 682 (March 20, 1978) a 10 percent discount on taxes due is granted to anyone paying his taxes in full within the prescribed period of time.

The law also provides for penalties against those who are tax delinquent, yet as the data in Table III-7 show, only 57 percent of 1979 collectibles were ultimately collected.[1] Furthermore, there were provinces and cities with collection rates as low as 3 percent. One could effectively argue that the most pressing problems associated with the property tax in the Philippines have to do with its collectibility rather than with basic structural weaknesses in the levy.

In this section we first review the legal means available to encourage compliance with the Real Property Tax Code. Since these legal remedies apparently have not been totally successful, we turn to a discussion of the

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[1] It must be recognized, however, that to the extent duplicate records and other errors exist in the tax rolls, the collectable amounts may be overstated thus biasing downward the collection efficiency data in the Table.

TABLE III-7

EFFICIENCY OF COLLECTIONS OF REAL PROPERTY TAX: CALENDAR YEAR 1979
(In Pesos)

	Taxable Assessed Value of Real Property 12/31/78	Estimated Collections	Actual Collections Current Year	Efficiency of Collections (Percent)
Region I				
Abra	39,361,220	393,612	313,210	79.57
Benguet	336,383,320	3,363,833	2,276,603	67.68
Baguio	365,400,970	7,308,019	4,381,850	59.96
Ilocos Norte	298,299,830	2,982,998	1,388,013	46.53
Laoag	118,107,100	1,181,071	397,438	33.65
Ilocos Sur	409,835,080	4,098,351	1,431,672	34.93
La Union	343,709,690	3,437,097	1,927,294	56.07
Mountain Province	85,933,450	859,335	92,534	10.77
Pangasinan	1,156,312,500	11,563,125	4,256,634	36.81
Dagupan	85,433,730	1,281,506	783,645	61.15
San Carlos	55,455,100	554,550	117,252	21.14
Total	3,294,231,906	37,023,497	17,366,145	46.91
Region II				
Batanes	11,036,470	110,365	78,311	70.96
Cagayan	544,878,703	5,448,787	1,642,395	30.14
Ifugao	56,362,430	563,624	106,022	18.81
Kalinga-Apayao	135,391,880	1,353,919	321,244	23.73
Isabela	763,329,425	7,633,294	1,820,634	23.85
Nueva Viscaya	367,386,780	3,673,868	804,231	21.89
Quirino	59,590,225	595,902	151,750	25.47
Total	1,937,975,913	19,379,759	4,924,587	25.41%

TABLE III-7 (CONT.)

	Taxable Assessed Value of Real Property 12/31/78	Estimated Collections	Actual Collections Current Year	Efficiency of Collections (Percent)
Region III				
Bataan	974,068,840	9,740,688	5,133,583	52.70
Bulacan	1,305,138,986	13,051,390	6,334,990	48.54
Nueva Ecija	779,976,520	7,799,765	2,619,271	33.58
Cabanatuan	116,600,200	1,749,003	649,941	37.16
Palayan	6,340,360	95,105	11,297	11.88
San Jose	54,799,630	547,996	174,729	31.89
Pampanga	941,417,200	9,414,172	3,257,816	34.61
Angeles	253,734,200	2,537,342	1,496,629	58.98
Zambales	385,396,360	3,853,964	1,436,260	37.27
Olongapo	217,779,440	2,177,794	956,713	43.93
Tarlac	578,325,990	5,783,260	2,659,004	45.98
Total	5,613,577,726	56,750,479	24,302,233	43.58
Region IV				
Batangas	916,106,340	9,151,063	6,152,905	67.24
Batangas	298,860,280	2,988,603	1,767,492	59.14
Lipa	107,656,960	1,076,570	544,712	50.60
Cavite	770,288,040	7,702,880	5,087,006	66.04
Cavite	92,890,810	928,908	592,327	63.77
Tagaytay	102,366,440	1,740,229	1,217,295	69.95
Trece Martires	9,844,066	98,441	54,971	55.84
Laguna	928,327,160	9,283,272	6,803,939	73.75
San Pablo	135,239,020	1,352,390	842,936	62.33
Marinduque	224,496,370	2,244,964	1,884,513	83.94
Mindoro Occidental	107,929,590	1,079,296	391,531	36.28
Mindoro Oriental	189,028,960	1,890,290	1,019,697	53.94
Palawan	153,133,880	1,531,339	677,108	44.22
Puerto Princesa	57,592,100	575,920	223,091	38.74
Quezon	1,012,773,940	10,127,739	5,086,059	50.22
Lucena	151,473,754	1,514,738	663,104	43.78
Aurora	102,603,000	1,026,030	---	---
Rizal	1,558,141,070	15,581,411	6,377,836	40.93
Romblon	64,389,050	643,891	313,837	48.74
Total	6,982,140,830	70,537,974	39,705,359	57.12

TABLE III-7 (CONT.)

	Taxable Assessed Value of Real Property 12/31/78	Estimated Collections	Actual Collections Current Year	Efficiency of Collections (Percent)
Region IV-A METRO MANILA				
Manila	9,077,944,000	166,428,975	122,435,237	73.57
Quezon	5,024,680,000	92,119,135	61,0[illegible]4,248	66.30
Caloocan	1,268,122,000	23,248,908	12,882,303	55.41
Pasay	825,406,000	15,132,445	10,662,175	70.46
Las Pinas	870,835,000	11,611,135	5,027,565	43.30
Makati	6,276,895,000	83,691,933	62,128,642	74.23
Malabon	905,731,000	12,076,643	6,685,168	55.36
Mandaluyong	1,050,291,000	14,004,000	10,544,290	75.29
Marikina	831,660,000	11,089,000	6,360,814	57.36
Muntinglupa	900,583,000	12,007,607	4,694,231	39.09
Navotas	320,805,000	4,277,350	2,201,284	51.46
Paranaque	3,029,263,000	40,391,173	9,683,127	23.97
Pasig	1,924,388,000	24,658,507	16,750,314	65.28
Pateros	32,455,000	433,383	206,745	47.70
San Juan	786,067,000	10,480,903	5,176,063	49.39
Taguig	313,570,000	4,180,933	2,300,534	55.02
Valenzuela	801,984,000	10,693,120	5,011,945	46.87
Total	34,240,659,000	527,044,247	343,834,685	65.24
Region V				
Albay	313,805,860	3,138,059	964,107	30.72
Legaspi	102,204,730	1,022,047	750,064	73.39
Camarines Norte	171,503,370	1,715,034	602,417	35.13
Camarines Sur	297,090,690	2,970,907	957,273	32.22
Iriga	50,223,271	627,791	170,373	27.14
Naga	118,238,300	1,182,383	766,077	64.79
Catanduanes	61,111,970	611,120	179,256	29.33
Masbate	258,337,190	2,583,372	1,057,180	40.92
Sorsogon			712,633	
Total	1,372,515,381	13,350,713	6,159,380	39.32

TABLE III-7 (CONT.)

Region VI	Taxable Assessed Value of Real Property 12/31/78	Estimated Collections	Actual Collections Current Year	Efficiency of Collections (Percent)
Aklan	153,250,[illegible]50	1,532,509	692,136	45.16
Antique	82,717,380	837,174	432,009	51.60
Capiz	289,855,950	2,898,560	742,164	25.60
Roxas	70,824,540	885,307	325,686	36.79
Iloilo	686,097,390	6,860,974	3,932,938	57.34
Iloilo	410,902,820	6,163,542	2,939,636	47.69
Guimaras	39,142,720	391,427	227,627	58.15
Negros Occidental	1,583,959,570	15,839,596	9,64[illegible],101	60.89
Bacolod	800,249,050	12,003,736	6,273,674	52.26
Bago	122,713,815	1,840,707	1,033,031	56.12
Cadiz	109,263,520	1,092,635	564,721	51.68
La Carlota	108,425,450	2,168,509	1,561,673	72.02
San Carlos	91,425,590	918,756	639,513	69.61
Silay	153,631,740	1,536,317	998,675	65.00
Total	4,703,910,385	54,969,749	30,008,584	54.59
Region VII				
Bohol	265,969,750	2,659,698	1,203,559	45.25%
Tagbilaran	48,972,180	489,722	223,468	45.63
Cebu	486,997,160	4,869,972	2,653,363	54.48
Cebu	1,129,712,730	22,594,255	7,927,481	62.95
Danao	91,436,555	914,366	935,216	43.22
Lapu-Lapu	82,454,400	824,544	667,[illegible]76	80.95
Mandaue	159,753,320	1,597,533	1,402,981	87.82
Toledo	140,694,710	1,406,947	284,091	20.19
Negros Oriental	313,132,860	3,131,329	1,223,302	39.07
Bais	127,260,510	1,908,908	848,217	44.43
Dumaguete	69,406,400	694,064	427,155	61.54
Canlaon	18,500,980	277,515	80,495	29.01
Siquijor	44,318,390	443,184	168,013	37.91
Total	2,978,609,945	41,812,037	17,504,817	41.87

TABLE III-7 (CONT.)

	Taxable Assessed Value of Real Property 12/31/78	Estimated Collections	Actual Collections Current Year	Efficiency of Collections (Percent)
Region VIII				
Eastern Samar	180,256,920	1,802,569	487,148	27.03
Northern Samar	111,828,030	1,118,280	395,070	35.33
Western Samar	178,514,400	1,785,144	427,779	23.96
Calbayog	49,106,570	491,066	193,655	39.44
Leyte del Norte	563,239,810	5,632,398	2,493,840	44.28
Ormoc	97,111,960	971,120	657,924	67.75
Tacloban	119,185,150	1,191,852	715,448	59.73
Leyte del Sur	123,884,490	1,238,845	604,532	48.80
Biliran	37,675,660	376,757	198,468	52.68
Total	1,460,802,990	14,608,031	6,173,864	42.26
Region IX				
Basilan	102,746,920	1,027,469	171,850	16.73
Sulu	61,733,210	617,332	40,144	06.50
Tawi-Tawi	31,586,644	315,866	57,236	18.12
Zamboanga del Sur	307,701,770	3,077,018	1,026,945	33.37
Pagadian	45,268,600	565,858	180,207	31.85
Zamboanga	219,734,330	2,197,343	1,074,102	48.88
Total	768,771,474	7,800,886	2,550,484	32.69
Region X				
Agusan del Norte	162,731,220	1,827,312	1,041,861	57.02
Butuan	137,431,760	1,374,318	799,703	58.19
Agusan del Sur	266,810,390	2,668,104	393,809	14.76
Bukidnon	291,151,410	2,911,514	1,014,070	34.83
Misamis Occidental	165,125,920	1,651,259	850,239	51.49
Ozamiz	97,425,530	1,217,819	682,592	56.05
Oroquita	32,154,710	321,547	175,607	54.61
Tangub	15,325,960	153,260	87,872	57.34
Misamis Oriental	245,257,020	2,452,570	1,851,069	75.47
Cagayan de Oro	287,022,990	2,870,230	1,736,443	60.50
Gingoog	79,320,560	793,206	331,502	41.79

TABLE III-7 (CONT.)

	Taxable Assessed Value of Real Property 12/31/78	Estimated Collections	Actual Collections Current Year	Efficiency of Collections (Percent)
Region X (cont.)				
Camiguin	44,603,520	446,035	277,554	62.23
Surigao del Norte	189,019,500	1,890,020	1,386,791	73.37
Surigao	53,211,270	532,113	270,916	50.91
Zamboanga del Norte	359,661,840	3,596,618	1,277,764	35.53
Dapitan	22,988,370	344,826	180,864	52.45
Dipolog	69,485,740	694,857	176,250	25.36
Total	2,349,708,210	25,745,608	12,534,906	48.69
Region XI				
Davao del Norte	555,853,850	5,558,539	2,709,723	48.75
Davao del Sur	394,227,210	3,942,272	2,634,239	66.82
Davao	1,025,331,150	11,534,975	6,646,891	57.62
Davao Oriental	323,011,290	3,230,113	1,255,543	38.87
South Cotabato	401,297,230	4,012,972	1,670,101	41.62
General Santos	484,380,840	5,451,534	1,206,109	22.12
Surigao del Sur	471,037,800	4,710,378	2,907,592	61.73
Total	3,655,339,370	38,440,783	19,030,198	49.51
Region XII				
Lanao del Norte	138,551,030	1,385,510	860,259	76.05
Iligan	813,596,762	10,169,960	4,788,531	47.09
Lanao del Sur	228,432,070	2,284,321	117,968	05.16
Marawi	43,414,783	651,222	20,456	03.14
Maguindanao	289,169,630	2,891,695	735,460	25.43
Cotabato	94,898,120	1,067,604	559,382	52.40
North Cotabato	305,468,460	3,054,685	1,238,405	40.54
Sultan Kudarat	293,242,240	2,932,422	1,130,192	38.54
Total	2,206,772,995	24,437,419	9,450,563	38.67
GRAND TOTAL	71,565,016,125	932,401,182	533,545,805	57.22

SOURCE: Ministry of Finance.

types of taxpayers who apparently are most likely to be delinquent and review the kinds of techniques not presently included in the statutes that might be applied in municipalities and cities.

Legal Incentives for Compliance

Interest is charged on delinquent taxpayers. While the rate is set at 2 percent per month, there is an upper limit of 24 percent on the delinquent amount. Thus, once a taxpayer is delinquent for more than one year there is effectively no additional cost for subsequent nonpayment. Given that even relatively safe investments in the Philippines yield returns of 12-14 percent, the effective penalty is quite low. This suggests that the 24 percent maximum rate should be increased, possibly by omitting the maximum time period for penalties.

In addition to the interest penalty, there are three legal remedies that local governments can use to obtain past due taxes: distraint of personal property, public auction of the delinquent's property and civil action.

Distraint of personal property involves the seizing of personal properties such as crops, equipment, personal possessions. PD 464 (Section 69) provides, however, that certain items may not be seized, e.g., one horse, cow or carabao that the delinquent selects, necessary clothing, necessary household furniture, etc. After proper notice, the confiscated property can be sold at a public auction administered by the provincial or city treasurer, with proceeds of the sale (over and above the delinquent taxes plus penalties and costs of the sale and seizure) reverting to the delinquent taxpayer. All of this can be avoided, of course, by payment of the delinquent taxes and penalties at any time prior to the auction.

The public auction remedy involves seizure of the real property on which taxes are due. Once again there must be advance notice of the sale. The proceeds of the sale in excess of what is owed the jurisdictions (including costs) revert to the delinquent taxpayer. If sold, the delinquent taxpayer does, however, retain possession for one year; furthermore, he has the right to redeem the property by paying delinquent taxes and penalties, costs of the sale plus 20 percent interest on the purchase price. The purchaser of the property is then reimbursed for the purchase price plus the 20 percent interest fee. This final feature makes the purchase of tax-auction property considerably more attractive, thus helping to ensure an adequate number of bidders.

Civil action refers to the fact that the delinquent tax constitutes an indebtedness of the taxpayer to the jurisdiction and therefore, as with any such debt, civil legal proceedings can be initiated. Furthermore, when a parcel on which taxes are delinquent is the subject of court proceedings, the award of ownership will be contingent upon payment of delinquent taxes.

Reasons for Delinquency

Given these potentially strong legal remedies to combat delinquency, the question arises as to why collection efficiency is so low. There are several possible answers to this question.

The most obvious reason is that the legal remedies outlined above are seldom used in the Philippines. Several reasons are given for this lack of legal action against tax delinquents. While a list of the largest tax delinquents is to be prepared annually by the treasurer and submitted

to the provincial fiscal officer, apparently the provincial officer often does not carry out any further proceedings against the delinquent taxpayer. Possibly this is due to oversight, an overworked staff or political pressures against any such proceedings. The use of personal property distraint has also been avoided, possibly because of the political ramifications or, it was stated to us several times, the personal property to be seized was removed before the action was taken (in the examples cited to us, the personal property to be seized were fish from the taxpayer's fish pond). Finally, it must be recognized that in any rural or sparsely populated area, nearly all residents are known to each other. A neighborhood closeness makes the successful use of the auction remedy less likely than in a highly populated, more impersonal area; furthermore, the political ramifications of such action may be severe as the electorate observes their neighbors' livelihood being auctioned away.

A second possible reason for low collection rates has to do with the problems associated with the determination of the legal owner of properties. If duplicate tax declarations exist, with the recorded owner not actually in possession of the property, there will be little chance of collecting the taxes. Likewise, the problems associated with land reform and lack of tax declarations filed by new owners means that these taxes likely will go uncollected.

A third possible reason for delinquency could stem from the management and record-keeping methods used, at least in some localities. Under a properly managed system there would be systematic scanning of the property tax payment records (nearly always contained on cards filed within

the municipal or city treasurer's office). If the filing system is not adequate or if the workloads due to other day-to-day efforts are too great to check for overdue payment of taxes and to notify the delinquent taxpayer, there is greater likelihood that delinquent taxes will not be paid. Usually at least one clerk is assigned responsibility for maintaining the property tax payment records. This person, or an assistant, periodically goes through the file noting those taxpayers for whom property tax liabilities are delinquent and sends written notices.

In our interviews with local officials we found considerable variance in the frequency of checking through the files for delinquents. Stated frequencies ranged from daily to quarterly. In addition, at least some localities actually sent out collectors (usually the person in charge of the property tax or a clerk in the treasurer's office) to meet with at least the largest delinquents.

A fourth reason relates to the specific problems of farmlands. Agricultural land is especially prone to periods of low productivity. For example, unpredictable events such as floods, typhoons, drought, or low prices can contribute to low incomes from such lands and therefore to an inability of the landowner to pay the due taxes. Since assessments are not altered annually in response to such events, these types of parcels are likely to be delinquent in times of stress.

To better understand the underlying nature of the tax delinquency problem, we have compiled information on the extent (Table III-8) as well as the causes and means used to stimulate payment (Table III-9). The

TABLE III-8

LARGEST TAX DELINQUENCIES IN SELECTED ILOILO MUNICIPALITIES: 1980

Municipalities	Total Delinquencies[a]			As Percent of 1979 Current Year RPT Revenues	
	Largest Five	Largest Ten	Range Among Largest Ten	Largest Five	Largest Ten
Dingle	44,642	63,765	3,713- 20,759	108.9	155.5
Dumangas	183,083	213,446	3,522-104,551	183.5	214.0
Guimbal	7,542	8,991	247- 2,166	55.1	65.6
Passi	129,792	169,029	4,793- 36,092	115.2	150.0
Pavia	12,050	16,099	342- 4,895	11.8	15.7
Tigbauan	2,463	3,039	108- 795	11.6	14.3

[a]As of May, 1980.

[b]Information on only the nine largest delinquents were available from Guimbal.

SOURCE: Data obtained from municipal treasurers.

TABLE III-9

INFORMATION ON COLLECTION EFFICIENCY

City/Municipality Province	1979 Collection Efficiency	Major Delinquents Industries	Reasons Cited For "Problems"	Reasons Cited For "Success"
Legaspi City	73.4	Agriculture		Tie tax to business license
Libon, Albay	19.0	Rice/grain	Land reform	
Malinao, Albay	29.2	Agricultural	Typhoons and low agricultural prices	Barangay-level campaigns
Oas, Albay	28.8	Rice	Land reform	
Tabaco, Albay	50.1	Agriculture	Low agricultural prices	Send collectors into field
Iloilo City	47.7	Panay Electric (125.3%)[a] Manufacturing, The Church	Estates	
Dingle, Iloilo	52.3	Land reformed estates	Land reform	
Dumangas, Iloilo	57.2	Catholic Church Absentee land-owners (15.8%)[a]	Absentee owners, refuse to pay; land reform	Several court cases
Guimbal, Iloilo	63.6	Agriculture	Land reform, poor records	
Passi, Iloilo	42.1	Sugar	Land reform, low sugar prices	
Pavia, Iloilo	99.6	Few delinquents		Barangay-level campaign Court case
Tigbauan, Iloilo	97.1	Agriculture		Information program in barangays

[a]Delinquent taxes of largest delinquent as percent of 1979 current year RPT revenues.

SOURCE: Survey interview data.

example of six Iloilo municipalities shown in Table III-8, gives some idea of the concentration of delinquent property taxes among larger taxpayers. The data show that for three of the jurisdictions, the amount outstanding from the largest delinquents in early 1980 actually exceeded total collections in the previous year. (In the case of Dumangas it was more than twice the amount collected.) The concentration of delinquent taxes in the hands of relatively few taxpayers raises an important policy issue. When one or two delinquents account for the vast proportion of largest delinquents, as is the case in Dumangas and to a lesser extent in Dingle, legal remedies are likely to be the most effective approach to alleviate the problem. On the other hand where even the largest of delinquents is quite small, as is true in Guimbal and Tigbauan, extra-legal remedies (e.g., campaigns, moral suasion) may be a more effective solution.

Table III-9 provides a slightly different perspective on the problem of property tax delinquencies as observed in several different municipalities in the Provinces of Albay and Iloilo and Legaspi City and Iloilo City. Of the two cities represented, Legaspi had a considerably higher collection efficiency in 1979 than did Iloilo. Legaspi carries out an interesting policy that should be especially effective in cities--tying property tax payments to the issuance of Mayors' Permits. That is, a Permit is not granted unless the business shows proof of payment of its property

tax liabilities. It is interesting to note that Legaspi City's major delinquency problems are related to agricultural properties, which are not subject to business taxes. In Iloilo City the principal delinquent as of 1979 owed considerably more in back taxes than the entire yield of the current portion of the property tax that year. When delinquencies are as concentrated as in this case, the legal remedy for collection would seem to be the most effective and efficient solution.

For the municipalities represented here, nearly all are characterized as agricultural areas with the result that delinquencies are not nearly as concentrated as in the case of the cities. It would appear from the success achieved in Pavia and Tigbauan that campaigns to encourage property owners to pay taxes can be successful, especially when the focus of the campaign is at the barangay level. (Several different forms of campaigns are discussed below.) For the predominantly rural municipalities in these two provinces, however, the two principal causes of delinquency in the payment of property taxes are land reform and the uncertainty of agricultural yields and prices.[1]

Two other potential problems associated with tax collection include absentee landlords (cited in Dumangas) where apparently the bulk of the landlords live in a nearby city (in this case Iloilo City) and simply refuse to pay taxes and in any case are very difficult to reach. In these cases legal means may be the most appropriate technique to alleviate the problem. The Catholic Church was also cited in both Iloilo City and Dumangas as being

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[1] See the final section of the Chapter as well as Appendix III-A for further discussion of land reform and the property tax.

among the largest delinquents (apparently the Church obtained donated property that under the statute is taxable since it is income earning). Finding a "solution" to the Church property problem is not so easy. Legal means are likely to create considerable political difficulties and campaigns may be ineffective in this circumstance.

In any case the data in the Table suggest that collection of property taxes at a rate in excess of 90 percent is definitely not impossible within the Philippines and that an effective route to improvement in this source of revenue is to improve collection practices.

Non-Court Methods for Improving Collections

While the three legal means for collecting delinquent taxes should not be discouraged and may, indeed, be extremely effective methods, especially when dealing with businesses and large property owners, less formal methods can be cheaply applied and are likely to improve the overall productivity of this revenue source. Here we describe several different techniques that have been applied and suggest that such methods can be extremely effective in more rural municipalities.

Running Campaigns in the Barangay. The barangay, especially given recent policy initiatives to emphasize its role, provides a natural vehicle for organizing tax campaigns. Because the barangay receives a share of the collection of property taxes, it should be possible to convince taxpayers of the localized benefits to be derived from payment of taxes. Improved property tax collection rates may well result.

In the same vein, we found that some municipalities (e.g., Malinao and Tabaco, Albay) attempted to decrease compliance costs by sending tax collectors to the barangay thus making it unnecessary for taxpayers to travel to the municipal treasury to pay their taxes. Not only does this reduce compliance costs, but it also may aid in creating a psychological incentive to pay if a taxpayer is among neighbors who are complying with the law.

An innovative program initiated in Pavia, Iloilo seems relatively low cost and, based upon collection records, productive. Under this program the local treasurer's office sponsored movies in the barangays. During each intermission (of which there were several) the municipal treasurer and barangay captain gave short talks on the advantages of paying property taxes. Such programs may prove to be as effective as any legal pursuits, especially in rural areas characterized by many small property holders.

Barangay Captains. Closely related to formal campaigns in the barangays are campaigns eliciting the aid of barangay captains in encouraging their barangay residents to pay property taxes. A short workshop on the benefits to be derived from tax compliance may be sufficient to educate the captain who, in turn, can inform his constituents. In Jordan, Guimaras, this is supplemented by a ₱2,000 prize awarded to the barangay with the highest collection rate.

Public Lists. At times public praise or embarrassment is sufficient to prompt tax compliance. For example in Jordan, a list of the top taxpayers is posted for display in the municipal treasury. We did not encounter any municipality that does the same for the major delinquents; however, this would seem to be a potentially fruitful approach, especially in the rural municipalities.

Use of Collectors. The statutes are silent on the use of tax collectors. While this may not be an especially efficient method for collecting taxes in communities where the bulk of the delinquents are small taxpayers, it is a reasonable policy where a few large taxpayers dominate the delinquent list. At the same time, the effectiveness of the collection effort is likely to be aided considerably if the taxpayer realizes that the use of legal means to collect taxes is, in fact, a reality.

Tying Taxes. The Legaspi experience would suggest that tying payment of the property tax to issuance of the Mayor's Permit is effective. Of course, since permits are obtained only by businesses, the use of the technique in predominantly rural municipalities is less likely to lead to substantial payoffs.

Revenue Performance of the Property Tax

The property tax may have important equity and land use effects, but its purpose is primarily to generate revenues for local governments. To evaluate the real property tax in this regard, we examine the growth in tax yield, the responsiveness of revenues to growth in income and inflation, and the variation across jurisdictions in property tax revenue performance and importance. One has to conclude from such an evaluation that an increase in property tax revenues, and in the elasticity of the tax, are attainable goals. Before examining these specifics in the growth of Philippine taxation, we turn to a very rough comparison with the growth in property taxation in other developing countries.

Comparison With Other Developing Countries

One can compare the relative burdens of property taxes across countries in two ways--on a statutory basis and with respect to actual practices. On a statutory basis the property tax in the Philippines cannot be viewed as imposing an excessively high burden when compared with other developing countries.

Yoingco and Quintos have made a comparison of property taxes in the six ASEAN countries.[1] The information provided there would suggest that the range of statutory property tax rates (Basic Tax plus SEF) of from 2-3 percent in the Philippines is not out of line. However, the fractional assessment scheme used in the Philippines, together with the several exemptions including the low value exemption, significantly reduces the overall burden of the tax--though we cannot say whether these reductions are greater than in other countries. Bahl, in a comparison of property taxes in major cities throughout the world (including Manila), provides data that would indicate that statutory rates in Manila are not excessively high (nor are they at the lowest end of the range).[2]

Since the actual burden of property taxes is so closely tied to its administration, an examination of statutory rates often gives misleading impressions about intensity of use. IMF data on property taxes as a percent of gross national product and as a percent of total taxes enable us to compare the Philippines with other developing countries for several years.

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[1] Yoingco and Quintos, Philippine Tax System Under the New Society.

[2] Bahl, "The Practice of Urban Property Taxation in Less Developed Countries."

These data, shown in Table III-10 for the years 1953-55 through 1972-76 were collected as part of the International Monetary Fund tax effort study series.[1]

It is clear from these data that since the mid-1950s the role of property taxes within the Philippines has been diminishing both in terms of relative importance in the tax structure and relative to total economic activity. From 1953-55 until the 1972-76 period, property taxes declined from nearly 12 percent to only 3 percent of total tax revenues. Property taxes were also cut relative to GNP during the 1966-68 to 1972-76 period, from 0.8 percent to only 0.3 percent. The Philippines is not alone, however, in these general trends. The data in Table III-10 show that property taxes in other developing countries have declined relative to total taxes and as a percent of GNP.

When compared with other Asian countries, the relative (to GNP) property tax burden in the Philippines for the 1972-76 period was considerably below the regional average. In terms of rank ordering among these 15 countries, however, the Philippines is exceeded by only four countries--the Republic of China, Nepal, Korea and Sri Lanka.

Taken together, these data do not suggest that the level of property taxation in the Philippines is high by comparison with other developing countries. If comparative norms are somehow a relevant measure, then steps designed to increase the burden of property taxes in the Philippines would seem feasible.

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[1] Raja J. Chelliah, "Trends in Taxation in Developing Countries," IMF Staff Papers, Vol. 18, No. 2, (July 1971), pp. 254-331; Raja J. Chelliah, Baas Hessel, and Margaret Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969-71," IMF Staff Papers, Vol. 22, No. 1 (March 1975), pp. 187-205; and Allan Tait et al., "International Comparison of Taxation for Selected Developing Countries," IMF Staff Papers, Vol. 26, No. 1 (March 1979), pp. 123-156.

TABLE III-10

A COMPARISON OF PROPERTY TAXATION IN THE PHILIPPINES AND OTHER DEVELOPING COUNTRIES

	As a Percent of Total Taxes				Ratios to GNP		
	1953-55[a]	1966-68[a]	1969-71[b]	1972-76[c]	1966-68[a]	1969-71[b]	1972-76[c]
Philippines	11.8	8.2	4.4	2.9	0.8	0.4	0.3
Other Asian Countries							
Afghanistan	---	---	---	1.7	---	---	0.1
Bangladesh	---	---	---	...	---	---	...
Burma	---	---	---	...	---	---	...
China, Republic of	13.0	11.3	14.5	12.2	1.7	2.6	2.4
India	16.0	9.3	7.8	0.1	1.1	1.0	0.02
Indonesia	0.87	2.1	...	0.8	0.2	...	0.13
Iraq	---	---	---	0.8	---	---	0.3
Jordan	---	---	---	0.2	---	---	0.03
Korea	5.5	8.3	3.8	4.1	1.0	0.6	0.6
Malaysia	---	12.9	0.5	0.6	2.2	0.1	0.14
Nepal	55.1	26.3	23.8	16.4	0.8	1.1	0.9
Pakistan	7.8	5.7	3.8	2.7	0.5	0.3	0.3
Singapore	---	28.2	27.1	---	3.5	3.6	---
Sri Lanka	3.0	2.9	4.3	2.0	0.5	0.8	0.4
Syrian Arab Republic	---	---	---	1.8	---	---	0.2
Thailand	.09	2.1	3.0	2.1	0.3	0.4	0.3
Turkey	---	---	---	0.5	0.8	---	---
Vietnam	---	---	---	---	---	---	---
Yemen Arab Republic	---	---	---	...	---	---	...
Average for:							
Asia	12.6[e]	10.2[e]	8.4[g]	2.7[j]	0.8[f]	1.0[g]	0.3[j]
Other Asian LDCs[d]	12.7	10.4	8.9	2.7	0.80	1.1	0.3
Non-Asian LDCs	6.4	4.8	3.9	1.6	0.75	0.6	0.2
All LDCs	8.3[f]	6.1[f]	5.0[h]	1.9[i]	0.77[f]	0.7[h]	0.2[i]

Key: ... denotes zero or insignificant amount.
--- information not available.

TABLE III-10 (CONT.)

[a]Compiled from Chelliah (July 1971).

[b]Compiled from Chelliah *et al*. (March 1975).

[c]Compiled from Tait *et al*. (March 1979).

[d]Excludes Philippines.

[e]Includes China, India, Indonesia, Korea, Malaysia, Nepal, Pakistan, Philippines, Singapore, Sri Lanka, Thailand, Vietnam.

[f]Consists of 50 countries.

[g]Same as footnote (e) excluding Vietnam.

[h]Consists of 47 countries.

[i]Consists of 63 developing countries.

[j]Includes all the countries listed under "Other Asian Countries" as well as the Philippines.

SOURCES: Raja J. Chelliah, "Trends in Taxation in Developing Countries," IMF Staff Papers, Vol. 18, No. 2, (July 1971), pp. 254-331; Raja J. Chelliah, Baas Hessel, and Margaret Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969," IMF Staff Papers, Vol. 22, No. 1 (March 1975), pp. 187-205; and Allen Tait *et al*., "International Comparison of Taxation for Selected Developing Countries," IMF Staff Papers, Vol. 26, No. 1 (March 1979), pp. 123-156.

Growth in Tax Yield

Property tax revenues may grow for any of four reasons: (1) reassessment of existing properties, (2) the addition of new properties to the tax rolls, (3) an increase in nominal property tax rates, and (4) an increase in collection efficiency. Some combination of these factors of increase resulted in little growth in per capita real property tax revenues during the early 1970s (see Table III-11). Indeed, there were substantial real declines in some years before the situation was reversed in 1977 and 1978.

In current pesos, the per capita increase was from ₱4.97 in 1970 to ₱16.61 in 1979. To analyze the factors leading to this increase, the 1974-1979 period might be used in that it includes one full revaluation cycle. There was a general revaluation in 1973 and another in 1979, though the new assessment rolls were not completed in every jurisdiction in either year. The data in Table III-12 set out the four components of changing property tax revenues between 1974 and 1979. The number of parcels increased by only about 8 percent over the period, while assessed value per parcel increased by about 76 percent. The nominal tax rate has remained constant over the 1974-79 period, but collection efficiency increased from 41 percent to 56 percent between 1974 and 1979. Thus, the principal causes of property tax revenue growth over the period would appear to be reassessment of existing properties and improvements in collection efficiency. As may be seen from this Table, however, the pattern has varied from year to year.

TABLE III-11

PER CAPITA PROPERTY TAX REVENUES: 1969-1979

Year	In Current Pesos		In Constant Pesos	
	Amount	Percent Increase	Amount	Percent Increase
1969	6.07		9.20	
1970	4.97	(19)	6.56	(29)
1971	4.29	(14)	4.65	(30)
1972	5.10	19	5.10	10
1973	6.54	29	5.62	11
1974	7.41	14	4.74	(16)
1975	8.23	11	4.94	5
1976	8.37	2	4.60	(7)
1977	12.94	55	6.46	41
1978	14.44	12	6.72	4
1979	16.61	15	6.63	(2)

SOURCE: Commission On Audit Reports on Local Governments (1969-1971); Ministry of Finance (1972-1979); Central Bank of the Philippines, Statistical Bulletin, 1978 (CPI, 1972=100); National Census and Statistics Office.

TABLE III-12

INDICATORS OF PROPERTY TAX PERFORMANCE

Year	Number of Parcels	Percent Change	Assessed Value	Percent Change
1974	12,095,287		₱43,911,027,291	
1975	12,588,655	4.08	46,279,928,639	5.39
1976	12,055,681	(4.23)	49,491,049,874	6.94
1977	12,309,845	2.11	55,646,382,125	12.44
1978	13,204,942	7.27	67,302,340,738	20.95
1979	13,073,319	1.00	83,825,748,117	24.55

Year	Property Tax Revenue (million pesos)	Percent Change	Collection Rate[1]	Revenue/ Assessed Value	Assessed Value per Parcel
1974	307		41.15	.0070	₱3,630.42
1975	346	12.70	43.96	.0075	3,676.32
1976	368	6.36	43.76	.0074	4,105.21
1977	586	59.24	61.95	.0105	4,520.48
1978	674	15.02	58.92	.0100	5,096.75
1979	799	18.55	56.07	.0096	6,402.91

[1]Collectibles were estimated by using this formula: [(Av x .01) + .70 (Av x .01)]

The assumptions are:
1. Collectibles from the basic property tax equals assessed value multiplied by 1 percent tax rate.
2. Collectibles from the SEF tax equals assessed value multiplied by 1 percent less 30 percent which is remitted to the national treasurer.

SOURCES: For assessed values and number of land parcels: "Assessor's Report to the Ministry of Finance." For revenues: Commission on Audit and Ministry of Finance.

Analysis of property tax revenue growth at this level of detail cannot be provided for every jurisdiction--time and resource constraints and data limitations are too severe. Even per capita property tax revenue increases cannot be presented because annual population estimates are not available for individual jurisdictions.

The aggregate growth in property tax collections is presented in Table III-13 for Iloilo and Albay Provinces.[1] The ten year history of collections in Iloilo shows considerable variation in the year-to-year increases in property tax revenues--from a low of only 0.2 percent between 1977 and 1978 to the nearly 98 percent increase between 1972 and 1973 in the aftermath of PD 76. The overall growth in property tax revenues during this period, 173 percent, greatly exceeded the population increase of only 12.4 percent. In contrast, Albay experienced declines in property tax revenues between 1973 and 1975. On the other hand, since 1975 Albay property taxes have grown more rapidly than in Iloilo.

It is difficult to explain this erratic tax revenue growth behavior when these data are compared with the tax base data of Table III-2. In part, the differences may be due to the stock nature of the tax base information (measured as of January 1 of each year) and the revenue flow data (especially since in earlier years the fiscal years did not begin on January 1). At the same time the considerable differences are unlikely attributable only to these measurement difficulties. Instead, it seems more likely that much of the annual variability can be traced to year-to-year fluctuations in collection efficiency. Since collections are made at the municipal level, case studies of individual jurisdictions shed some

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[1] Includes only the provincial portion of property tax revenues, i.e., 45 percent of total collections.

TABLE III-13

ANNUAL GROWTH RATES IN GENERAL FUND PROPERTY TAX REVENUES, ILOILO AND ALBAY PROVINCES: 1970-1979[a]
(in percent)

Fiscal Year	Province	
	Albay	Iloilo
1970-1971	NA	14.5
1971-1972	NA	2.1
1972-1973	NA	97.9
1973-1974	-17.2	12.5
1974-1975	-54.8	5.0
1975-1976	75.4	30.0
1976-1977[b]	59.6	16.1
1977-1978	6.1	0.2
1978-1979	13.0	7.2

NA: not available.

[a]Includes current year plus previous years plus penalties but excludes excess SEF collections.

[b]These growth rates are based on FY1976 (ending June 30, 1976) compared with FY1977 (ending December 31, 1977). The six month transition period, July 1-December 31, 1976 has been excluded for comparability purposes.

SOURCE: Computed from data supplied by provincial treasurers.

light on the factors affecting property tax growth and on variations in the pattern among jurisdictions.

For the four selected Albay municipalities (Table III-14) several generalizations concerning property tax performance are possible. For Camalig, Libon and Malinao the property tax as a proportion of total General Fund income increased between 1977 and 1979. Moreover, each jurisdiction experienced increases in property tax collection rates. Tabaco, which relies very heavily upon business taxes as a revenue source (24.2 percent of total 1979 revenues), experienced very little growth in property tax revenues from 1977 to 1979, hence this revenue source declined in relative importance. This suggests again that where a substantial business tax base is available, the business tax will be substituted for the property tax. Assessed values increased substantially only in Camalig between 1978 and 1979, in the wake of completion of tax mapping in that municipality. In the other jurisdictions assessed values tended to remain quite constant during this period. Again it would appear that collection efficiency constitutes the key to productivity of the local property tax. For example, had Libon been able to achieve a 70 percent collection efficiency on current taxes in 1979, as did Camalig, its current property tax yield would have exceeded ₱234,000 thus increasing total General Fund income by over 40 percent.

Comparable statistics on the revenue performance of the property tax in selected Iloilo municipalities are shown in Table III-15. In Iloilo, property taxes play a generally more important role in the overall revenue structure of the municipalities than in Albay--reflecting some combination of differences in their economies and in the way they administer the tax.

TABLE III-14

PROPERTY TAX COLLECTIONS IN SELECTED ALBAY MUNICIPALITIES: 1977-1979
(in pesos)

General Fund	Camalig			Libon			Malinao			Tabaco		
	1977	1978	1979	1977	1978	1979	1977	1978	1979	1977	1978	1979
Current Year Collection	26301	37188	50140	28190	27302	29509	11639	21298	17488	42168	45117	52172
Previous Year Collection	9838	9275	15871	19445	21414	27968	4513	5099	8889	11971	611	4400
Penalties	1421	1948	4155	3398	4746	6166	898	1427	1914	2304	3514	2390
Total from RPT	37560	48411	70166	51033	53482	63643	17050	27824	28291	56443	49242	58962
RPT as Percent of Total General Fund Income	7.9	8.7	11.5	13.8	14.3	15.0	8.7	12.0	11.2	4.1	3.3	3.6
Assessed Valuation (in 1000 Pesos)[a]	12089	12280	15928	33708	33968	32773	12661	12766	12458	23611	25102	25158
Collection Efficienty (in percent)	45.8	66.0	70.4	17.8	16.9	19.0	19.3	30.1	29.2	37.4	38.4	50.1

Growth Rates (in percent)

	Camalig		Libon		Malinao		Tabaco	
	1977-78	1978-79	1977-78	1978-79	1977-78	1978-79	1977-78	1978-79
Total from RPT	28.9	44.9	4.8	19.0	63.2	1.7	-12.7	19.7
Total General Fund Income	18.3	9.6	1.6	13.1	18.1	8.5	8.3	11.7
Assessed Valuation	1.6	29.6	0.1	-3.3	0.1	-2.4	6.3	0.2
Collection Efficiency	44.1	6.7	-5.1	12.4	56.0	-3.0	2.7	30.5

[a]Based on taxable assessed valuation as of December 31 of the previous year.

SOURCE: Compiled from data supplied by provincial treasurers.

TABLE III-15

PROPERTY TAX ' CTIONS IN SELECTED ILOILO MUNICIPALITIES: 1977-1979
(In pesos)

General Fund	Dingle 1977	Dingle 1978	Dingle 1979	Dumangas 1977	Dumangas 1978	Dumangas 1979	Guim 1977	Guim 1978	Guim 1979
Current Year Collection	50287	45690	41002	85510	101519	99755	14503	13167	13697
Previous Year Collection	14985	15890	26614	39895	59945	48354	4086	2287	4340
Penalties	3844	3759	5802	5998	11069	11432	925	575	1101
Total From RPT	69116	65339	73418	131403	172533	159541	19514	16029	19138
RPT as Percent of Total General Fund Income	14.9	14.4	13.4	23.2	27.3	22.9	8.3	6.8	7.4
Assessed Valuation[a] (in 1,000 Pesos)	16598	17262	17430	27550	38544	38753	471[illegible]	4726	4796
Collection Efficiency (in percent)	NA	NA	52.3	NA	NA	57.2	NA	NA	63.6

Growth Rates (in percent)

	Dingle 1977-78	Dingle 1978-79	Dumangas 1977-78	Dumangas 1978-79	Guimbal 1977-78	Guimbal 1978-79
Total From RPT	-5.4	12.4	31.3	-7.5	-17.8	19.4
Total General Fund Income	-2.4	20.6	11.8	10.5	-0.3	10.1
Assessed Valuation	4.0	1.0	39.9	0.5	0.2	1.5

TABLE III-15 (CONT.)

General Fund	Passi 1977	Passi 1978	Passi 1979	Pavia 1977	Pavia 1978	Pavia 1979	Tigbauan 1977	Tigbauan 1978	Tigbauan 1979
Current Year Collection	121049	119229	112668	56996	59829	102339	23971	21492	21261
Previous Year Collection	18477	21561	31393	13296	14354	21364	9189	3705	9064
Penalties	2959	4017	7344	3529	1608	7887	1658	1007	1911
Total From RPT	142485	144807	151405	73821	75791	131590	34818	26204	32236
RPT as Percent of Total General Fund Income	12.7	12.0	14.6	14.7	13.5	18.7	10.4	6.4	7.3
Assessed Valuation[a] (in 1,000 Pesos)	64773	65019	65318	10608	10665	20042	3915	3915	4009
Collection Efficiency (in percent)	NA	NA	49.1	NA	NA	99.6	NA	NA	97.1

	Growth Rates (in percent)					
	Passi		Pavia		Tigbauan	
	1977-78	1978-79	1977-78	1978-79	1977-78	1978-79
Total From RPT	1.6	4.6	2.7	73.6	-24.7	23.0
Total General Fund Income	7.3	-14.0	11.4	25.7	20.9	8.8
Assessed Valuation	0.4	0.5	0.5	87.9	0.0	2.4

NA: not available.

[a]Based on taxable assessed valuation as of December 31 of the previous year.

SOURCE: Compiled from data supplied by provincial treasurers.

In Iloilo, there was considerable stability in the base of the property tax, with the exception of large increases in assessed values in Pavia between 1978 and 1979 and in Dumangas between 1977 and 1978. Interestingly, the Pavia collection rate did not suffer in the face of the substantial growth in assessed values. This suggests that much of the increase may have been due to a small number of new properties added to the roll. Indeed, when the largest taxpayers in Pavia are reviewed, one finds that San Miguel Brewery paid ₱128,190 in municipal property taxes in 1979 (the first year of operation for the brewery in Pavia).[1]

The different performance of the property tax in the two chartered cities compared in Table III-16 presents an interesting contrast. Iloilo City seems to be de-emphasizing the property tax as it moves toward increasing reliance on business taxation. Its collection rate is relatively low and there have been only minimal increases in assessed valuation. In contrast, Legaspi City has maintained a lower, but approximately constant, property tax share with a much higher collection rate and a general valuation increase in 1978-1979. In addition, Legaspi City has tied property tax and business tax collections together via the Mayor's Permit requirement.

Taken together, these data reflect another aspect of the financial situation of Philippine municipalities which also has implications for the discussion of cash balances and reserve positions discussed above. This is the fact that, at least based on this small and non-random survey of local

[1] The ₱128,000 includes both the basic tax as well as the SEF therefore exceeds the amount shown in Table III-13.

TABLE III-16

PROPERTY TAX COLLECTIONS, ILOILO CITY AND LEGASPI CITY: 1977-1978
(in pesos)

General Fund	Iloilo City			Legaspi City		
	1977	1978	1979	1977	1978	1979
Current Year Collection	3,066,983	3,157,772	2,935,949	561,962	752,457	724,216
Previous Year Collection	792,358	750,949	794,744	152,883	185,110	191,297
Penalties	145,895	152,976	157,717	30,383	36,772	40,380
Total From RPT	4,005,238	4,061,697	3,887,810	745,228	974,339	955,893
RPT as Percent Total General Fund Income	24.2	21.4	18.7	15.2	17.5	16.5
Assessed Valuation[a] (in 1000 Pesos)	390,432	404,042	410,903	81,232	83,566	102,205
Collection Efficiency (in percent)	NA	NA	47.7	NA	NA	73.4

	Growth Rates (in percent)			
	1977-78	1978-79	1977-78	1978-79
Total From RPT	1.4	-4.3	30.7	-1.9
Total General Fund Income	14.4	9.6	13.8	4.0
Assessed Valuation	3.5	1.7	2.9	22.3

NA: not available.

[a]Based on taxable assessed valuation as of December 31 of the previous year.

SOURCE: Compiled from data supplied by provincial treasurers.

governments, there is considerable variation in year-to-year growth rates in both property tax revenues and total General Fund revenues. This, of course, adds to the inherent difficulties associated with financial management of these governments and would lead one to expect larger reserves than in jurisdictions where revenues grow at reasonably stable rates.

Income Elasticity. Another way to consider the revenue yield of a tax is to examine its income elasticity, i.e., the percentage response in revenues relative to a percentage increase in personal income in the community. Income elasticities are especially relevant to a discussion of a revenue source since, as incomes increase within a locality, there are likely to be increased demands for public services. It is therefore desirable that yields from a tax source at least keep pace with these service demands, i.e., that the income elasticity of the tax be at least equal to the expenditure elasticity of demand. Since we do not know the latter, we might assume that expenditure requirements will grow roughly in proportion to income, hence an income elasticity of unity might be a reasonable goal for the local tax system.

Table III-17 reports on property tax base, rate and total elasticities.[1] The relative size of the rate and base elasticities indicates whether reassessment or increasing collection efficiency has yielded more growth in property tax revenues. The base elasticity measures the ratio of the percentage growth of assessed value of property to the percentage growth

[1] The normal procedure in public finance is to estimate the revenue-income elasticity from a "cleaned" tax series. That is, one would eliminate all discretionary rate and base changes from the revenue series and then estimate the automatic responsiveness to income growth. In this exercise, we have not cleaned the revenue series, hence, we are estimating some combination of the automatic and discretionary response of tax revenues to income increases.

TABLE III-17

ELASTICITY OF PROPERTY TAX REVENUES AND PROPERTY TAX BASE[a]

Year	Base Elasticity	Rate Elasticity	Total Revenue Elasticity
1975	.38	2.36	.90
1976	.46	.92	.42
1977	.66	4.76	3.14
1978	1.48	.72	1.07
1979	1.01	.76	.77

[a]The rate elasticity is the ratio of the annual percentage change in property tax revenues to the annual percentage change in the assessed value of property. The base elasticity is the ratio of the annual percentage change in the assessed value of property to the annual percentage change in personal income. Total revenue elasticity is the product of the rate and base elasticities.

SOURCES: Assessed value of property: Reports of Assessors to the Ministry of Finance; personal income: National Economic and Development Authority, NAS Estimates, 1971-1979: revenue from the Property Tax: Ministry of Finance.

in personal income. The base elasticity averaged about 0.8 over the 1974 to 1979 period, i.e., the assessed value of property grew only 80 percent as rapidly as personal income.

The rate elasticity measures the ratio of the percentage growth in property tax revenues to the percentage growth in assessed value. The rate elasticity averaged about 1.9 over the 1974 to 1979 period, i.e., property tax revenues grew almost twice as rapidly as assessed value. If both nominal property tax rates and collection efficiency were constant over the 1974 to 1979 period, the rate elasticity would have an average of unity. Since nominal tax rates were constant over the 1974 to 1979 period, the rate elasticity estimates can be attributed to increased collection efficiency over the period.

The total revenue elasticity, which measures the ratio of the percentage increase in revenues to the percentage growth in personal income, averaged about 1.3 over the 1974-1979 period. Alternatively stated, property tax revenues--discretionary factors included--grew 30 percent faster than personal income during this period.

Another way to estimate the income elasticity of the property tax is on a cross-section basis. The cross-section approach has the advantage of holding constant the legal definition of the tax base and the legal tax rate--since data are taken from a single point in time. Cross-section relationships, then, must reflect differences among local governments in collection efficiency and in the relationship between assessed value and personal income.

For each of the four provinces under study here, we have regressed per capita property taxes in municipalities on per capita income. A double logarithmic functional form (natural logarithms of both the dependent and independent variables) is used, such that the coefficients can be interpreted directly as (constant) income elasticities. That is, the estimated relationship is:

$$\ln RPT \text{ per capita} = a + b \text{ (ln Income per capita)}$$

The results, shown in Table III-18 are mixed. In no case is a substantial amount of the variation in property taxes per capita explained by differences in income levels across the municipalities within a province; only in the case of Sorsogon is the estimated elasticity (0.32) significantly different from zero at the 0.05 level of significance. The Bulacan findings show a considerably higher point elasticity estimate than the other provinces, but it is not significantly different from zero at any reasonable level of significance. In all cases the elasticities and explanatory power of income differences is less when payment of delinquent taxes and penalties are included in the measure of the dependent variable--a finding that is a priori reasonable given the likelihood that such payments are probably driven by random factors.

The overall implication of these elasticity findings is that while collection efficiency is the key to the yield of the property tax, administrative factors such as campaigns and uses of legal remedies may be more important in determining relative yields than is simple concern for differences in abilities to pay. Any recommendations concerning this revenue source must, therefore, pay particular attention to this aspect of the administration question.

TABLE III-18

CROSS-SECTION INCOME ELASTICITY ESTIMATES OF THE REAL PROPERTY TAX, SELECTED PROVINCES: 1977[a]

Province	Current Year Property Tax		Total Property Taxes[b]	
	Elasticity	R^2	Elasticity	R^2
Albay	0.33 (1.43)	.16	0.19 (1.39)	.15
Bulacan	0.83 (1.26)	.07	0.50 (0.81)	.03
Iloilo	-0.17 (0.49)	.01	-0.05 (0.16)	.00
Sorsogon	0.32 (2.13)*	.27	0.13 (0.69)	.04

[a]Absolute t-values in parentheses.

[b]Includes current year plus past years plus penalties.

*Significant at the .05 level of significance.

SOURCE: Computed by authors.

Conclusions and Recommendations

The practice of property taxation in the Philippines is far from primitive. By comparison with other developing countries, the structure of the tax is sound and the quality of assessors and assessment practice is impressive. On the other hand, the revenue performance of the property tax has suffered from a poor record of enforcement.

This trend can be reversed and the property tax may be a more effective method of mobilizing domestic resources if only the Central Government takes a few important and perhaps overdue steps. The first would require recognizing that increasing the effectiveness of the local government property tax will mean raising overall tax burdens and leaning heavily on delinquent (and often influential) taxpayers. Neither action will be politically popular, especially taking legal action against those who attempt to evade the tax. The second step will involve forcing a coordination among several ministries to the end of improving property tax administration. It is simply beyond the powers of local governments to sort out problems which require cooperation between the Registrars of Deeds, Ministry of Agrarian Reform, Ministry of Local Government and Community Development, Ministry of Finance, etc. To force a coordination between these ministries as regards property tax administration will be no easy task--each ministry has its own agenda and priorities. Yet if the government sees the mobilization of local revenues as an important national priority, conflicts can be placed in a proper perspective and coordination can be worked out. A third important step is to

recognize that some Central Government investment in improving the tax will be required, i.e., fixing the property tax will not be a costless exercise. Finally, there is need to create a set of incentives and penalties to induce a more active participation by local governments and local residents in property tax improvement programs.

To be sure there are important administrative and management improvements to be made at the local government level, but in the highly centralized Philippine system, the really important reforms and implementing actions must be initiated by the Central Government. This conclusion is underlined by the recommendations for property tax reform presented below.

We would suggest changes in five general areas:

a. reform in the tax structure
b. more intensive use of taxes on property
c. improvements in record-keeping and management
d. changes in reassessment practices
e. improvements in the collection process.

Structural Reforms

The major problems with the property tax in the Philippines do not have to do with the rate and base structure. Still, our analysis has pointed to two important changes that could increase local government revenues in one case, and remove a disincentive to property investments in another. We would recommend:

a. elimination of fractional assessments on improvements, and

b. replacement of certain tax exemptions with payments-in-lieu of taxes.

Fractional Assessments of Improvements. The discussion above showed quite explicitly that the current technique of assessing certain higher valued improvements at a higher rate than land imposes a tax penalty on property investments. This penalty could be removed if all improvements were assessed at the same percentage rate, regardless of their value. The arguments against this reform are twofold. The first is that such a small change in tax burden will have no effect on property investment decisions and therefore will involve a needless loss in local tax revenues. There is no direct evidence (that we have found) to support or refute this argument. There is, however, some indirect evidence that the effects on property investment decisions will be large enough to matter. Lying behind the giving of exemptions to pioneer industries must be a belief that property taxes do matter. Moreover, as the property tax grows in revenue importance, this deterrent to property investments will become more important.

The second argument against eliminating fractional assessments is that the burden of the property tax would be shifted toward the residential sector[1] and toward lower income taxpayers. This is probably a correct evaluation of the impact, but causes one to raise the question of how important are equity vs. development concerns in formulating property tax policy? One view is that local governments in general and the property tax in particular are not the best instruments for dealing with income redistribution. On the revenue side, distributional objectives might be better left to Central Government tax policy. This would lead one in the direction of arguing to emphasize the revenue raising and investment effects of the property tax while ignoring, within certain bounds, its equity effects.

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[1] Because average improvement values are likely to be higher in the commercial/industrial sector.

Payments-in-Lieu of Taxes. Exemption from the property tax of government-owned properties, religious properties, low value 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 economy, they also confer national benefits. 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 and are not influenced by local governments. In the case of government properties, we would recommend a system of payments to local governments in lieu of property taxation. In the case of pioneer industry exemptions, we would recommend a serious reconsideration of the pioneer status of certain firms. In many cases the exemption is no longer necessary and amounts to an unnecessary giveaway of local government resources. Where the Central Government makes the decision that the property tax exemption should be retained, the Central Government should make a payment-in-lieu on behalf of the exempted firm, to the local government. The reasoning here is that since the Central Government makes the decision to grant the exemption, it should also pay the subsidy.

This reform would be equitable on benefit grounds, and it would also provide considerable increases in total revenues. Our estimates suggest that in the Provinces of Iloilo and Albay alone, such an arrangement in 1979 could have increased provincial property tax collections by as much as one-third. Moreover, the current assessment process in the Philippines would not need to be greatly altered to accommodate this change--the values of such properties are already assessed and recorded. Furthermore, as was

noted in the text such payments-in-lieu of property taxes are not at all an unusual practice in developing countries.

We would recommend that the religious exemptions and low value exemptions be retained--the former on social, political and ability-to-pay grounds (given the evidence concerning delinquent taxes provided above) and the latter on equity grounds as well as from the standpoint of administrative efficiency.

Increased Intensity of Use

Compared with many other developing countries and by comparison with the use of other taxes in the Philippines, the property tax is not heavily used. If property tax effort were increased to only 0.5 percent of GNP, the 1972-76 average for Asian developing countries,[1] a significant improvement in the fiscal importance of local governments would have been attained. Most of the reforms discussed here--having to do with a better implementation of the tax--will contribute to this increased effort. There are three other possibilities: to increase the rate ceiling, to make use of special assessments, and to increase property tax rates on idle land.

Increase in Rate Ceilings. By law, the property tax rate, including SEF, is limited to 2.0 percent of assessed values in municipalities and provinces and 3.0 percent in cities. When fractional assessments on land and improvements are taken into account, the legal rate is unlikely to be much greater than 1 percent of market value, even if all property were valued at its full market level. If underassessment and collection problems are considered, the rate is even lower. The ratio of tax collections to assessed value was, itself, less than 1.0 percent in the reassessment years of 1974 and 1979 (see Table III-12 above).

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[1] Tait, et al., "International Comparison of Taxation for Selected Developing Countries."

This argument leads to the suggestion that the government give some consideration to selectively raising the rate ceiling, or by allowing a special surrate. The quick response to this suggestion will be "why give more taxing powers to jurisdictions that already cannot collect their legal due ? Moreover, won't some jurisdictions merely substitute increased rates for increased collection efforts?" The answer to the first question is that many jurisdictions are now up against the legal taxing limit *and* have high collection efficiencies. Is it proper to constrain revenues in these jurisdictions because others have been lax? The answer to the second question is that authority to levy the surrate could be given only to those local governments that have high rates of collection and have completed tax mapping. Such a policy would fit the notion of providing incentives to local governments to improve their property tax performance.

The Idle-Lands Tax. Holding land out of productive uses, most likely in expectation of long-term capital gains, may be rational from the standpoint of an individual landowner but imposes serious social and economic costs on society. Application of the idle lands tax as it is currently constituted under PD 464 (as amended) is therefore a socially beneficial policy. While increased revenues and intensity of use of the property tax will be one result of this action, revenue yield is a secondary objective to improving the efficiency of land use and penalizing speculation.

We urge that local governments make use of the idle lands tax. This can happen only if the Central Government sees the merit in this tax and mandates its use--despite the obvious political repercussions

of such actions. 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 more likely implement it.

Some structural reforms in idle land taxation are called for. The National Tax Research Center in a memo (August 14, 1978) to the Director-General of NEDA 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. We would concur with these recommendations.

Special Assessments. 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 levy imposed upon the landowners who benefit most directly from the project is justified and desirable. These "special assessments" allow the property tax to be used as a benefit levy and, when used in the place of general tax revenues, may free up resources for other uses. Special assessments also are an excellent way for local governments to mobilize additional resources for capital formation in that they tap a segment of the population with a willingness and generally greater ability to pay for public improvements. We recommend that the Central Government encourage the use of special assessments.

Apparently the greatest obstacle to use of the special levy has been political rather than administrative. To overcome this opposition will probably require an effective job of "selling" the idea of the special levy as a means for a group of taxpayers to obtain services that otherwise would not be forthcoming. There are likely projects which would yield benefits to a neighborhood but which, on a municipal-wide basis, could not be justified as having a high priority. Such projects are ideal candidates for imposition of the special levy.[1] It is also desirable that barangay captains be made aware of the existence of the special assessment. In this manner the tax, possibly supplemented by the barangay share of the general property tax, could be used to finance neighborhood projects.

To ensure that the levy is administered effectively, it will be necessary to hold a series of training sessions at the provincial level to instruct assessors in the most recent techniques available for determining the base of this tax. Likewise, similar sessions might be necessary with treasurers to show how current record-keeping practices might have to be altered to allow for imposition of the special levy. In any case we would strongly urge that such steps be undertaken to take advantage of this aspect of property taxation which currently already exists in the law.[2]

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[1] As we will note below, more liberal borrowing terms might be given as an inducement to more use of the special assessment.

[2] The National Tax Research Center in a memo (January 30, 1979) to the Minister of Finance also recommended greater use of the special assessment; specifically they called for: (1)utilization of the tax by the Central Government; (2)establishing a unit within MOF that would provide technical assistance to local assessors in administering the tax; (3)allowing the entire cost of a project to be financed under a special assessment rather than limiting it to 50 percent; (4)use as the basis of the tax the increase in land value rather than the original taxable value; (5)establish a revolving fund to which proceeds of the special assessment would accrue and (6)provide sufficient working capital to the fund to insure that projects could be completed quickly.

Improving Records Management: Maintaining the Tax Roll

An essential prerequisite to effective assessment and collection is the establishing and maintaining of an accurate tax roll, i.e., knowing who is to be taxed and the characteristics of their properties. The inaccuracy of tax rolls is a major stumbling block to mobilizing more property tax revenues in the Philippines. Continued emphasis needs to be given in two areas of reform: tax mapping and record-keeping. Establishing tax liability in land reformed areas is a growing problem which needs resolution.

Tax Mapping. 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 high--too high to overcome the inherent short time horizon that characterizes most political decisions. The problems, then, are how to mobilize more resources for tax mapping, how to improve the efficiency of the tax mapping practice, and how to induce more enthusiastic local participation and some local financing.

First, more Central Government funding will have to be allocated for tax mapping loans. Less than 20 percent of local governments have even begun tax mapping and the process is not going very far on a ₱50 million Revolving Fund in the MOF. Simultaneous with making more loan funds available, the MOF staff to evaluate and assist in preparing tax mapping proposals will have to be increased in size. It is presently too small to

handle the needs of even the present ₱50 million Revolving Fund. A principal source of this increased funding will be Central Government general revenues.

A second way to mobilize more resources for tax mapping is to make fuller use of the USAID-financed grant program. We fully support the recommendations of the Holland-Wasylenko-Bahl report which calls for an integration of these programs under the MOF.[1] By combining these programs, it may be possible to provide initial seed money on a grant basis and the remainder on a loan basis. Moreover, if payments on the latter are deferred, the obstacle of local governments having to make substantial initial contributions might be removed and more local participation might be induced.

Combining these programs would have other advantages. Tax mapping could be targeted on certain types of jurisdictions to fit government priorities, e.g., initially on all municipalities and cities of a certain class. A body of technical expertise could be developed within the MOF for continuing technical assistance. The tax mapping program, and its funding, could be integrated with the preparation of manuals for tax mapping and for other aspects of property tax administration.

Third, incentives must be provided by the Central Government to induce more local government participation. This might be done in two ways. First, the grant program will have to provide more initial seed money to reflect the higher cost of mapping and to cover a larger share of the initial cost. This will mean targeting the program on a smaller number of local governments, but because the reimbursements for mapping

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[1] See Holland, Wasylenko, and Bahl, "Evaluation of Real Property Tax Administration Project," pp. iii-xi.

will be greater, it is more likely to induce more enthusiastic local government participation.[1] An additional way to reduce the local cost of participating in tax mapping is to lower interest costs and to defer repayment on the loan financed portion. Repayment could be deferred to begin three years after the loan was made--in hopes that increased property tax revenues would be realized by then. The first five years of the loan (repayment) could remain as it currently is designed--an interest-free loan. Then below-market interest rates could be charged on the loan for the remaining five years. If necessary, the government could declare the loan in default after these 13 years--or any time before--and claim BIR Allotments to recoup the borrowed amount. This easing of the terms of the loan may be sufficient, especially when combined with an information program, to provide the incentives necessary to bring about more tax mapping. 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 USAID grant assistance.

Fourth, there is need for more on-site technical assistance in tax mapping techniques and procedures. This becomes an especially acute problem if the USAID program is transfered to the MOF, since the more effective training has apparently been through the MLGCD. A comparable (to MLGCD) training capability in tax mapping will have to be developed in MOF. In any case, the objective should be to create an in-house capability to tax map and to maintain tax maps in assessors' offices.

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[1] For detail on how the seed grant might be altered, see Holland, Waslenko, and Bahl, pp. 34-38.

The problem with these recommendations, of course, is that they are not without costs. The MOF Revolving Fund and the USAID grant funds are important resources, but still not enough. Additional local resources have to be coaxed out with a set of incentives, and Central Government contributions--at least to beef up the MOF staff--will have to be made. We would recommend allowing the use of a share of Allotments earmarked for economic development purposes for tax mapping. Certainly an investment in the apparatus necessary to raise property taxes in the future is a justifiable development-oriented expenditure.

Record-Keeping. The assessment process is plagued by inefficient record-keeping and management. While tax mapping can go a long way towards sorting out this problem, additional steps are necessary. The MOF is nearing approval of a revised manual for RPTA and has given far more study to the records management question than we have. We would offer only a suggestion about one important element of reforming the records management function.

In communities which are not tax mapped, duplicate records are a major problem. In communities which are tax mapped, steps must be taken to prohibit duplication of records from taking place. Until a more satisfactory solution can be reached, cross-checking for duplicates--by hand--is likely to be the only method by which incorrect or duplicate entries will be found. The investment in a property tax clerk for this job would have a substantial payoff.

In the longer run, a more satisfactory method must be developed to insure that as the ownership of parcels is transfered, the property tax rolls are adjusted. Since reliance totally upon the parties to the trans-

action leaves too much to chance, the Central Government must take steps to insure that recorders of deeds relay all transaction information to the assessor to insure that the current owner of a parcel is the one who is taxed. Likewise, issuers of building permits and surveyors should report their activities to the extent they are relevant to assessed values. Since each of these communications of information is required under PD 464, no new legislation is required; all that is necessary is the imposition of proper incentives or penalties to insure that this information transfer is carried out. Not to do this is to seriously compromise the sustainability of the tax mapping achievements.

Land Reform

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, local finance officials--but the basic problem would seem to be with the system. While there are many "excuses" for the record of non-compliance, the relevant question now is what might be done.

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. We would suggest a tax amnesty on a portion of past due taxes so that tenants could enter into the taxpaying process

without a large accrued liability of past unpaid taxes. This amnesty should not be advertised or granted until a method to assess and collect taxes in land reform areas is established. Otherwise, the problem will simply recur and the amnesty will have no meaning.

The MAR and Bureau of Lands should be encouraged to speed the completion of the mapping process in reform areas. To help overcome the financial constraints to this completion, a partial cost recovery might be considered. While it may be contrary to the spirit of transferring land to tenants at "reasonable" prices, surveyors' fees could possibly be used to at least partially offset these costs. In a purely private transaction the purchaser of land is expected to bear these costs, thus such fees would not contradict common practices. We would recommend such a program.

We further recommend that, until mapping is completed, property taxes 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 the administrative costs.

A concentrated effort should be made to inform new owners of their legal responsibilities to pay property taxes and of the potential benefits to be had from the increased government revenues. The MAR could play a lead role in informing tenants of their taxpaying responsibilities under PD 464 and its various amendments. The information process can also be aided by the MLGCD given its role in the formation of local cooperatives to which tenants are required to belong. The coops and the barangays would seem to provide a natural information dissemination organization which the MLGCD should encourage.

Local assessors and treasurers must be encouraged, if not pressured, to gain an understanding of the administrative processes involved in land reform. An understanding of this process is crucial to designing programs to improve the tax administration process as it relates to the land reformed areas. Interagency dialogues between local representatives of the MAR and the treasurers and assessors, and explanatory manuals, would be of great assistance to both groups in gaining an understanding of their mutual problems. Once such understandings are improved, tax awareness campaigns in the land reform areas, especially through the coops, would seem the next natural step.

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 so many developing countries. There is, however, a major problem with the assessment cycle.

The current triennial reassessment cycle has two major disadvantages. First, it requires complete reassessments of all properties at a single point in time, thus adding to the overall costs of administering the tax. Not only does this peak loading of the work mean that it is necessary to hire relatively large amounts of casual labor at particular times during the cycle, but such peaking may also make it more likely that errors will creep into the effort. Second, when reassessments occur only once every three years in an economy characterized by fairly high inflation rates, accurate reassessment will mean that taxable values will experience large incremental jumps once every three years, then be relatively flat during

the interim period. This has a disadvantage for both the public sector and the taxpayer. The local government must anticipate slow growth in property tax revenues during the interim period while taxpayers will experience large single year increases in tax bills, thereby possibly lowering their willingness to comply with the tax or prompting them to bring pressure for a rate reduction.

To deal with these problems, we would recommend two changes in the assessment system. 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 associated with the current system and would also provide a bouyancy to the property tax system since approximately one-third of the tax base would be revalued annually.

While reassessment of only a fraction of all parcels each year would add bouyancy to the system while avoiding the current large workloads, it would still result in large single year increments to tax liability. So as to reduce this, our second recommendation is that increases in assessments on individual properties 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. This, in turn, might have a beneficial effect upon property taxpayer compliance.

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. The recommendations here concentrate on three aspects of the tax collection problem that would seem most likely

to help these efforts--coordination of collection of various taxes, efforts to ensure that taxpayers do not become delinquent and efforts aimed at collecting previous years' taxes.

Coordination of Tax Collection Efforts. One way of insuring taxpayer compliance with the tax 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 provision by requiring that, before a deed be issued to a new owner, the previous owner must show proof of payment of past due taxes. There are other opportunities to take this approach. One such case is the business tax. In Legaspi City, businesses must show proof of payment of their property taxes for the previous year as well as of the business license tax before a Mayor's Permit is issued. The MOF should encourage a wider use of this practice, especially in cities and larger municipalities.

There are, admittedly, limitations to this technique. For example, an owner of multiple parcels may show proof of payment on only a single parcel and still be judged fit to receive a clearance, or property owners may mislead officials by indicating they own no taxable property. Though important, these limitations seem more the exception than the rule and do not defeat the case for tax enforcement coordination.

Collections of Current Taxes. 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 (1) allow the taxpayer to comply with the law at the lowest possible cost and (2) 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. Closely associated here is the use of barangay level campaigns designed to show its residents the direct benefits they might gain from compliance with legal statutes. The aid of the barangay captains may be of greatest assistance, given their leadership position within the neighborhood. The several campaign techniques discussed above (see pp. III-52-53) would seem to be effective ways of using the barangay structure in increasing property tax compliance.

Collection of Delinquent Taxes. Despite their political unpopularity, the legal remedies for collection of delinquent taxes must be used. This is especially true in the case of larger taxpayers. 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 evasion will be serious.

Sale of land or personal property at public auction is likely to have a payoff much greater than the direct recovery of delinquent taxes, i.e., there should be an increase in collection efficiency as other delinquent taxpayers observe what could happen to their own cases.

Provincial and 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 in any one year collecting the greatest proportion of past due taxes would in effect be allowed to maintain use of, say, 60-70 percent of the delinquent tax take rather than the legal 45 percent. This may provide suf-

ficient incentive to a local political leader to accept the heat associated with sale at auction of some delinquent properties. Barangay captains might be given a share (e.g., 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 in the penalty rates. The current maximum of 24 percent reached after one year is insufficient in the current inflationary environment of the Philippines. An *additional* 1 percent per month for the two years following initial delinquency would put a more formidable penalty on property tax evasion.

Finally, especially in smaller rural areas, the use of public knowledge of delinquency (e.g., posting of delinquent taxpayers' names) could provide a non-monetary, yet effective, incentive for compliance. In any case, the key to collection would seem to be imposition of sufficent penalties or rewards to provide the incentives necessary to produce tax compliance.

APPENDIX III-A

THE EFFECTS OF LAND REFORM ON LOCAL PROPERTY TAX ADMINISTRATION IN THE PHILIPPINES

Agrarian reform has been a major policy initiative in the Philippines since the formation of the New Society. A side effect of this program--and one that is not so widely recognized--is on the administration and collection of property taxes. The purpose of this Appendix is to provide a more detailed description of the agrarian reform process in the Philippines, noting how this process interacts with local property tax administration.

We begin by providing a brief historical background of land reform efforts in the Philippines and a more detailed description of the statutory provisions for land reform. As is often the case, the actual outcome has not been the same as that anticipated, with some particularly unhappy consequences for local property tax administration in land reform areas.

Brief History of Land Reform in the Philippines[1]

Agrarian reform has been a long-standing issue in the Philippines. The system of large landed estates with share-cropping or leasing arrangements has existed since the Spanish era.[2] During the American era there were several attempts to reform Philippine agriculture including purchase of 160,000 hectares of land from the Catholic Church to promote homesteading, and passage of a Rice Share Tenancy Act in 1933 designed to regulate

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[1] It should be emphasized that our research has not focused on land reform, thus the discussion here is based primarily on a combination of a review of secondary sources and interviews rather than a formal, in-depth study.

[2] Ministry of Agrarian Reform, Primer on Agrarian Reform (Manila, undated), pp. 6-7.

landlord-tenant relationships.[1] None of these attempts were very successful.

Additional initiatives to alter the agricultural system were begun after independence in 1946. Republic Act 34, passed in 1946, regulated contracts between landlords and sharecropping tenants while in 1954 Republic Act 1199 further defined relationships between land owners and tenant farmers. In 1955 the Land Reform Act (RA 1400) created the Land Tenure Administration (LTA) that provides for expropriation of large estates to be distributed to landless tenants. It, however, contained a large number of loopholes; thus, between 1955 and 1962 only 19,155 hectares actually changed hands.[2]

It was Republic Act 3844 (1963) that established the Agricultural Land Reform Code that, together with its amendments (RA 6389 and RA 6390, both enacted in 1971), became the legal foundation for land reform efforts during the New Society period. The Agricultural Land Reform Code contains two initiatives--conversion of sharecroppers into leaseholders and leaseholders into owner-operators. While it was the law of the land throughout most of the 1960s, it was never very effective in reforming Philippine agriculture, primarily because of lack of funds, strong opposition from land owners and no timetable for completion. Thus, by 1971 only about 50,000 sharecroppers (5 percent of the total tenant farmers) had become leaseholders and only 340,000 farmer-tenants had altered their status from leaseholder to owner-operator.[3]

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[1] The World Bank, The Philippines--Priorities and Prospects for Development (Washington, D.C.: 1976), p. 476.

[2] Ibid.

[3] Ibid.

Land reform became a primary thrust of the New Society program under President Marcos. In the second Presidential Decree (26 September 1972 or only five days after declaration of marital law), the entire country of the Philippines was proclaimed a land reform area with the objectives of Republic Act 3844 still intact. On 21 October 1972, PD 27, also known as the Tenants Emancipation Act, was put into force. This decree has formed the basis of land reform efforts during the past nine years.

Agrarian Reform Under PD 27

PD 27 deemed that tenant farmers of private agricultural lands devoted to rice or corn production were to become owners of a five hectare unirrigated (three hectares if irrigated) farm and that landowners of rice or corn land could not retain ownership of more than seven hectares. It also specified that the fair price for the land was to be set at two and one-half times the value of the average harvest of three normal crop years prior to the decree and that the tenant would have fifteen years in which to pay for the land (including interest at a rate of 6 percent per year). The tenant was to become a member of a farmer's cooperative and the co-op would pay the remaining amortizations in case of default. The government was to reimburse the original owner in shares of stock in government-owned and government-controlled corporations. However, the tenant would not be able to transfer title to the land other than by hereditary succession or to the government.

The above were the main features of PD 27; however, as is most often the case with Presidential Decrees, specific administrative details were worked out later. Furthermore, subsequent PD's clarified and expanded upon the original declaration.[1] These statutes, letters of instructions, and various memoranda specify the operations underlying the transfer of the land, processes for determining price, duties and rights of the original owner as well as provisions for the formation of necessary new institutions. We review each briefly here.

Transfer of Lands

While Presidential Decrees 2 and 27 set forth the basic scope and methods to be followed in pursuing agrarian reform, the administrative details of actually transferring ownership obviously required considerably more detail. The process of ownership transfer, known as Operation Land Transfer, has been carried out under the direction of the Ministry of Agrarian Reform (MAR) and involves several important steps.

Upon determining eligibility and delineating the boundaries of the property, tenants are issued Certificates of Land Transfer (CLT's) which serve to verify participation in the land transfer program but do not constitute outright titles to the land. Under PD 315 (22 October 1973) the CLT could, however, be issued as collateral in obtaining production loans from the Land Bank of the Philippines or other rural banks.

While the Certificate of Land Transfer did not give title to the land, PD 266 (4 August 1973) provided that the MAR was to record the land transfer with the Land Registration Commission which, in turn, was to transmit a copy of the CLT to the Register of Deeds in the province or city where

[1] A document prepared by the Ministry of Agrarian Reform, Vital Documents on Agrarian Reform in the New Society (Manila, undated) contains 39 additional PD's related to the land reform process issued subsequent to PD 27.

the land was located. In this manner, the procedure, if carried out fully by all parties including the local Register of Deeds, would provide information to local assessors as to the current owner of the land.

Because the process was recognized to take time and there would be great temptation for land owners to avoid land reform by altering long-standing owner-tenant relationships before official land transfers were made, MAR Memorandum Circulars 2 and 2A state that the status quo should be maintained in those relationships. Furthermore, the tenant farmers were required to continue to pay the landowner the lease rental payment that had traditionally been paid so that later, when the land transfer operation was carried out, these payments would be counted as amortization payments. Thus, the tenant farmers were urged to obtain and keep receipts for these rental payments; however, apparently it was not always done.

Upon full payment for the property the tenant was to receive an Emancipation Patent. This was to represent full emancipation of the farmer from the "bondage" of tenancy. Under the statutes the Emancipation Patent would not be issued unless the tenant was a member of a recognized and authorized cooperative and was actually cultivating the land himself. While the term "emancipation" would seem to suggest total freedom, the tenant is still not allowed to sell his land to anyone other than his own heirs or to the government who, in turn, could award it to another qualified tenant.

The actual procedure associated with obtaining the Emancipation Patent is an involved one and required 15 separate steps to be carried out. Furthermore, in a memorandum dated 15 September 1976 it is stated that

before an emancipation patent is issued, there must be a copy of official receipts and/or certification by the municipal treasurer showing that the applicant has fully paid the realty taxes due on the land parcel applied for. Theoretically, then, this should serve to insure that local property taxes will be paid on all transferred properties.

Determination of Price

While PD 27 specified a straightforward formula for determining valuation of the land, apparently it was difficult to administer. Rather than basing the price on an agreed-upon level of production, the owner and tenant would reach agreement on an ultimate price with this amount then "backed-into" the statutory formula to derive a corresponding yield. There were at least two difficulties with this more ad hoc approach. First, it provided the landlords a way of slowing the actual transfer of land since they tended to delay reaching agreement on the settlement price. Second, there was apparently some fear that landlords would have superior bargaining power under this arrangement.

To alleviate this situation, a Local Barangay Committee on Land Production (BCLP) was formed in each barangay (Memorandum Circular 26 dated November 5, 1973). These committees included a representative of the local Samahang Nayon; the barangay captain; two representatives of landowners cultivating their own lands; two representatives of land owners who have tenants; four representatives of the tenants and one MAR representative who is the secretary of the BCLP but cannot vote. The Committee has the

responsibility for determining average yields for the three normal crop years in the barangay prior to October 21, 1972 and for classifying the rice and corn lands within the barangay. Since the prices of the crops were maintained nationally, determination of average yield was the only necessary information for land price determination.

Duties and Rights of the Landowners

Several constraints were placed upon the landowners to insure that they would not alter practices simply to avoid inclusion in land reform. For example, landowners were not allowed to eject tenants even if the landowner would like to cultivate the land himself. The landowner was, however, given the right to choose the seven hectares of land which he preferred to hold. Furthermore, PD 57 (19 November 1972) stipulated that the landowner would be exempt from capital gains tax on the sale of the property.

Compensation of the owners could take on one of several different forms (PD 251, 21 July 1973). These included using (1) cash payment of 10 percent of the total with the balance in 25-year tax free 6 percent Land Bank bonds; (2) payments of 30 percent in shares of preferred stock issued by the Bank with the balance in 25-year tax free 6 percent Land Bank bonds; (3) full guarantee on the payment of the 15 equal annual amortizations to be made by the tenant; (4) payment through the establishment of annuities or pensions with insurance; (5) exchange arrangement for stocks in government-owned or controlled corporations or private corporations where the government has holdings; (6) any other

settlement mode adopted by the board of directors and approved by the President of the Philippines. In the case of smaller land holdings (a landowner with more than 7 but less than 24 hectares of affected lands) the owner could be paid 20 percent of the cost of the land and the balance in 25-year tax free Land Bank bonds. He was also entitled to an additional 10 percent cash payment to be used either for the education of his children, for their insurance or for housing. In any case the total cash payment would never be more than 30 percent of the total cost of the land.

The landowner did however, have several duties to perform. Before he could obtain any cash payment through the Land Bank he had to provide several documents including proof of payment of all previously-owed property taxes on the property. Thus, again on a statutory basis, local property tax administration should not have been affected by land reform since proof of tax payment was a necessary condition for compensation for the transferred property.

Institution Building Under Land Reform

The Land Bank of the Philippines had been created prior to the formation of the New Society; however, it was deemed inadequate to provide the necessary capitalization to carry out the broad-based reforms outlined in PD's 2 and 27. Thus, PD 251 (21 July 1973) was designed to strengthen the capabilities of the Land Bank by providing for additional capitalization and giving it a central role in the financial transactions involved in the transferring of land reformed properties. (See Chapter IX for a more complete discussion of the Land Bank, including its role in local government financial affairs.)

The second institution that was to play a major role in the land reform process were the agricultural cooperatives. All farmer-tenants were to become members of a local co-op prior to issuance of the CLT and were to show proof of membership before being issued an Emancipation Patent. PD 175 (11 April 1973) declared it national policy "...to foster the creation and growth of cooperatives as a means of increasing income and purchasing power of the low-income sector of the population in order to attain a more equitable distribution of income and wealth." This PD enumerates the principle powers and privileges of cooperatives and gives the Ministry of Local Government and Community Development administrative authority over all types of cooperatives.

Actual Progress of Land Reform in the Philippines

While the statutory framework underlying Land Reform would seem to provide adequate means for completing the task on a timely basis, there have been problems and delays. Many of these have been recognized and are being remedied, but to the extent that problems persist and are related to the administration of the property tax, localities can anticipate continued difficulties associated with the process.

Progress of Land Reform

Estimates of the number of parcels and hectares to be included under agrarian reform suggest that it will cover over 950,000 tenants, 430,000 landlords, and 1.5 million hectares.[1] While originally it was planned that

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[1] World Bank, p. 178.

the entire land reform process would be completed by the end of 1977,[1] delays have beset the program. According to one recent report, as of 30 September 1980, over 501,000 CLT's had been issued to nearly 360,000 tenants. Apparently the MAR has reduced its target since the mid-1970s since this progress is considered to represent "90.63 percent of the target scope".[2] According to the same report, 2,461 Emancipation Patents had also been issued by the end of September 1980.[3]

Delays in Land Reform

While progress has been made, the data suggest it has been slower than originally planned. To the extent that the process of transferring ownership from landowners to tenants hinders property tax administration, continued delays in the process serve only to add to the problems associated with local revenue administration in the Philippines. There are several reasons for these delays that, therefore, in turn have implications for local property tax administration.

Mapping. Before the land can be legally transferred, adequate maps must be made of the affected areas. Not only does the lack of such maps slow the land transfer process, but also hinders property tax administration directly since it makes it nearly impossible for the local assessor to determine exact land boundaries and legal landowners.

The MAR appears to recognize this problem and has placed mapping among its priority budgetary items for the early 1980s. Yet mapping

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[1] Ibid., p. 480.

[2] Conrado F. Estrella, "Policies, Programs and Accomplishments," Agrarian Reform Review, Commemorative issue on the Eighth Anniversary of the Tenant Emancipation Decree (October 21, 1980), p. 43. Mr. Estrella is the Minister of Agrarian Reform.

[3] Ibid.

is a slow process that can easily be hindered by noncooperative landlords. Further impeding the mapping process is the lack of sufficient cadastral survey data in many of the provinces.[1] An interesting aspect of this lack of adequate survey data is that it hinders both the land reform process and tax mapping--both features that have direct implications for successful levying of the property tax in rural areas.

Role of Landlords. As might be anticipated, cooperation of landlords has been a major impediment to completing the land reform process. While compensation is made for the land, the form of this compensation provides little incentive to willingly surrender the land. The 10 percent down-payment on larger estates (greater than 24 hectares) with the remainder in 25 year Land Bank bonds not only inserts a degree of uncertainty regarding the likelihood that the bonds will have value upon maturity but also can involve a substantial capital loss. In the Land Bank report, for example, it is shown that when using a 10 percent rate of discount, the bond (plus interest) will have a present value equal only to approximately 40 percent of its face value.[2]

It is little wonder then that landlords have not been enthusiastic supporters of land reform. Among the strategies they have apparently employed include impeding the mapping process, altering uses of land into forms not liable for reform, and entering into legal disputes contesting

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[1] The World Bank report, The Philippines--Priorities and Prospects for Development, notes that a major reason why the Republic of China was so successful in implementing land reform was the existence of complete land ownership records updated only four years prior to the imposition of land reform (p. 480).

[2] Ibid.

the reform process. In addition, even if the landlord expects that ultimately the land will be transferred, the capital losses associated with obtaining the non-liquid bonds provides an incentive to continue under sharecropping or leasehold arrangements as long as possible, even if finally those payments will be credited towards amortization of the transfer of land. At least in that manner, the payments will be in spendable cash rather than less liquid bonds. Furthermore, by not providing receipts to the tenants for these payments, the landlord increases the likelihood that not all of the past payments will be credited towards amortization.

Administration. There are, of course, numerous administrative steps required before land is transferred. All of this takes time as well as a large amount of resources. Furthermore, collection of amortization payments from over 300,000 tenants is a large undertaking. Any program designed to financially effect a substantial portion of the population is likely to encounter administrative problems. One can easily list factors that can impede progress in such a program--lack of adequate records, maps, literacy, etc. all come to mind. Furthermore, creation of a bureaucracy necessary to carry out these functions is, itself, a massive undertaking. Thus it is not surprising that the early target dates were not met; indeed, one might argue that it is a wonder that so much progress has been made. At the same time, to expect all of the problems to vanish quickly would seem unrealistic and therefore, what is most likely needed in terms of the effects of agrarian reform on property tax administration, is an improved understanding of the process by local financial administrators, and their willingness to work within the constraints and, wherever possible, to aid the transfer process.

Implications for Property Tax Administration

The PD's and implementing rules would seem to be quite clear with respect to payment of the property tax. The landowner is required to pay before compensation is received and the tenant before the emancipation patent is received. The rules have not been followed. The reasons behind this non-compliance are not altogether clear but probably stem from a combination of factors, including a great deal of uncertainty and lack of information on the part of participants, delays in completing the transactions and minimal incentives for the participating Central Government agencies to insure compliance with local tax statutes by owners or tenants. We elaborate on these possible reasons here, but recognize that only a more formal analysis will provide definitive answers.

Legal Opinion

One part of the problem associated with non-compliance may stem from a legal opinion stated on 27 February 1973 by the Department of Justice.[1] This opinion stated that since the MAR was at that time restricting implementation of PD 27 to lands with areas of 100 hectares of more,[2] the Secretary of Justice found that only tenants on such lands (i.e., large estates) were to be held liable for payment of local property taxes. Owners of tenanted lands of less than 100 hectares were, at least temporarily, to continue to pay their real property tax in spite of the fact that

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[1] Vicente Abad Santos, Secretary of Justice, "Opinion No. 35, S 1973" in a letter to the Secretary of Agrarian Reform (February 27, 1973).

[2] MAR had decided to carry out the land reform process in several phases with the first phase to focus only on landed estates of greater than 100 hectares with later phases devoted to smaller land holdings.

some were interpreting PD 27 to mean that all rice and corn lands were to be transferred.

This, quite obviously, could add confusion to an already uncertain situation. Owners of smaller properties very likely recognized that long-term ownership of their property was very unlikely. With the entire situation in flux, it would seem quite reasonable that such owners would forego complying with the tax, at least until more definitive decisions had been made concerning the administration of the program. Furthermore, the maximum penalty rate of 24 percent on delinquent property taxes would do little to speed payment given the likelihood that land transfers would not occur for several years.

The uncertainty associated with this single legal opinion is not, however, the only possible reason for owners' non-compliance. Even under the statutes and methods of administration of the program, there could be other reasons why owners allowed their taxes to become delinquent.

Owners' Non-Compliance

There are two separate cases to consider under the heading of owners' non-compliance. The first involves owners who follow, albeit unwillingly, the legal procedures and enter into formal agreements with the MAR and Land Bank to be compensated for their property. In such cases, if the MAR fully complies with the statutory requirements, no problems with compliance should arise. That is, under the regulations associated with PD 27, payment will occur only if proof of payment of past due property taxes is given. Whether or not the MAR fully carries out this requirement is, of course, another question.

Where the owner has not utilized the "services" of the MAR and Land Bank but, instead, has continued tenancy relationships similar to those prior to PD 27, full collection of past due taxes is much less likely. First, owners, especially if they have been well aware of PD 27 and its amendments, are very likely to have been delinquent in paying taxes under the expectation their land would be transferred. Yet, once transferred, the extent of legal remedies is greatly reduced for it will be impossible to auction land which has already been transferred from the delinquent taxpayer. Only distraint of personal property and civil actions are possible, yet neither of these remedies have historically been greatly used by local authorities.

It should also be recognized that, while PD 27 limits agrarian reform to rice and corn lands, PD 2 declared all of the Philippines a land reform area. This, then, may have a spillover effect on all property tax compliance. To the extent any large landowner feels that PD 27 could be amended sometime in the future, he may be more willing to remain delinquent on property tax payments.

Tenants' Non-Compliance

There are at least three possible courses of action that tenants may take in response to land reform; yet, each has different property tax compliance implications. First, where the tenant obtains a CLT and plans to earn an emancipation patent, property tax delinquency should not be a problem. That is, assuming that the tenant is aware of his obligations and the requirements associated with the granting of the emancipation patent, there will be the recognition that all local taxes must be paid.

A second possibility is that, while the tenant receives a CLT, he may not be concerned with obtaining an emancipation patent since he still will not have the legal right to sell his property to whomever he wishes. In such cases there is no strong incentive for the tenant to comply with the tax since the "carrot" of an emancipation patent is not applicable.

A third possibility, and related to the landowner discussion above, is where the tenant-landlord relationship has not been altered since 1972. In these cases there is no reason to expect that the tenant has been complying with the tax even though the interpretation is that his lease payments are credited towards amortization of the property.

This third alternative raises at least two additional issues that are at least partially applicable to the first two alternatives. The first issue is one of legal remedies in the case of tenant noncompliance either in the past or in the future. As noted above, a principal approach to handling property tax delinquency is the auction method. Yet, even if an emancipation patent has been issued, the question arises as to whether or not a transferred parcel could be sold at public auction since the statutes are quite clear that these properties cannot be transferred to just anyone. Whether this would mean that the MAR would have to limit bidders on the auctioned property to "eligible" participants in land reform is very unclear. In addition, there might be philosophical difficulties associated with forcing the new landowners from their properties after such a large effort to reform the entire land ownership institution within the Philippines.

A second general issue that arises when considering compliance with the property tax by tenants concerns the ability of these new landowners to pay the tax, especially a relatively large amount of back taxes. It is likely that these tenants do not have any excess capital and possibly suffer from cash flow problems. When there is an accumulation of past due property taxes to be paid, e.g., in the case the tenant had been unaware that his lease payments were being credited towards amortization but delinquent taxes were being accumulated, to expect that this new landowner would be able to immediately pay off these back taxes seems quite unlikely. If this is a severe problem (a fact which only further, more detailed, research can determine), there may be good reasons to declare a tax holiday on delinquent taxes on reformed land. If there is little likelihood that these tenants will be able to reimburse their delinquent taxes in the near future, compliance in the future may be aided by cancelling all past taxes. Further, by educating the new landowners about their responsibilities and about the benefits from property tax compliance, future compliance may be enhanced.

In any event, information would seem to be a crucial ingredient in any attempt to alleviate problems associated with administering the property tax in land reform areas. The previous tenants are unlikely to ever have been active participants in local financial administration and are unlikely to be aware of their responsibilities. By increasing the amount of information these tenants have about property and other taxes and about the benefits that compliance may hold, compliance may increase.

It would seem that, as discussed in Chapter III, the barangay would be a communications channel to provide this information although the cooperatives could also be used.

In addition, cooperation of the participating Central Government Ministries must be stressed if local property tax administration is to be improved in the land reform areas. Among these are the MLGCD which can use its influence over the cooperatives to insure its role in informing tenants of their property tax responsibilities and the MAR which also can provide similar information when it issues the CLT or any other information it passes on to tenants. Finally, the Land Bank could, perhaps, become a part of the tax collection process. For those tenants who are using the Land Bank as the collection agency for amortization payments, there is the possibility that the amortization payments be increased to include payment of current year taxes. While this would probably add to the administrative costs incurred by the Land Bank, it could greatly increase the level of compliance on the part of tenants. It would, however, require a statutory change since the original PD 27 specifies the legal form of the amortization payment. Nevertheless, if the Central Government is serious about improving local government financial capacity, such a change should be seriously considered.

Conclusions

The land reform process as envisioned in the statutes would seem to contain sufficient safeguards against lack of property tax compliance by the participating landowners and tenants. It does, however, contain

sufficient loopholes and disincentives to encourage noncompliance. At the same time there may be means to alter the agrarian reform process such that these difficulties can be overcome. One important and quite feasible step in this process is to insure that all Central Government agencies playing a role in either land reform or local finance administration--MAR, MLGCD, the Land Bank, MOF--all understand the constraints and objectives faced by each other so that, through cooperation, both Agrarian Reform and Local Finance can be carried out successfully.

CHAPTER IV

THE BUSINESS LICENSE TAX

The business license tax (BLT) is a major source of city and municipal government revenue in the Philippines. In many jurisdictions, it accounts for more General Fund revenue than does the real property tax (see Table II-8). Despite this importance and despite the many problems with the tax, relatively little attention has been given to the possibilities for reforming the BLT.[1] In this Chapter we consider the problems and reform options in the areas of base determination, rate level and structure, and collection efficiency.

Statutory Basis

The BLT is really a collection of three types of business tax or licenses which may be levied by local governments. The statutory basis is PD 231 (amended). The major form of business tax is a gross receipts tax, with the tax rate varying according to type of business and total sales. The second form is an annual fixed amount levied without regard to the volume of sales. It is on the order of a license paid for the privilege of doing business in the local area. The third is an amusement tax, a flat percentage rate on admissions, etc., levied only by provinces and cities. The overall structure of the BLT, then, is quite complicated, though most revenue is derived from the first form.

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[1] We could find only an NTRC study of the BLT in Metro Manila. See Study on Local Business Taxes in Manila (Manila: NTRC, 1978).

Determination and Assessment of the Tax Base

There are two issues associated with the determination of the business license tax base: (a) specifying the category into which a particular business falls and (b) determining the amount of taxable gross receipts. Apparently the classification of business for tax purposes does not cause great difficulty, especially in smaller localities where the nature of specific businesses is familiar to nearly everyone.[1] It is considerably more difficult to obtain an accurate estimate of annual gross receipts and herein lies the major problem with the BLT.

The treasurer's office maintains a file of all businesses in the locality and as new businesses are formed, new cards are added to this file. Each card contains the name of the business, its address, the nature of business performed (which serves as the basis for determining which rate schedule is applicable), and space for entering, yearly, (a) gross receipts of the business during the previous year, (b) the tax due and (c) the payment record. This record-keeping seems straightforward enough, but there are many cards and manual manipulation is cumbersome and leaves much room for error.

The measurement of gross receipts is not an easy job, nor is it done with great accuracy. For larger business with verifiable records, the BLT works. The problem comes in the case of smaller businesses which do

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[1] We encountered one instance in which classification has caused problems. In Bocaue, Bulacan it was stated that since chemical manufacturers and chemical dealers pay different rates, classification decisions can have substantial revenue effects. The Bureau of Internal Revenue was called on for assistance because they also classify businesses in administering the corporate business tax and several indirect excise taxes imposed at the Central Government level.

not have records which can be easily examined to verify the reported amount of gross receipts. In these cases, the tax becomes an almost voluntary matter. Most treasurers apparently take the word of the businessman as to the amount of gross receipts and therefore tax liability. This is often justified on grounds that the declaration of gross receipts involves a "sworn statement" by the businessman. Moreover, the job of verifying sworn statements would require much more staff than most local treasurers have available. In light of this procedure, it should come as no surprise that there is a severe underreporting problem.

Some steps have been taken to get a better estimate of gross receipts. One seemingly unsophisticated but apparently effective method, used in some jurisdictions, is simply "haggling" over the amount. Treasurers may not be able to establish the amount of gross receipts, but they may be able to guess that gross receipts have increased. When local treasurers recognize cases where inflation is increasing gross business revenue by large amounts--goods that have price inelastic demands--their haggling powers are certainly strengthened. On the other hand, proper haggling is a time consuming process and understaffed treasurers' offices may not engage in it on a large scale. A second method used to increase the accuracy of reporting, at least for larger businesses, is to require that the businessman present accounting records to substantiate any self-reported revenue data. This method does, however, require that the treasurer's staff have some ability to analyze an income statement.[1]

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[1] In the case of larger business operations, the use of an outside expert by the treasurer's office may be well worth the investment.

Intergovernmental cooperation could also help eliminate the reporting problem. The Philippines levies a national sales tax and both personal and corporate income taxes. The submittal of income tax records to the local government could be an efficient and yet simple method for obtaining evidence regarding past years' gross revenues. Of course, this would require a great deal of cooperation with the Central Government and if the BLT could be tied to the central tax structure, perhaps a more effective kind of local sales tax could be developed. We have more to say about this below.

Rate Structure

The rate structure of the BLT is regressive, i.e., firms with higher levels of gross receipts are taxed at lower rates. For example, in the case of retailers and wholesalers operating in cities, firms with gross receipts less than ₱1000 pay at a (maximum) 4.5 percent rate, while firms with gross receipts of ₱100,000 pay at a 2.4 percent rate, and firms with gross receipts of ₱1,000,000 pay at a 1.37 percent rate. This general structure of declining effective rates holds across all classes of business activity.

A regressive rate structure makes the revenue elasticity of the BLT lower than it would be under a flat rate or progressive rate structure. As firms increase their gross receipts because of real income growth and inflation, they are "bumped-up" into higher gross receipts brackets where the average tax rate is lower. Under a flat rate structure, real income

growth and inflation would generate a greater revenue flow. On the positive side, the current regressive rate structure (a) does not provide the inducement to understate gross receipts that a progressive structure would provide, (b) is less inflationary than a flat rate or progressive structure and (c) reduces the disincentives to investment and expansion of firm operations.

Notwithstanding these advantages of the current structure, we propose that the present rate structure be altered by creating a flat rate at least as great as that currently imposed on the smallest business within each business group. This, itself, would lead to greater revenues from the tax but, more importantly, would increase the elasticity of the revenue source. It would still be possible to retain the current differentials in rates across different types of businesses. Any further substantial changes in the overall structure of rates should, however, await further and more in-depth research into the question.

As noted above, not all business activities are taxed on a gross receipts basis. In some cases the rates are *specific*, e.g., per bowling alley lane or per night in the case of boxing contests. The *specific* rate structure clearly is inelastic and does not contribute a rapid revenue growth during periods of inflation and income growth. Such a rate structure may also induce undesirable economic incentives. A greatly oversimplified example may be used to make the point. The BLT on theaters permits a tax of ₱800 per annum if the theater contains balcony and orchestra seats for 500-999 persons, while a similar theater with

seating capacity of 1,000 or more persons pays a ₱1,000 per year tax. Suppose an "optimal size" theater (without regard to the tax) would be built to seat 1,010 persons. Given the tax differential due to the ten seats, the builder may decide to build a 999 seat theater instead. In this case the differential tax based only upon seats will result in suboptimal investment. The BLT rates may not be large enough to have such effects, but the possible inefficiencies inherent in such a structure should at least be recognized.

Collection Procedures and Problems

Administration of the BLT is relatively straightforward. Upon determination of the tax base, application of the statutory rate directly yields the total tax liability. While the statute declares all business taxes to be due by January 20, it also permits localities to allow for quarterly payments, which is the procedure generally followed. Payment is made directly at the treasurer's office and relatively little use is made of collectors. Collection of the tax is (or should be) aided greatly by the fact that shortly after the first of the year each business must obtain a Mayor's Permit (a license for doing business within the jurisdiction). Since a prerequisite to obtaining the Mayor's Permit is payment of the previous year's business taxes, the likelihood that a business will be delinquent on its local tax levy is greatly decreased.

Collection efficiency under the BLT is not easily measured. The usual ratio of collections to collectibles is misleading because it misses the revenue loss due to underreporting (just as the analogous property tax

measure misses the effects of undervaluation). In effect, the traditional measure of BLT collection efficiency refers to the extent to which known taxpayers with a known tax base actually make payment and by this measure, collection efficiency for the business tax appears quite good. Probably the key reason is the fact that businessmen must show proof of past years' payment of the BLT in order to obtain a new Mayor's Permit.

The major collection difficulty is associated with late payment. As noted above, the tax can be paid quarterly in the 12 months following the tax year without interest penalty; thus, at least some taxpayers are often late in their tax payment. In such cases late charges are applied to the quarterly amount overdue and delinquency letters are sent to the businesses.

There are also problems with businesses that do not obtain a Mayor's Permit and therefore evade the business tax. These, however, do not appear to be major. At least some municipalities have tax collectors who enter business establishments to insure that a Mayor's Permit has been obtained.

Revenue Performance

Less complete data are available on the business tax base than on the property tax base because gross receipts data are not available in so extensive a form as is property assessment information. As a result, we can say relatively little about the base elasticity of the BLT. We can, however, track the revenue performance of the BLT over time and across our sample of cities and municipalities. As was shown in Table II-8

above, business taxes are an important source of General Fund income, especially in cities.

Sectoral Composition

In order to get some idea about the base elasticity of the BLT, we have extracted data on the revenue composition by industrial sector, for two cities--Iloilo and Legaspi--for 1977 and 1979. These data, though far from flawless, do tell us something about the structure of BLT revenue growth and its potential responsiveness to income and prices. By far the most substantial portion of the business tax in both cities was collected from retailers and wholesalers. Amusement admissions constituted the second most productive source in both cities and manufacturing was of a lower order of importance. A quick look at IV-1 should convince one that the BLT is essentially a tax on traders and places relatively little burden on producers.

Three years is, of course, a very short period, but we can get some feel for the sectors of revenue growth by comparing the 1977 and 1979 revenue distributions. In total, these taxes grew by over 40 percent in Iloilo City and by nearly 25 percent in Legaspi City. However, when it is also recognized that the consumer price index over these three years increased by 25 percent, one must conclude that the business tax in Legaspi was just keeping pace while that in Iloilo was more impressive. One cannot infer from these results that the business tax is inherently responsive to inflation, even though it is primarily a gross receipts tax on traders.

TABLE IV-1

BUSINESS TAXES IN ILOILO CITY AND LEGASPI CITY: 1977 AND 1979

Tax	Iloilo City			Legaspi City		
	Percent of Total		Percent Increase	Percent of Total		Percent Increase
	1977	1979	1977-79	1977	1979	1977-79
1. Manufacturing	4.2	7.3	147.9	5.9	8.6	81.1
2. Eateries	1.9	1.8	38.0	6.4	5.9	15.0
3. Services	8.4	6.2	4.2	3.9	3.2	3.4
4. Spirits	3.1	2.2	2.6	1.6	1.3	0.2
5. Tobacco	0.7	0.6	12.8	1.5	1.1	-7.5
6. Amusement Devices	0.2	0.1	-12.7	0.3	0.2	-23.3
7. Amusement Places	3.1	3.6	60.6	1.1	1.0	17.1
8. Amusement Admis.	12.8	9.7	7.5	11.9	12.5	29.8
9. Pawnshops/Banks	1.7	1.4	15.8	2.2	2.3	32.4
10. Insurance	0.3	0.2	-8.4	---	---	---
11. Boarding Houses	0.1	0.0	4.1	0.1	0.2	197.7
12. Lodging Houses	0.2	0.1	-25.1	---	---	---
13. Hotels	0.3	0.2	-20.4	0.6	0.6	15.6
14. Private Detective	0.1	0.1	9.8	0.0	0.0	-24.9
15. Real Estate	2.0	2.2	57.3	0.6	0.7	47.0
16. Fish ponds	0.0	0.0	-56.8	---	---	---
17. Cemeteries	0.0	0.0	104.0	---	---	---
18. Billboards	0.3	0.2	-17.6	0.1	0.0	-70.4
19. Printing	0.2	0.2	40.6	---	---	---
20. Mills	0.3	0.2	21.6	0.2	0.0	17.1
21. Delivery Trucks	0.3	0.4	95.6	---	0.3	N.A.
22. Peddlers	0.1	0.1	77.5	2.4	0.4	-81.4
23. Retail-Wholesale	59.6	63.0	49.8	49.1	51.5	30.2
24. Other	---	---	---	12.0	10.0	3.1
Total Amount	₱5,461,316	₱7,741,495	41.8	₱2,010,906	₱2,498,921	24.3
Total as Percent of Total General Fund Revenues	33.0	37.3		41.1	43.1	

--- : Not available.

SOURCE: Constructed from data supplied by local treasurers.

The faster growth rates in Iloilo City vis-a-vis Legaspi City could be attributed to several possible causes. First, the economy of Iloilo City may be a bit more broad-based than that in Legaspi City so that any cyclical fluctuations that are industry-specific would affect the former city less so than the latter. Second, it may be that in general the local economy in Iloilo City was stronger during this period than in the Bicol region. In this respect, note that the retail-wholesale portion of the tax increased by nearly 50 percent in Iloilo City compared to only 30 percent in Legaspi City. Third, it may be that administrative practices in Iloilo City were somehow more effective than in Legaspi City in capturing the taxable base (despite the fact that we were told there are eight clerks assigned to the BLT in Legaspi City and only six in Iloilo City). A much more detailed analysis of the local economy and administrative practices in these two areas is necessary to sort out the relative effect of these alternative possibilities.

Variations Among Municipalities and Cities[1]

In order to obtain a more systematic view of the relation between the revenue yields of the BLT and various socio-economic characteristics of jurisdictions, we have carried out a cross-section analysis on BLT collections in 98 municipalities and 42 cities. We have studied the variation among municipalities within each province, among all 98 municipalities, and among the 42 cities. Ordinary least squares regression has been used on 1977 data, with the revenue and income variables expressed in natural logarithms, to estimate four models:

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[1]This discussion is a bit technical. The general reader may skip to page IV-15 without loss in continuity.

$$1: \quad BLT_p = \alpha_1 + \beta_1 Y_p$$

$$2: \quad BLT_p = \alpha_2 + \beta_2 Y_p + \delta_2 U_p$$

$$3: \quad BLT_p = \alpha_3 + \delta_3 U_p + \gamma_3 NY_p$$

$$4: \quad BLT_p = \alpha_4 + \delta_4 U_p + \gamma_4 NY_p + \Gamma_4 P$$

One measure of the income elasticity of the yield of the BLT can be found by regressing per capita BLT revenues (BLT_p) on per capita personal income (Y_p) as in model 1. However, as suggested in the tax effort discussion of Chapter II, the BLT appears to be very much an "urban tax" hence our Model 2 includes a variable measuring the percent of population living in urban areas (U_p). The data in Chapter II suggested that non-agricultural income was more systematically associated with tax revenues than was total personal income--again an indication of the role of a more developed local economy. Thus, Models 3 and 4 use per capita non-agricultural income (NY_p) rather than per capita income and combine it with urbanization in Model 3 and both urbanization and population (P) in Model 4. Several interesting conclusions can be drawn from the results of this analysis, which are presented in Table IV-2.

The cross sectional response to income (income elasticity) varies greatly over the four provinces. The coefficient for Bulacan is above 2, suggesting that per capita BLT revenues vary among municipalities in the province even more than in proportion to the wide variations in personal income which exist. Since we can't believe that the income elasticity could be as high as 2.22, we must conclude that high income communities have other characteristics which also stimulate higher BLT revenues per

TABLE IV-2

CROSS SECTION ESTIMATES OF INCOME ELASTICITIES OF BUSINESS LICENSE TAX[a]: 1977

Province	Model	Independent Variables: Inter-cept	ln(Per Capita Income)	Percent Urban	ln(Per Capita Non-Agricultural Income)	Population (in thousands)	R^2	F
Albay	1	-3.98	.63 (1.22)				.09	1.50
	2	-4.04	.60 (1.21)	.03 (1.49)			.22	1.92
	3	-3.88		.03 (1.74)	.66 (2.95)**		.46	6.10
	4	-3.52		.03 (1.98)	.50 (2.15)*	.01 (1.66)	.56	5.51
Bulacan	1	-14.43	2.22 (2.51)*				.23	6.32
	2	-9.64	1.49 (1.58)	.01 (1.73)			.33	4.97
	3	-11.84		.004 (.75)	1.94 (3.46)**		.53	11.27
	4	-10.05		.007 (1.27)	1.72 (2.94)**	-.01 (1.23)	.56	8.21
Iloilo	1	5.02	-.74 (1.99)*				.05	3.97
	2	5.17	-.81 (2.23)*	.02 (1.92)			.16	3.96
	3	-2.16		.02 (1.59)	.32 (1.38)		.10	2.32
	4	-2.51		.02 (1.52)	.44 (1.75)	-.01 (1.24)	.14	2.09
Sorsogon	1	-.12	.05 (.09)				.00	.01
	2	.26	-.09 (.21)	.04 (3.72)**			.53	6.93
	3	-1.02		.03 (3.11)**	.13 (.85)		.56	7.67
	4	-2.04		.02 (2.12)	.25 (1.72)	.02 (2.24)	.70	8.49

TABLE IV-2 (CONT.)

Province	Model	Inter-cept	ln(Per Capita Income)	Percent Urban	ln(Per Capita Non-Agricultural Income)	Population (in thousands)	R^2	F
Four Provinces Pooled	1	-2.58	.42 (1.51)				.02	2.27
	2	-.35	.04 (.17)	.02 (5.25)**			.24	15.23
	3	-3.04		.02 (4.06)**	.52 (4.45)**		.37	28.27
	4	-3.04		.01 (3.85)**	.51 (4.30)**	.002 (.38)	.37	18.73
Cities	1	-12.13	1.98 (3.55)**				.26	12.63
	2	-10.27	1.68 (2.70)**	.01 (1.05)			.28	6.89
	3	-4.32		.004 (.69)	.92 (2.08)*		.23	5.19
	4	-2.60		.004 (.76)	.57 (1.30)	.005 (2.24)*	.33	5.55

[a]Dependent variable: ln(Per capita business license tax). Numbers in parentheses are absolute t-values.

*Significant at less than the 0.05 level.

**Significant at less than the 0.01 level.

SOURCE: Computed by authors.

capita. In Albay, the income elasticity is a much lower 0.63, but not statistically significant, while in Sorsogon, the statistical relationship is even weaker. The results for Iloilo are perplexing. They suggest that higher levels of income are associated with lower per capita BLT revenues. This result could have a number of interpretations. One is that there are differences in tax rates, with higher income communities levying lower rates. Another is that the per capita income measure reflects large amounts of agricultural income which, in turn, does not reflect much business taxpaying capacity. This is more likely the explanation. Where per capita income is high, there is a high agricultural component and, therefore, a lesser ability to collect BLT revenues. With respect to all of the estimates of Model 1, it is clear that not much of the variation can be explained within provinces. This means that either additional variables have to be included to account for different levels of willingness and capacity to collect BLT revenues, or that there are intangible and personal factors which underlie the more effective use in some communities than in others.

The addition of urban population and the non-agricultural measure of per capita income improves the results greatly (except in Iloilo where none of the models can be considered very strong). In Albay the non-agricultural income elasticity of the BLT ranges from 0.50-0.66 and approximately one-half of the variation in per capita BLT revenues can be explained.[1] The Bulacan elasticity is considerably greater, suggesting

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[1] That this elasticity is nearly identical to that for the statistically insignificant per capita income variable (and the coefficients on the urban variable in Models 2 and 3 are identical) adds credence to the speculation that the systematic income--BLT relationship is attributable to non-agricultural income which is more easily capturable by the BLT.

that municipalities with a 1 percent higher level of per capita non-agricultural income collect nearly 2 percent more in per capita BLT revenues. Again, this elasticity is unexpectedly high. One possible explanation is that as development occurs and incomes rise, an associated critical level of population and buying power is reached and the area becomes a marketing center. This then creates a business tax base that reflects not only the socio-economic characteristics of the municipality itself but also its ability to draw economic activity from other areas.[1]

In Sorsogon only the urbanization variable is significantly different from zero and the income elasticity estimate is very low and statistically insignificant. The high F values and non-significant coefficients in Model 4 for Sorsogon suggest a high degree of multicollinearity, not at all a surprising result since the province contains only a few urbanized areas that serve as regional market centers.

Given this highly diverse set of results for individual provinces it is not surprising that the pooled data (98 municipalities) show no significant relationship between per capita income and the BLT. (Indeed, the simplest model explains only 2 percent of the variability in per capita BLT across all municipalities.) On the other hand, both urbanization and per capita non-agricultural income remain significant and positive in each

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[1] This point may be expanded with the aid of a hypothetical example. Consider two neighboring communities A and B. Assume that locality A has achieved a higher degree of "development" which shows up in the form of higher per capita incomes, urbanization, etc., and has become the marketing center for both communities. It will then earn higher than expected BLT revenues while community B, with its lower per capita incomes, earns lower than expected BLT revenues. When BLT per capita is regressed on income, a 1 percent difference in income is not surprisingly associated with a 2 percent difference in BLT per capita.

of the models in which they are used, and account for from one-fourth to one-third of the variance explained. It is impossible, however, to determine the extent to which the relatively high levels of these variables and BLT per capita in Bulacan are responsible for these results. In any case, the failure to explain more of the variation makes one point clear: among the other factors which explain variations in per capita BLT revenues is the willingness to enforce and collect the tax.

Interestingly, in the case of the cities, per capita income is significant and the implied income elasticity is high (approximately 2). The urbanization variable is not significant (Model 2), even if used in conjunction with per capita non-agricultural income (Model 3). As may be seen from Model 4, population size does seem to matter--larger cities raise more BLT per capita than smaller cities, irrespective of their level of income. As in the case of the pooled data, the city models explain one-third or less of the variance.

Increases in Selected Cities

We could not put together a long enough nationwide time series to study the revenue growth in the BLT. We have, however, been able to observe how BLT revenues fared in selected Iloilo and Albay municipalities during the 1977-1979 period (see Tables IV-3 and IV-4). With this extremely small sample it is difficult to reach any definitive conclusions; but the data seem to preclude general statements concerning the growth in BLT revenues in particular types of jurisdictions. The most striking feature of this growth pattern is a great deal of year-to-year variation, especially in the case of the Iloilo jurisdictions.

TABLE IV-3

BUSINESS LICENSE TAX PERFORMANCE IN SELECTED ALBAY MUNICIPALITIES: 1977-1979
(in pesos)

General Fund	Camalig			Libon			Malinao			Tabaco		
	1977	1978	1979	1977	1978	1979	1977	1978	1979	1977	1978	1979
Business Tax	73,297	88,698	92,087	30,131	32,440	33,469	14,709	34,180	35,229	301,253	361,536	398,451
Business Tax as Percent of General Fund Income	16.5	16.0	15.1	8.2	8.7	7.9	7.5	14.8	14.0	22.1	24.5	24.2
	Growth Rates (in percent)											
	1977-78	1978-79		1977-78	1978-79		1977-78	1978-79		1977-78	1978-79	
Business Tax	21.0	3.0		7.7	3.2		132.4	3.1		20.0	13.2	
General Fund Income	18.3	9.6		1.6	13.1		18.1	8.5		8.3	11.7	
	Socio-Economic Characteristics											
1975 Population	41,702			47,890			24,889			65,254		
1970-75 Population Growth (Percent)	7.08			9.71			8.32			7.73		
Percent Urban, 1975	8.64			13.2			0			19.6		
Mean 1975 Household Income (Pesos)	6,641			4,523			4,151			7,341		
Per Capita Non-Agricultural Income (Pesos)	767			152			358			835		

SOURCES: Financial data from the provincial treasurer; socio-economic data from National Census and Statistics Office, "1975 Integrated Census of the Population and Its Economic Activities, Phase II, Albay," No. 289 (Manila, February 8, 1980).

TABLE IV-4

BUSINESS LICENSE TAX PERFORMANCE IN SELECTED ILOILO MUNICIPALITIES: 1977-1979
(in pesos)

	Dingle			Dumangas			Guimbal		
	1977	1978	1979	1977	1978	1979	1977	1978	1979
Business Tax	48,658	59,856	54,701	37,404	54,711	61,290	45,119	56,435	21,278
Business Tax as Percent of General Fund Income	10.5	13.2	10.0	6.6	8.6	8.8	19.2	24.1	8.2

	Growth Rates (Percent)					
	1977-78	1978-79	1977-78	1978-79	1977-78	1978-79
Business Tax	23.0	-8.6	46.3	12.0	25.1	-62.3
General Fund Income	-2.4	20.6	11.8	10.3	-0.3	10.1

	Socio-Economic Characteristics		
1975 Population	25,683	38,457	18,409
1970-75 Population Growth (Percent)	12.80	10.53	10.64
Percent Urban, 1975	7.75	4.80	23.66
Mean 1975 Household Income (Pesos)	4,104	4,429	4,389
Per Capita Non-Agricultural Income (Pesos)	428	335	343

TABLE IV-4 (CONT.)

	Passi			Pavia			Tigbauan		
	1977	1978	1979	1977	1978	1979	1977	1978	1979
Business Tax	69,666	60,627	54,775	109,100	149,940	153,685	13,950	14,346	14,869
Business Tax as Percent of General Fund Income	6.2	5.0	5.3	21.7	26.8	21.8	4.2	3.5	3.4

	Growth Rates (Percent)					
	1977-78	1978-79	1977-78	1978-79	1977-78	1978-79
Business Tax	-13.0	-9.6	37.4	2.5	2.8	3.6
General Fund Income	7.0	-14.0	11.4	25.7	21.0	8.8

	Socio-Economic Characteristics		
1975 Population	47,017	14,423	27,443
1970-75 Population Growth (Percent)	23.99	10.44	12.14
Percent Urban, 1975	15.52	18.06	9.57
Mean 1975 Household Income (Pesos)	9,891	5,961	6,746
Per Capita Non-Agricultural Income (Pesos)	443	432	552

SOURCES: Financial data from the provincial treasurer; socio-economic data are preliminary figures furnished by the National Census and Statistics Office.

In Albay, Tabaco relies most heavily on the BLT. This reliance grows out of the fact that Tabaco is the largest of the four Albay municipalities represented here and serves as a market center for several surrounding municipalities. The other three municipalities are more rural in nature and much less important as trading centers. Their BLT revenues are understandably lower relative to total revenue. The extremely large increase between 1977 and 1978 in Malinao is difficult to explain but may be attributable to a new industrial plant that prior to 1978 was exempt from 50 percent of all local taxes under the preferential treatment afforded pioneer industries (Republic Act 5186).

In general, there is much less reliance on the BLT in Iloilo. The municipality of Pavia relies more heavily upon this revenue source than do the other five jurisdictions represented here. While Pavia's population size and income characteristics are not significantly different from the other jurisdictions, and its location adjacent to Iloilo City may hamper its possibilities to serve as a market center, it has attracted some manufacturing activity which contributes heavily to its BLT base. Interestingly, the highest income community, Passi, has one of the lowest revenue dependency rates associated with BLT. In part, this may be due to its location in a sugar-growing area--this implies a relatively high per capita income but a low business tax base. The less urbanized areas in general seem to rely less on the BLT, again suggesting that it is essentially an "urban" tax.

Annual growth in the BLT is quite erratic in these six jurisdictions. We have no good explanation for these fluctuations. However, variations of this type can usually be traced to two major causes. The first is the location of a new business which results in a dramatic one-year increase in the tax. This is particularly true if it is a large business which accounts for a significant share of the total revenue yield. The second reason has to do with enforcement of the tax. If there is a major push to collect the BLT in a particular year, it may show up in a substantial increase, or if enforcement is lax in a particular year, in a substantial decrease. Even a single large, but late, payment of the tax in relatively small communities can greatly influence the annual pattern.

Conclusions and Recommendations

The BLT is a productive revenue source that local governments will continue to rely heavily upon. It is not as good a revenue source as a shared sales tax with the Central Government could be, its base assessment problems are substantial and probably insurmountable, and it does not automatically grow with income and inflation. On the other hand, it has important advantages: it generates a great deal of revenue, it brings businesses as entities into the local taxpaying community, and it might be used to increase the collection efficiency of the property tax. One might take either of two directions in suggesting a program of reform: First, assume that the BLT will remain an important local revenue source and raise the question as to how it might be adjusted to become more productive. Second, consider the possibility of replacing the BLT with a share of Central Government sales tax.

Structural Reforms

There is room to improve the BLT structure, so as to make it more easily administered and to make its revenue growth more responsive to community income growth and to inflation One might begin by noting that the primary objective of such reform is to increase revenue, though onerous allocative and distributional effects should be avoided. Rate structure reform could be the first step to increasing the elasticity of the tax. Converting the system to a flat rate structure--at a rate *higher* than that currently levied on larger businesses--would increase the revenue yield as well as the income elasticity of the tax.[1] An increase in rates might ordinarily suggest increased taxpayer resistance and therefore a decline in collection efficiency, but not likely in this case. Firms with higher levels of gross receipts--those who stand to bear the greatest burden of this proposed rate structure change--are the most easily monitored taxpayers.

Such an alteration in rates could yield substantially greater revenues from the BLT while still not creating a tax liability on businesses that would prove onerous. What is needed is a more complete study of the possible revenue generation and tax burden effects of alternative rate structures.

A second reform also has to do with the rate structure. In most municipalities, the greatest number of payers of the business license tax are small firms which, by convention, are assessed flat amounts. Our

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[1]The new structure would, however, still apply to differential rates across industry types.

examination of BLT files in several communities showed that in many cases these amounts have not changed in several years. Yet, with inflation at a fairly rapid rate, we know that even these small firms are realizing substantial increases in gross receipts. Therefore, the flat rate payments made by the smallest taxpayers should be at least partly indexed to inflation. One simple scheme would be to increase (decrease) the flat charge annually by 50 percent of the preceding year's consumer price increase. This would not be unfair, it could be easily done, and it would provide some amount of revenue increase.

The major problems with the BLT, however, would remain. It is complicated and there is no good way for local governments to estimate year-to-year changes in gross receipts. Essentially it will remain a tax on the largest firms in the community, with nominal contributions by smaller firms. As has been noted above, there are a few actions which might be taken to marginally improve the situation: haggling to increase tax liabilities, especially during periods of inflation; requiring the presentation of accounting records by larger firms; hiring an additional clerk or an occasional consultant to follow up on collections or to scrutinize business records; increasing the "late charges" applied to delinquent businesses; and more vigorously tying the Mayor's Permit requirement to that of the BLT. Even with these reforms, however, the BLT is going to remain a very difficult tax to collect and one without a substantial income elasticity.

One possibility that deserves some attention is the hiring of a business tax collector, perhaps with Central Government assistance. The program might be as follows. Two collectors would be hired at the provincial level, and undergo training in the analysis of financial statements and in the specifics of the BLT. Their charge would be to concentrate on determining the BLT liability of large and middle-sized businesses, and providing technical advice to municipal treasurers on BLT record-keeping, assessment and collection procedures, etc. The training and central oversight costs and a part of the annual salary and operating costs might be covered directly by the Central Government with the remainder covered by the municipality. Such a program might be initiated in two or three provinces on a trial basis to determine its feasibility. On the surface, it would appear to promise revenue returns far above costs, it has the feature of requiring a matching local government contribution, and it strengthens the underlying fiscal capacity of local governments.

An Alternative Tax

The problems with the BLT are substantial enough to where other revenue sources might be considered in the longer run. If the Central Government decided to give local governments a more elastic revenue source, there might be some consideration given to use of a shared Central Government sales tax. While we have not studied this alternative--it was not in our terms of reference--a number of advantages and disadvantages are immediately apparent.

Given that the current Philippine sales tax is a levy imposed on sales at the manufacturer's level, one principal advantage is that it would likely be more income elastic than the BLT, i.e., it would grow more in response to local government expenditure needs. Its second principal advantage is that it would be less costly to administer since administrative responsibility would be shifted to the Central Government. A third advantage is that it could be stimulative of local government tax effort. The latter could work by allowing the local government to choose the rate it would levy--up to a maximum--in order to receive a share. Communities choosing to tax themselves more heavily with a higher surcharge would receive a greater amount of revenue.

It would, however, have several significant disadvantages. First, it would not be equalizing--communities having more production activities would benefit most. The current BLT is not so severely counterequalizing, but more prosperous communities do get more revenue than less prosperous ones. However, since the current national sales tax is levied at the first stage of production rather than at the point of sale, tying a local surcharge to this tax would mean that a community with a retail/wholesale economic base would suffer in comparison to a community where manufacturing is predominant. This then relates to a second problem with any sharing scheme--that the coverage of the national sales tax is not so great as the coverage for the BLT. That is, many smaller firms would not be reached by the national tax and therefore would drop out of the local taxpaying

community. This is contrary to the spirit of attempting to decentralize participation in a governmental process and to mobilize a greater share of growing local resources for government purposes.

On the whole, the idea of local sharing of the sales tax, as it is currently instituted in the Philippines, is unlikely to prove advantageous. It may be that a preferable method of revising the local tax structure is to increase the role of the intergovernmental grant system while still, if possible, taking advantage of the two main pluses associated with the sharing idea--lowered administrative costs and rewarding those communities that are willing to tax themselves more greatly. We turn to this question in the following Chapter by suggesting that the amounts of these intergovernmental flows could be increased while simultaneously inserting a local tax effort measure in the determination of the local shares.

CHAPTER V

INTERGOVERNMENTAL FISCAL RELATIONS

Because the local finance and governance system in the Philippines is subject to such a high degree of central control, changes in the system of intergovernmental relations will be at the heart of any reform effort to strengthen the hand of local government. Consistent with its stated role to encourage decentralization, the Philippine Government has been active in this area in recent years. The Allotment system has been continuously revised and the barangay unit has been promoted to almost a full partnership in the formal Central and local governmental system. Whether these changes have been successful in moving the government closer to its objectives, and whether they have reinforced one another are issues posed in this chapter.

The scope of inquiry here is not so wide as the chapter title may suggest. Intergovernmental relations covers many topics--in a sense this entire report is about intergovernmental relations in the Philippines. Even if the subject is narrowed to intergovernmental fiscal relations, a very wide range of considerations is suggested: grants and subsidies to local governments, tax sharing between Central, provincial and local governments, approval of tax structure changes and borrowing, monitoring and approval of budgets, and appointment and supervision of local fiscal officers. In this section only the first two of these issues are considered,

with the focus on the Allotment System and on the growing role of the barangay unit in local government finances. In each case we return the same questions, "Is the grant program structured so as to encourage the mobilization of additional resources at the local government level? Is it somehow equitable? Does it provide an adequate flow of revenues to local governments? Does it stimulate capital spending?"

All facets of the intergovernmental transfer system aren't considered here, but the most important components are included. We see these as being

- The General (BIR) Allotment
- The Specific Tax Allotment
- The National Tax Allotment
- The Barangay Allotment shares
- The 10 percent barangay share of property taxes
- The ₱500 grant to barangays by local governments

The BIR Allotment

The BIR Allotment system was changed quite substantially during the 1970s.[1] Because some of these adjustments were complicated, it is all the more essential for us to begin with a description of the system as we understand it. History is especially important here because in some respects the old system was never completely abandoned. We then turn to an evaluation of the effects of the BIR Allotment on local government budgets and to alternative possibilities for reform.

History of Structural Changes

Prior to PD 155 (March 3, 1973), 17 percent of national internal revenue collections were distributed to local governments. The basis for the

[1] The latest change is PD 1741 in January 1981.

distribution was BIR collections in the preceding year, where

(1) 13 percent was allocated to provinces and cities

(2) 4 percent was allocated to municipalities.

These total amounts were then distributed on the basis:

(1) 70 percent according to population

(2) 30 percent according to land area.

In addition, local governments received an amount equivalent to about 6 percent of the preceding year's national internal revenue tax collections, in the form of local shares from the withholding tax and from "excess" income tax collections.[1] Particularly this additional component biased the distribution of central assistance toward a small number of relatively wealthy provinces. It was this bias and the desire to make the grant system more equalizing that brought on another major reform.

A new system was introduced with PD 144. Its major features included:

(1) 20 percent of national internal revenue taxes (not assigned to special funds and accounts) should be transferred to local governments, with the computation based on BIR collections during the third year prior to the current fiscal year

(2) The allocation would be divided among local government levels:

30 percent to provinces
45 percent to municipalities
25 percent to cities

(3) These funds would be shared according to a weighted three-factor formula:[2]

70 percent according to population
20 percent according to land area
10 percent according to equal shares

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[1] Under RA 2343, local units received 30 percent of the income taxes collected (in a jurisdiction) above the 1959 level.

[2] Apparently the 1970 census results were to be used in computing the allocation, thus no jurisdiction-level changes would be made in the allocation formula until the 1975 census results were processed.

It was also specified that

(4) For FY 1974-1976, the annual allotment for any local government would not increase by more than 15 percent nor decrease by more than 50 percent of the locality's FY 1971 allotment.

This last feature, then, linked FY 1974-76 allotments to the old system.[1]

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[1]Whether this constraint is binding depends, oddly enough, on the rate of growth in BIR collections. PD 144, as amended, provides that the total grant fund (F) be related to BIR collections as

$$F_t = .2BIR_{t-3}$$

The municipal share is 40 percent, or,

$$F_t^m = .08BIR_{t-3}$$

Any given municipality would receive an allotment (A_i) from

$$A_i = .7F_t^m\ P_i/\sum P + .2F_t^m\ L/\sum L + (.1)(.00067)F_t^m$$

where the .00067 equals 1/1,500 given approximately 1,500 municipalities in the country. Substituting and eliminating the last term as inconsequential, we derive

$$A_{it} = (.056\ P_i/\sum P + .016\ L_i/\sum L)BIR_{t-3}$$

where A_i is the amount received, provided that it is not more .than 15 percent above the 1971 allotment. The 1971 total grant fund (F) was

$$\hat{F}_t = .2BIR_{t-1}$$

and

$$\hat{F}_t^m = .08BIR_{t-1}$$

For any given municipality

$$\hat{A}_{it} = .7P/\sum P\ \hat{F}_t^m + .3\ L/\sum L\ \hat{F}_t^m$$

substituting

$$\hat{A}_{it} = (.056\ P/\sum P + .024\ L/\sum L)BIR_{t-1}$$

Now we may write, for example, that the entitlement for a municipality in 1977 is

$$A_{i,77} = (.056\ P_i/\sum P + .016\ L_i/\sum L)BIR_{74}\ ,\ \text{or,}$$

$$A_{i,77} = 1.15(.056\ P_i/\sum P + .016\ L_i/\sum L)BIR_{70}$$

whichever is less.

In this case, if the growth in BIR collections between 1971 and 1974 was greater than 15 percent, the constraint is not binding.

Two additional features were included in PD 144. First, economic development expenditures received greater emphasis in that

(5) 20 percent of a jurisdiction's Allotment was to be earmarked for developmental projects approved by the Ministry of Local Government and Community Development (MLGCD).

Second, the role of the barangay was emphasized in that

(6) Each barangay was to receive 10 percent of property taxes collected within the barangay and, in addition, each jurisdiction was to contribute up to ₱500 to each barangay within its boundaries. The Provincial Treasurer was named custodian of these funds with expenditures requiring MLGCD approval.[1]

The BIR Allotment was amended one year later (September 21, 1974) by PD 559 which specified barangays as co-recipients of the Allotment. Through FY 1976 barangays were to receive ₱56 million that had previously been earmarked for division among provinces, municipalities and cities. After FY 1976, the split among local governments was to be:

a. 25 percent (had been 30) to provinces
b. 40 percent (had been 45) to municipalities
c. 25 percent to cities
d. 10 percent to barangays.

PD 559 specified that the amount set aside for barangays was to be distributed in the form of community development project grants with the distribution administered by the President. Thus there was an alteration in the BIR grant system away from general grants and toward projects grants.[2]

The BIR Allotment system was changed again in PD 937 (May 27, 1976). This amendment was made, at least in part, to address the grant distribu-

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[1] Barangays do have annual budgets, although given the limited nature of their activities, these budgets are not very complex. Their funds are held in trust with the local treasurer acting as agent.

[2] Interestingly, PD 559 drops entirely any mention of 10 percent of the property tax revenues earmarked for barangays. Yet apparently, this tax sharing continues.

tion during the six month transition from a July 1 - June 30 fiscal year to a January 1 - December 31 fiscal year, effective January 1, 1977. In addition, PD 937 specified that in FY 1977 a "hold-harmless" provision (no decreases in the annual Allotment) replaced the 50 percent maximum decrease in annual Allotments while Allotment increases were restricted to 25 percent of the FY 1976 amount (rather than 15 percent above the 1971 amount as specified in PD 144).

PD 144 was further altered by PD 1231 (November 4, 1977). It specifies that allocations for the fiscal years 1978 through 1980 would be equal to those determined for 1977 (under PD 937). In fact, this temporary measure may be the most important change in the grant system since the enactment of PD 144. In effect, it has held constant the peso level of the grant to be distributed and brought on a drastic decline in the real distribution. By 1980, only about one-third of the actual grant entitlement was being distributed.

In January 1981, PD 1741 was enacted, providing for: (a) the grant of additional aid to local governments whose income declined in 1980 due to low crop prices; (b) the allowance of year-to-year increases in Allotments beyond the 25 percent ceiling for certain local governments.[1] The second of these provisions is especially important in terms of its effect on the distribution of the Allotment. The PD provides that for third, fourth, fifth and sixth class local governments, increases of

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[1] We have not had the opportunity to review this PD in detail.

more than 25 percent may be made subject to adequate justification as recommended by the Ministry of Local Government and Community Development, and subject to the availability of funds. The PD also notes that if these conditions are met, the Allotment may be increased by up to 30 percent (third class local governments), 35 percent (fourth class local governments), 40 percent (fifth class local government) or 45 percent (sixth class local government). While such additional aid may be justified on equity grounds, it does not provide incentives for increasing tax effort. That is, those governments experiencing revenue declines are more likely to be awarded additional grants than those putting forth greater efforts to maintain their revenue flows.

BIR Allotment Objectives and Impacts on Local Finances

The objectives of the BIR Allotment, as spelled out in PD 144, are multiple, i.e.,

> "...for purposes of administrative simplicity and efficiency and in order to establish a more equitable system of distribution of allotments and introduce the developmental concept of the allocation of funds to local governments..."

PD 559 speaks of the need to

> "...accelerate the transformation of local governments into self-reliant and progressive communities..."

From these Presidential Decrees, one might infer the following objectives:

- to create a more equitable distribution of allotments
- to stimulate economic development expenditures
- to stimulate the further mobilization of local resources

To this list, we might add two more objectives that seem to regularly come up in interviews about the strengths and failings of the Allotment system. There was much concern, at the Central Government level, about whether local governments were *accountable* for their expenditure of Allotment funds. At the local government level, the concern was over the *certainty* of how much Allotment would be received and the *elasticity* of Allotment revenues with respect to income growth and inflation.

Equity

Does the BIR Allotment system accomplish an equity objective? The answer in the Philippine case depends, in part, on how one defines equity i.e., on what the government is trying to equalize. One possibility is simply to provide more resources to poorer areas, i.e., to equalize per capita personal incomes. Another is to equalize local government fiscal capacity, perhaps by providing greater grants where the local tax base is lower or where expenditure needs are thought to be greater. A third would be to allocate more Central Government resources where per capita expenditures are lower, i.e., to attempt to equalize the per capita amount spent. A fourth would be simply to equalize the per capita distribution of the Allotment as if to argue that every person in the country has the right to the same peso amount, regardless of where he lives or how wealthy he is.

It simply isn't clear which of these concepts of equity the Government has identified. The distribution according to land area and population may be an attempt to take account of greater expenditure needs, but will be income equalizing only if the more populous areas tend to be poorer. The most recent provision of lifting the ceiling on lower class munici-

palities also may reflect the objective of increasing the flow of resources to poorer municipalities, if lower class municipalities tend to have lower incomes. The correlations in Chapter II above do not suggest that this is the case.

Because these matters are not spelled out explicitly in government policy, one must turn to the evidence on the actual distribution of the Allotment to look for implicit objectives. Working with cross-section data for 1977 for a sample of 96 municipalities in four Provinces (Albay, Sorsogon, Iloilo, and Bulacan), and 40 chartered cities throughout the country, we have estimated the simple correlation between the per capita Allotment received, per capita personal income, per capita assessed value, per capita expenditures, and population size.[1] Statistically significant relationships would indicate that, de facto, Allotments were distributed with biases in favor of or against these variables.

The results for chartered cities (Table V-1) show no significant relationship with any of these variables, i.e., none can explain the variation from a high per capita Allotment of ₱36.24 in Bais to a low of ₱4.94 in Baguio. The absence of a relationship with population is not surprising. Since 70 percent of the city share is distributed on a population basis, the [illegible] distribution of the Allotment should be neutral with respect to population size. But to find no relationship with any of these criteria is a surprise. Either grants to cities--25 percent of the total BIR Allotment--are systematically related to some other vari-

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[1] Of course, our results are influenced by the inclusion of only these four provinces. We note this important caveat here and caution that it should be kept in mind throughout this analysis.

TABLE V-1

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

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

[a]Includes the cities listed in Appendix II-A less two for which data regarding the BIR allotment were deemed to be in error.

[b]Includes the municipalities in Albay, Bulacan, Iloilo and Sorsogon as listed in Appendix II-A.

SOURCE: Computed by authors.

able not included here--or they are distributed in a random, ad hoc manner.

The 40 percent distributed to municipalities shows a more consistent pattern. Significantly greater amounts of per capita Allotment were distributed to municipalities that had greater fiscal capacities (as measured by per capita assessed value) and to those that made higher per capita expenditures. Jurisdictions with smaller populations received significantly larger amounts. With respect to municipalities, then, the resulting per capita distribution of Allotment would not seem to reflect the intent of the population-land area-equal share formula. Again, the special provisions of the various PDs have created a kind of ad hoc distribution that favors jurisdictions that already have a greater capacity to finance. While this kind of bias is not without its virtues, as we shall see below, it points out that the system was not successful in equalizing income, fiscal capacity or expenditure levels among municipalities.

The city and municipal shares constitute only 65 percent of the total BIR Allotment in any single year (barangays share in 10 percent of the total and provincial governments account for the remaining 25 percent). Unfortunately, we were unable to gather the necessary data to analyze the equity implications of the provincial government distribution. Since there are no good data on the socio-economic characteristics of barangays, analysis of this lowest level of government was also impossible.

From this evidence on cities and municipalities in the four provinces, three rather important conclusions might be drawn about the equity of the distribution of Allotments. The first is that it does not appear to equalize,

indeed, it may even be counterequalizing. Second, the actual distribution is apparently influenced as much by mandatory ceilings, maximum increases, etc. as by formula provisions. Third, the distribution pattern and equalizing effects are quite different as between cities and municipalities, leading us to conclude that the Allotment system would not appear to be a system at all, but a combination of grant programs for cities, municipalities, etc.

Fiscal Stimulation

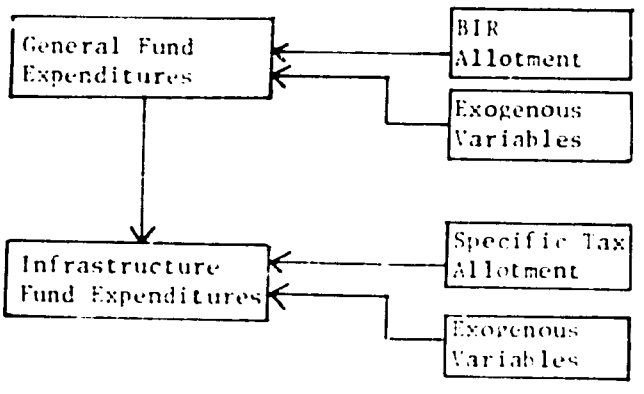
To what extent is the BIR Allotment program stimulative of local government fiscal activities? Does it induce local governments to spend and tax more than they would have otherwise, or is it substitutive in the sense of allowing local governments to tax less than they otherwise would have? Economic theory would suggest the latter. On the one hand, a lump sum grant (with no matching requirement or maintenance of effort clause, such as the BIR Allotment) provides no extra inducement for the local government to increase spending beyond the amount of the grant. Ordinarily one would expect a peso of Allotment to be divided between, (a) increased expenditures, (b) tax relief, and (c) increased cash balances.[1]

On the other hand, the BIR Allotment may turn out to be less substitutive than one might expect. One reason is that there is a large backlog of unmet public service needs which virtually guarantees that any increased amount of revenue available to the local government will likely find its way into the local budget. This would reflect a combination of a high

[1] In theory, the division between (a) and (b) depends on the income elasticity of demand for public and private goods. Whereas, (c) may be affected by a precautionary motive, i.e., it would tend to be larger if total officials were more risk-averse.

income elasticity of demand for local public goods and the fact that once a government receives grant money it is more likely to spend the money than return it in tax relief, the so-called "flypaper effect."[1]

There really are two questions at issue here. The first is the impact of the BIR Allotment on General Fund expenditures. The second is the impact of the BIR Allotment on total economic development expenditures, which may take place in either the General Fund or the Infrastructure Fund. The measurement of these impacts turns out to be quite a complicated matter and requires a simultaneous consideration of the BIR and Specific Tax Allotment. The simple diagram below might aid in understanding this complexity. The BIR Allotment is paid to the General Fund and the Specific Tax Allotment to the Infrastructure Fund, but transfers from the General to the Infrastructure Fund over and above the mandatory proportion of General Fund income may occur. One might suppose that these transfers would be greater (and therefore General Fund expenditures lower and the BIR Allotment much less stimulative) if the Specific Tax Allotment were less.



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

What this means is that in order to get a reasonable estimate of the fiscal impact of the Allotment system, a model of expenditure determination which allows for the interdependence of the two Funds must be developed. Necessarily the model is complex and is presented here in some tedious detail. The reader primarily interested in results may skip directly to page V-23 without loss in continuity, but he should be cautioned about the many simplifying assumptions inherent to the model.

A Grant Impact Model. As discussed in Chapter II, the fiscal structure of local governments in the Philippines includes both the General Fund (GF) and Infrastructure Fund (IF). The BIR flows to the former while the Specific Tax Allotment flows to the latter. There is a statutory minimum transfer of monies from the GF to the IF; but jurisdictions may opt to transfer greater amounts. Furthermore, it is possible, although more difficult, for a jurisdiction to transfer funds in the opposite direction (IF to GF). This, then, suggests that the traditional expenditure determinants approaches, which would consider GF and IF expenditures independently, would be inaccurate. The model we develop here recognizes that activity in these two Funds is interdependent.

We anticipate that a higher level of Infrastructure spending per capita, IF_p, will be associated with a higher level of General Fund spending per capita, GF_p (i.e., $\partial GF_p / \partial IF_p > 0$). We also anticipate that the BIR Allotment and the Specific Tax Allotment (STA) will directly impact spending in the General and Infrastructure Funds respectively. There also are indirect grant impacts. For example, the provision for interfund transfers makes

it quite likely that an increase in Specific Allotment will indirectly generate an increase in General Fund spending, i.e., $\partial GF/\partial STA > 0$.

To model this process, we define...

$$GF_p = f(AV_p, NAg_p, IF_p, BIR_p) \quad (1)$$

$$IF_p = F(POP, U, GF_p, STA_p) \quad (2)$$

where

Endogenous variables:

GF_p: Per capita General Fund expenditures

IF_p: Per capita Infrastructure Fund expenditures

Predetermined variables:

AV_p: Assessed value of property per capita

NAg_p: Non-agricultural income per capita

U: Percent of population living in urban areas

POP: Total population

BIR_p: BIR Allotment per capita

STA_p: Specific Tax Allotment per capita[1]

This specification reflects the assumption that spending is jointly determined by demand and fiscal capacity variables, and, as such, the model cannot be interpreted as being built on either a demand-oriented or revenue-determined basis.

As noted above, we hypothesize

$$\partial GF_p / \partial IF_p > 0$$

---

[1] Originally, we estimated the fiscal impact of BIR_p and STA_p using indirect least squares. Using various combinations of income, population, and urbanization variables, we were unable to explain much variability.

This hypothesis implies that the exogenous demand and capacity variables will not fully explain spending in a particular fund but that there are positive cross effects.

We further expect that, given the form of the BIR Allotment Formula with no built-in incentive to increase revenue or expenditure efforts, that

$$\partial GF_p / \partial BIR_p \leq 1 \ .$$

In other words we hypothesize that the grant system does not encourage stimulation of locally supported expenditures, i.e., of tax effort. The impact of the Specific Tax Allotment may be a different matter, since capital grants may carry some built-in features that stimulate local spending. These are covered below (see pp. V-36-42).

Given the interdependent nature of the GF_p and IF_p functions--which we specify for estimation purposes to be linear--a simultaneous equation estimation technique is necessary to yield consistent estimates of the parameters. We have employed a two-stage least squares estimation technique to derive the estimates discussed below.

In estimating the impact of the Allotment system on General and Infrastructure Fund spending, the direct impact of the BIR on General Fund spending and its indirect effect on Infrastructure Fund spending have been recognized.

The first stage estimates regress each endogenous variable on all predetermined variables, so that $\hat{GF}_p$ and $\hat{IF}_p$ are generated as follows.

$$\hat{GF}_p = a_1 + b_1 BIR_p + b_2 STA_p + \underline{b}_3 \bar{\underline{X}} \qquad (3)$$

$$\hat{IF}_p = a_2 + c_1 BIR_p + c_2 STA_p + \underline{c}_3 \bar{\underline{X}} \qquad (4)$$

where $\underline{\bar{X}}$ is the matrix of predetermined variables (specified above), a_1, b_1, b_2, a_2, c_1, and c_2 are estimated coefficients, and $\underline{b}_3$ and $\underline{c}_3$ are vectors of estimated coefficients. (This notation is used simply to facilitate the discussion here since we are concerned primarily with the effects of BIR_p and STA_p on GF_p and IF_p.)

The second stage estimates will be

$$\hat{GF}_p = a_3 + d_1AV_p + d_2NAg_p + d_3\hat{IF}_p + d_4BIR_p \tag{5}$$

$$\hat{IF}_p = a_4 + e_1POP + e_2U + e_3\hat{GF}_p + e_4STA_p \tag{6}$$

where: $\hat{IF}_p$ and $\hat{GF}_p$ are generated from the first stage equations (3) and (4), and all coefficients are estimates.

Substitution of the first stage results into the second stage equations and partial differentiation yields,

$$\partial GF_p/\partial BIR_p = d_4 + d_3c_1 \tag{7}$$

$$\partial GF_p/\partial STA_p = d_3c_2 \tag{8}$$

$$\partial IF_p/\partial BIR_p = e_3b_1 \tag{9}$$

$$\partial IF_p/\partial STA_p = e_4 + e_3b_2 \quad . \tag{10}$$

The estimation of these partial derivatives and the answer to the grant impact issue are given in the next section.

The second major question to be addressed with this model is the impact of the grant system on total economic development spending. A complication arises because economic development spending may show up in either the General Fund or the Infrastructure Fund. While all Infrastructure Fund spending is development-oriented, only a portion of the

General Fund can be so considered. So as to capture these effects we have specified an expenditure submodel that essentially treats General Fund development spending as residual in nature. That is, as was suggested in Chapter II, general government spending has a large "fixed" component that must be undertaken regardless of the spending capacity of local governments. Likewise, the bulk of public welfare and safety spending is mandated (in this case, linked to revenues).

To capture these features we define total local economic development spending as the sum of IF_p plus the residual of total GF_p from "expected" general government and public welfare and safety spending. The expected levels of general government and public safety expenditures are determined by predicted GF_p and certain other socio-economic characteristics of the jurisdiction that are thought to influence community choices about spending for these functions.

More formally we define

$$DE_p = (\tilde{GF}_p - E_p^*) + \tilde{IF}_p \tag{11}$$

with

$$E_p^* = GG_p^* + PSW_p^* \tag{12}$$

where

DE_p: economic development expenditures per capita

E_p^*: expected General Fund, non-development expenditures per capita.

$\tilde{GF}_p$: the predicted value of GF_p from equation (5)

$\tilde{IF}_p$: the predicted value of IF_p from equation (6)

GG_p^*: expected general government expenditures per capita

PSW_p^*: expected public safety and welfare expenditures per capita

To estimate GG_p^* and PSW_p^* we specify

$$GG_p^* = f(POP, 1/\widetilde{GF}) = a_5 + g_1 POP + g_2\ 1/\widetilde{GF} \tag{13}$$

$$PSW_p^* = .18\widetilde{GF}_p + PSW_p^{**} \tag{14}$$

with

$$PSW_p^{**} = f(U, POP) \tag{15}$$

so

$$PSW_p^* - .18\widetilde{GF}_p = a_6 + h_1 U + h_2 POP \tag{16}$$

The GG_p^* equation (13) includes population under the assumption that there are certain general government functions that must be expanded above the "threshold level" as the number of residents expands, e.g., number of clerks in service agencies. Yet we also expect that as total spending expands, general government spending will become a smaller proportion of total General Fund expenditures (due to its fixed nature). Equation (14) provides specifically for the mandated 18 percent contribution to the INP while (15) suggests that these contributions will be supplemented in response to urbanization and population differences across jurisdictions.[1]

Evaluation of the grant system effect on economic development spending requires an estimation of $\partial DE_p/\partial BIR_p$ and $\partial DE_p/\partial STA_p$. Since the DE_p definitional equation (11) implicitly includes both the estimated total expenditure functions ($\widetilde{GF}_p$ and $\widetilde{IF}_p$) and the expenditure composition functions (GG_p^* and PSW_p^*), evaluation of these partials requires inclusion of the

---

[1] Equation (14) implicitly assumes that General Fund spending equals General Fund revenue since the INP mandate refers to revenue, not spending. In light of the discussion of cash balances and surpluses in Chapter II, this is obviously unrealistic; yet to encompass these features would greatly complicate the model and there are not adequate data on cash balances in any case. We would like to be able to fall back on the justification that our sample is large enough for these cash balances to wash out, but we do not have enough information to know if that is a reasonable assumption.

entire model. When fully specified, equation (11) can be expressed as:

$$
\begin{aligned}
DE_p = {} & \{a_3 + d_1AV_p + d_2NAg_p + d_3[a_2 + c_1BIR_p + c_2STA_p + \underline{c}_3\bar{X}] \\
& + d_4BIR\} - \{a_5 + g_1POP + g_2/[a_3 + d_1AV_p + d_2NAg_p \\
& + d_3(a_2 + c_1BIR_p + c_2STA_p + \underline{c}_3\bar{X}) + d_4BIR_p]\} \\
& - \{.18[a_3 + d_1AV_p + d_2NAg_p + d_3(a_2 + c_1BIR_p + c_2STA_p + \underline{c}_3\bar{X}) \\
& + d_4BIR_p] + a_6 + h_1U + h_2POP\} + \{a_4 + e_1POP \\
& + e_2U + e_3[a_1 + b_1BIR_p + b_2STA_p + \underline{b}_3\bar{X}] \\
& + e_4STA\} .
\end{aligned}
\tag{17}
$$

When this foreboding expression is differentiated with respect to BIR_p and STA_p we obtain:

$$
\begin{aligned}
\frac{\partial DE_p}{\partial BIR_p} &= d_3c_1 + d_4 - \frac{-g_2(d_3c_1 + d_4)}{V^2} - .18(d_3c_1 + d_4) + e_3b_1 \\
&= [d_3c_1 + d_4][.82 + \frac{g_2}{V^2}] + e_3b_1
\end{aligned}
\tag{18}
$$

and

$$
\begin{aligned}
\frac{\partial DE_p}{\partial STA_p} &= d_3c_2 - \frac{-g_2d_3c_1}{V^2} - .18d_3c_2 + e_3b_2 + e_4 \\
&= d_3c_2\,[.82 + \frac{g_2}{V^2}] + e_3b_2 + e_4
\end{aligned}
\tag{19}
$$

where

$$
\begin{aligned}
V = {} & [a_3 + d_1AV_p + d_2NAg_p + d_3(a_2 + c_1BIR_p + c_2STA_p + \underline{c}_3\bar{X}) \\
& + d_4BIR_p] .
\end{aligned}
\tag{20}
$$

Thus, again, the overall estimated impact of the grant system depends on a combination of parameters but, given the imposed non-linearity in the GG_p^* equation (13), also is expected to depend on the <u>level</u> of the BIR Allotment.

We now turn to a quantitative estimates of these parameters and their implications.

<u>Statistical Results</u>. This model should be tested on all local governments in the Philippines, or at least on a random, nationwide sample. Data are not available for such an analysis. We may, however, test for the stimulative effects of the BIR Allotment using our four-province sample of 96 municipalities.

Unfortunately, the results of estimating this model do not allow us to draw the firm conclusions we would have liked. The problem, we think, is a combination of not having a nationwide sample, not having enough data to correctly specify the model, and the inherent variability in the level of capital expenditures. These limitations notwithstanding, this statistical analysis does give up some interesting conclusions.

The regression results presented in Table V-2 bear out the hypothesis that per capita General Fund expenditures are higher where per capita Infrastructure Fund expenditures are higher, *even when income level, population size, etc., are taken into account*. This leads us to expect that the cross-effects of grants (e.g., the indirect impact of the Specific Tax Allotment on General Fund spending) will be important. As is expected, per capita General Fund expenditures are higher where per capita non-agricultural income and per capita assessed valuation are higher.

TABLE V-2

REGRESSION RESULTS FOR MODEL OF STIMULATIVE IMPACTS OF BIR AND SPECIFIC TAX ALLOTMENT GRANT SYSTEM

Independent Variables	First Stage[a]		Second Stage[b]			
	GF_p	IF_p	GF_p	IF_p	GG^*_p[c]	PSW**[d]
Intercept	4.44 (1.18)	.86 (.41)	-3.65 (1.14)	-.11 (.07)	14.38 (13.46)	2.20 (3.68)
BIR_p	1.40 (3.74)	.23 (1.11)	.72 (1.05)			
STA_p	-3.97 (1.76)	.87 (.70)		1.60 (1.38)		
AV_p	6.31 (7.45)	1.18 (2.52)	2.84 (1.70)			
NAg_p	4.64 (1.47)	.52 (.29)	8.53 (2.11)			
U	16.61 (4.64)	3.73 (1.88)		.60 (.32)		2.05 (1.41)
POP[e]	-.069 (1.56)	-.032 (1.32)		-.020 (.96)	-.031 (1.41)	-.049 (2.72)
$\hat{IF}_p$			2.69 (2.30)			
$\hat{GF}_p$				.177 (3.93)		
$1/GF_p$					-80.78 (6.08)	
R^2	.69	.20	.49[f]	.23[f]	.32	.08
F	33.16	3.76	21.55	6.74	22.24	3.89

Note: Entries in parenthesis are absolute values of t-statistics.

[a]Equations (3) and (4).

[b]Equations (5) and (6).

[c]Equation (13).

[d]Equation (16).

[e]Population in thousands.

[f]R^2 statistics are unreliable in the second stage of 2SLS.

The evidence makes it difficult to argue that there is a stimulative impact of the BIR Allotment. Our estimation of equation (7) *does* show that a ₱1 higher BIR Allotment is associated with a ₱1.33 higher level of General Fund expenditures (see Table V-3), but the level of statistical significance is low.[1] From equation (7), we derived

$$\partial GF/\partial BIR = \partial \hat{GF}/\partial BIR + (\partial \hat{GF}/\partial \hat{IF}) \cdot (\partial \hat{IF}/\partial BIR) \qquad (7')$$

hence,

$$\partial GF/\partial BIR = 1.33 = 0.72 + (2.69)(0.23) \qquad (7'')$$

However, neither the estimated coefficients which directly involve BIR_p (0.72 and 0.23) are significantly different from zero. In light of these results, we are hesitant to conclude that the expenditure impact of the BIR Allotment is significantly greater than zero. Such a conclusion suggests a substitutive effect, i.e., local governments either substituted the Allotment for what would have been higher taxes or they accumulated it in larger cash balances.

The indirect impact of the BIR Allotment on Infrastructure expenditures is negligible (see Table V-3) meaning that larger BIR grants do not free up substantially more resources to be transferred to the Infrastructure Fund expenditures. Again, however, the levels of significance are quite low.

---

[1] We realize that the t-statistics are only approximations in the second stage equations and that, strictly speaking, we should not base our conclusions on the level of significance. Still, in the first stage results, the explanatory significance of the IF_p equation is quite low which suggests that the predicted values of IF_p will not vary a great deal around the mean. Moreover, the STA_p and BIR_p are not significant in three of four cases. Finally, the BIR_p variable shows a low level of significance in the second stage equation.

TABLE V-3

BIR AND SPECIFIC TAX ALLOTMENT IMPACTS ON
LOCAL GOVERNMENT EXPENDITURES
(in pesos)

Per Capita Expenditure Category	Expenditure Response to a ₱1 Higher Amount of Per Capita BIR Allotment	Per Capita Specific Tax Allotment
General Fund	1.33 (7)[a]	2.34 (8)
Infrastructure Fund	0.25 (9)	0.90 (10)
Development Expenditures	0.98 (18)	(2.18) (19)

[a]Number in parenthesis refers to equation number in text.

The development expenditure submodel gives similar results, i.e., no evidence of a stimulative impact of BIR Allotments on capital expenditures. The results of the structural equations are sensible, and much as hypothesized. General government spending has a threshold level, and thereafter declines as a percent of total General Fund spending. Public safety and welfare expenditures are pretty much constant at 18 percent of General Fund expenditures (revenues). A ₱1 higher BIR Allotment tends to be associated with a ₱0.98 higher level of economic development expenditures (Table V-3), but, as above, the level of significance is too low in the structural equations for us to have any confidence in this result. We simply cannot produce good evidence that the BIR Allotment stimulates capital spending. This raises some interesting questions about government policy. If there is one clear objective of Central Government intergovernmental policy, it is to induce local governments to spend more for economic development purposes and less for consumption of goods and services. One approach to achieving this objective has been to require that 20 percent of the BIR Allotment be allocated to development projects. However, this does not assure--and we cannot find evidence--that development expenditures will be increased by 20 percent of the Allotment, over and above what would have been spent in the absence of the Allotment.

The problem with these results may have to do with the sample, in particular the coverage of only four provinces. Broader coverage would reduce the dominance of a "Province Effect" and would allow for more variability in the dependent and explanatory factors. In addition, we

know the equations are poorly specified, but we were unable to gather the necessary data. Estimation of this model on a nationwide basis should be a high research priority.

Levels of significance notwithstanding, it might be useful to interpret the results implied by column (1) of Table V-3 to get some idea of the capabilities of the model. A ₱1 higher level of BIR Allotment per capita would result in a ₱1.33 higher level of General Fund expenditures per capita, and a ₱0.25 higher level of Infrastructure spending. Of this net impact of ₱1.58, ₱0.98 is higher economic development spending (₱0.73 in the General Fund) and ₱0.60 is higher general government and public safety expenditure. Of the ₱0.60 in non-development spending, an average of ₱0.24 is automatically siphoned off by virtue of the 18 percent INP requirement. There is clearly much to be learned from such a model, and its estimation on a nationwide basis would seem well worth the necessary effort.

Accountability

Related to the grant impact issue is the question of accountability. Lump sum grants, such as the BIR Allotment, are often criticized on grounds that local governments may spend the money anyway they see fit and with any level of efficiency, i.e., they are not accountable for their actions. The problem is an old one of the consequences of separating the pleasure of expenditure benefits from the pain of taxation--if a government must tax its citizens to pay for services, it will be more solicitous in how it spends the money.

How can local governments be made more accountable? Two possibilities come to mind. First, if matching local funds are required, as in a partial cost reimbursement grant system, local governments must 'pay' to receive the grant and in that fashion become accountable to their own citizens with respect to how the grant monies are spent. To institute such a system in the Philippines would call for a complete overhauling of the existing general purpose grant system.

A second approach, more applicable in the case of a general purpose grant such as the BIR Allotment, is to build in a "maintenance of effort" factor. At present there is nothing explicit in the allocation formula which rewards a higher tax effort. In actual fact, however, the per capita BIR Allotment is positively correlated with the level of tax effort,[1] i.e., the simple correlation for 83 municipalities in Albay, Bulacan and Iloilo is 0.33, suggesting larger BIR Allotments do flow to jurisdictions making greater efforts.[2] Yet if the index were to be built directly into the formula, one would anticipate an even stronger relation.[3]

To get some idea of how such a system might work and of its potential impact, consider the following experiment. Assume the formula for distri-

---

[1] Tax effort is measured here as the ratio of own source tax revenues (T) to personal income (Y). For further discussion of tax effort, see Chapter II.

[2] Throughout this section Sorsogon is omitted from the analysis since we did not have land area information for the municipalities within the province.

[3] Governments, knowing that they will receive more Allotment if they increase their tax effort, would tax themselves more heavily than they otherwise would have. This result holds if only we assume some positive price elasticity of demand for government-produced goods.

buting the BIR Allotment is changed to

a. 50 percent: population
b. 20 percent: land area
c. 30 percent: tax effort[1]

For our sample, the actual (1977) distribution of Allotment is as shown in column (L) of Table V-4. For the same total amount of Allotment, the distribution under the hypothetical formula including tax effort is shown in column (3). The differences, shown in columns (4) and (5), indicate that municipalities with higher tax efforts gain substantially.

The differential effect of the inclusion of the tax effort factor may be studied more systematically with a straightforward regression analysis. The current system allocated 90 percent of BIR Allotments according to population (POP) and land area (A). That is,

$$BIR = f(POP, A). \tag{21}$$

To explain the variation across municipalities, we may estimate

$$BIR = a_o + a_1 POP + a_2 A \ . \tag{22}$$

Now, the BIR Allotment per capita, BIR_p can be inferred from (22) as

$$BIR_p = a_o/POP + a_1 + a_2(A/POP). \tag{23}$$

---

[1] The tax effort component, S_i, in the formula would simply be based on the relative size of a jurisdiction's tax effort vis-a-vis that of all other jurisdictions, i.e.,

$$S_i = \frac{T_i/Y_i}{\sum_i (T_i/Y_i)}$$

where T is total own source tax revenues in jurisdiction i and Y_i is personal income for the same jurisdiction.

TABLE V-4

DISTRIBUTION OF BIR ALLOTMENT UNDER ALTERNATIVE FORMULAE, SELECTED MUNICIPALITIES: 1977
(in pesos)

Municipality	(1) Actual Per Capita Amount	(2) Percent Share	(3) Hypothetical Per Capita Amount	(4) Percent Share	(3-1) Gain/ Loss	Tax Effort Ranking
Bulacan						
Angat	9.51	1.82	7.49	1.35	-2.02	14
Balagtas (Bigaa)	8.08	1.55	9.35	1.68	1.27	8
Baliwag	9.92	1.90	5.40	0.97	-4.52	10
Bocaue	5.65	1.08	4.91	0.88	-0.74	20
Bulacan	4.70	0.90	8.00	1.44	3.29	7
Bustos	7.24	1.39	6.07	1.09	-1.18	25
Calumpit	4.45	0.85	4.29	0.77	-0.16	44
Guiguinto	11.30	2.16	11.24	2.02	-0.05	4
Hagonoy	4.40	0.84	4.32	0.78	-0.08	27
Malolos	5.53	1.06	4.25	0.77	-1.28	12
Marilao	10.86	2.08	14.17	2.55	3.31	3
Meycauayan	9.73	1.86	4.72	0.85	-5.01	11
Norzagaray	5.98	1.14	18.80	3.38	12.82	1
Obando	4.81	0.92	5.27	0.95	0.46	24
Pandi	6.74	1.29	6.40	1.15	-0.33	32
Paombong	5.29	1.01	5.75	1.03	0.46	29
Plaridel	4.97	0.95	5.89	1.06	0.93	17
Pulilan	4.44	0.85	4.31	0.78	-0.13	52
San Ildefonso	4.65	0.89	5.13	0.92	0.48	31
San Jose del Monte	4.62	0.88	5.07	0.91	0.45	26
San Miguel	4.79	0.92	6.93	1.25	2.13	39
San Rafael	9.63	1.84	7.57	1.36	-2.07	42
Santa Maria	6.94	1.33	4.55	0.82	-2.39	28
Albay						
Bacacay	4.93	0.94	4.62	0.83	-0.31	59
Camalig	6.43	1.23	4.48	0.81	-1.95	72
Daraga	5.29	1.01	4.61	0.83	-0.68	15
Guinobatan	4.67	0.89	4.73	0.85	0.06	70
Jovellar	7.09	1.36	6.99	1.26	-0.10	68
Libon	4.98	0.95	4.69	0.84	-0.30	69
Ligao	4.69	0.89	5.30	0.95	0.61	21
Malilipot	4.52	0.87	4.56	0.82	0.04	77
Malinao	5.06	0.97	5.16	0.93	0.10	75
Manito	6.36	1.22	8.31	1.49	1.95	35
Oas	4.80	0.92	5.09	0.91	0.28	78
Pio Duran	3.84	0.73	5.16	0.93	1.32	57
Polangui	4.69	0.90	4.28	0.77	-0.41	65
Rapu-Rapu	5.67	1.09	6.81	1.22	1.14	54
Santo Domingo	5.32	1.02	8.36	1.50	3.04	16
Tabaco	5.88	1.12	4.22	0.76	-1.66	36
Tiwi	4.86	0.93	6.75	1.21	1.89	19

TABLE V-4 (CONT.)

Municipality	(1) Actual Per Capita Amount	(2) Percent Share	(3) Hypothetical Per Capita Amount	(4) Percent Share	(3-1) Gain/ Loss	Tax Effort Ranking
Iloilo						
Ajuy	6.22	1.19	6.39	1.15	0.13	64
Alimodian	6.48	1.24	6.00	1.08	-0.48	74
Anilao	6.53	1.25	7.54	1.36	1.01	49
Badiangan	7.41	1.42	6.22	1.11	-1.19	51
Balasan	6.27	1.20	6.11	1.10	-0.16	53
Banate	5.84	1.12	6.95	1.25	1.11	55
Barotac Nuevo	8.65	1.66	8.16	1.47	-0.50	5
Barotac Viejo	8.10	1.55	6.85	1.23	-1.25	46
Batad	11.27	2.16	5.74	1.03	-5.54	81
Bingawan	3.99	0.76	8.68	1.56	4.69	63
Cabatuan	5.15	0.99	4.55	0.82	-0.60	67
Calinog	6.77	1.29	10.20	1.83	3.43	6
Carles	4.64	0.89	4.70	0.85	0.06	80
Concepcion	5.33	1.02	5.39	0.97	0.06	82
Dingle	5.93	1.13	6.18	1.11	0.25	23
Duenas	6.55	1.25	5.01	1.08	-0.54	41
Dumangas	4.93	0.94	5.26	0.95	0.33	30
Estancia	5.87	1.12	7.91	1.42	2.04	13
Guimbal	5.66	1.08	6.32	1.14	0.66	34
Igbaras	5.81	1.11	6.15	1.10	0.34	73
Janiuay	5.23	1.00	5.62	1.01	0.34	33
Lambunao	4.74	0.91	5.18	0.93	0.43	79
Leganes	7.47	1.43	9.41	1.69	1.94	18
Lemery	5.81	1.11	7.15	1.29	1.34	71
Leon	5.31	1.02	4.86	0.87	-0.45	76
Maasin	5.90	1.13	5.35	0.96	-0.55	83
Miagao	4.89	0.94	4.65	0.84	-0.24	66
Mina	3.32	0.63	7.66	1.38	4.35	48
New Lucena	12.39	2.37	7.89	1.42	-4.50	37
Oton	4.78	0.91	4.90	0.88	0.12	43
Passi	9.47	1.81	5.24	0.94	-4.24	61
Pavia	8.05	1.54	11.91	2.14	3.86	9
Pototan	5.98	1.14	4.51	0.81	-1.47	56
San Dionisio	6.59	1.26	8.37	1.51	1.79	40
San Enrique	6.53	1.25	17.83	3.21	11.30	2
San Joaquin	5.35	1.02	6.17	1.11	0.82	60
San Miguel	8.73	1.67	7.05	1.27	-1.69	45
San Rafael	10.24	1.96	13.85	2.49	3.61	47
Santa Barbara	5.39	1.03	4.76	0.86	-0.64	62
Sara	5.32	1.01	7.15	1.29	1.83	38
Tigbauan	5.41	1.04	4.76	0.86	-0.65	58
Tubungan	6.87	1.32	6.37	1.15	-0.50	50
Zarraga	8.43	1.56	11.08	1.99	2.95	22

so we may estimate

$$BIR_p = b_o + b_1 POP^{-1} + b_2 (POP/A)^{-1} \tag{24}$$

$b_0 = a_1 = \partial BIR/\partial POP$, a constant

$b_1 = a_0 = POP^2(\partial BIR/\partial POP)$

$b_2 = a_2 = \partial BIR/\partial(A/POP)$.

To equation (24), we add tax effort, E_1 and estimate

$$BIR_p = c_0 + c_1(POP)^{-1} + c_2(POP/A)^{-1} + c_3 E \,. \tag{25}$$

When the BIR Allotment per capita under the current scheme is regressed on the inverse of population (and the inverse of population density, i.e., equation (24), we obtain

$$BIR_p = 5.1 + \underset{(3.58)}{32459.6(POP)^{-1}} - \underset{(0.74)}{52.2(POP/A)^{-1}}. \tag{26}$$

$R^2 = .144$ $\quad F = 6.70$ $\quad$ (t-statistics in parenthesis)

The extremely low explanatory power of this seemingly definitional relationship suggests that either certain ad hoc adjustments to the formula are used to allocate the Allotment across municipalities or, more likely, the 1977 Allotments were based upon population data from 1970 rather than from 1975 as are being used here.

When the tax effort variable (E) is added to explain actual 1977 allocations of the per capita Allotments, we obtain

$$BIR_p = 4.4 + \underset{(3.87)}{32891.3(POP)^{-1}} - \underset{(.75)}{49.5(POP/A)^{-1}} + \underset{(3.45)}{1.13E.} \qquad (27)$$

$$R^2 = .26 \qquad F = 9.05$$

The explanatory power of the equation is increased a bit and we find the tax effort variable to be positive and significant at less than the 0.01 level. This suggests that even without the specific inclusion of tax effort in the allocation formula, the 1977 Allotment distribution system did favor those areas which were making greater tax effort.

When the alternative scheme suggested here is used, the analogous regression results are:

$$\hat{BIR}_p = 1.02 + \underset{(14.31)}{44354.0(POP)^{-1}} + \underset{(12.78)}{307.6(POP/A)^{-1}} + \underset{(32.07)}{3.84E.} \qquad (28)$$

$$R^2 = .95 \qquad F = 534.9$$

Given that the population, area and effort data are exactly the same for determining the hypothetical allocation of $\hat{BIR}_p$ as were used to estimate equation (28), it is not terribly surprising that the fit of this equation and the levels of significance of the explanatory variables is so strong. More interesting, however, is that the results suggest that after having accounted for the other variables in the distribution formula, a 1 percent greater tax effort is associated with a ₱3.84 greater per capita BIR Allotment, or a differential of ₱2.71 compared to the current system.

Such an inducement would be quite susbstantial; ₱2.71 is equivalent to 43 percent of the average amount received under the present system. For a municipality, such as Pavia in Iloilo, tax effort is 1.36 percent which is over twice the average (0.64) of the 83 municipalities studied here. A changeover from the present system to the tax effort formula system, without changing the total amount distributed, would result in an increase of ₱55,603 to Pavia, or 48 percent of the amount they presently receive. One would not have trouble believing that an incentive of this kind would result in the mobilization of substantial additional resources.

On the other hand, municipalities currently putting forth less than average tax effort would find that under the alternative system, BIR Allotments would decline. For example, Libon in Albay had an estimated local tax effort ratio of 0.28 in 1977 and received ₱244,412 in the form of BIR Allotments during that year. Under the alternative system this Allotment would decline to ₱229,922 or a decrease of 5.9 percent. While not catastrophic, this decrease might be sufficient to encourage the locality to put forth greater effort in utilizing its tax capacity.

Elasticity and Certainty

Another criterion for evaluating the BIR Allotment is the elasticity of its revenue yield--is the BIR yield responsive to income growth and inflation and in that sense is it a good substitute for an income elastic, locally raised tax? One might frame the issue as follows: The Central

Government has opted not to give local governments an independent income elastic tax source, e.g., a sales or income tax. Instead, local governments have been given the BIR Allotment. Hence in evaluating the Allotment, we might ask whether it has responded to income growth and inflation as an independent tax source would have. Since local expenditure needs respond to these factors, local officials are prone to argue that the revenue structure should follow suit.

It is well known among local government officials in the Philippines and clearly shown in Table V-5 that the Allotment system is quite income inelastic--it would appear to have responded neither to GNP nor to inflation. There are two distinct components to the Allotment elasticity: (a) the growth in the amount of Allotment actually distributed relative to the amount due and, (b) the growth in the BIR basis relative to GNP. The former is the primary explanation of the low BIR Allotment elasticity. This low elasticity has been a result of discretionary government decisions--the government has felt that other needs were more pressing than local government finances and, as a result, has distributed less than the entitled amounts since 1975. The current peso amount distributed was not raised between 1977 and 1980, with the result that in 1980, actual distributions were only about 7 percent of the BIR basis, by comparison with the 20 percent authorized in PD 144. This decline has been a long-term pattern, as may be seen from both Table V-5 and Figure V-1.

TABLE V-5

GROWTH IN BIR ALLOTMENT
(in millions of pesos)

Year	Total Allotment Due	Actual Distribution	GNP	BIR Basis	Amount Distributed as a Percent of GNP	Amount Distributed as a Percent of BIR Basis
1981[a]	2472.6	---	---	12,363.1	---	---
1980	1853.0	658.9	274,334[b]	9,502.4	0.24	6.93
1979	1332.6	658.9	220,438[c]	7,593.3	0.30	8.68
1978	1117.3	658.9	178,543	6,366.3	0.36	10.35
1977	1140 6	658.9	154,280	6,498.9	0.43	10.14
1976a[d]	422.6	315.1		2,408.2	0.48[e]	13.08
1976	878.2	547.8	131,938[f]	4,391.2	0.42	12.47
1975	599.8	505.4	114,265	2,999.2	0.44	16.85

[a] Budgeted.

[b] Projected.

[c] Preliminary.

[d] Six-month Transition.

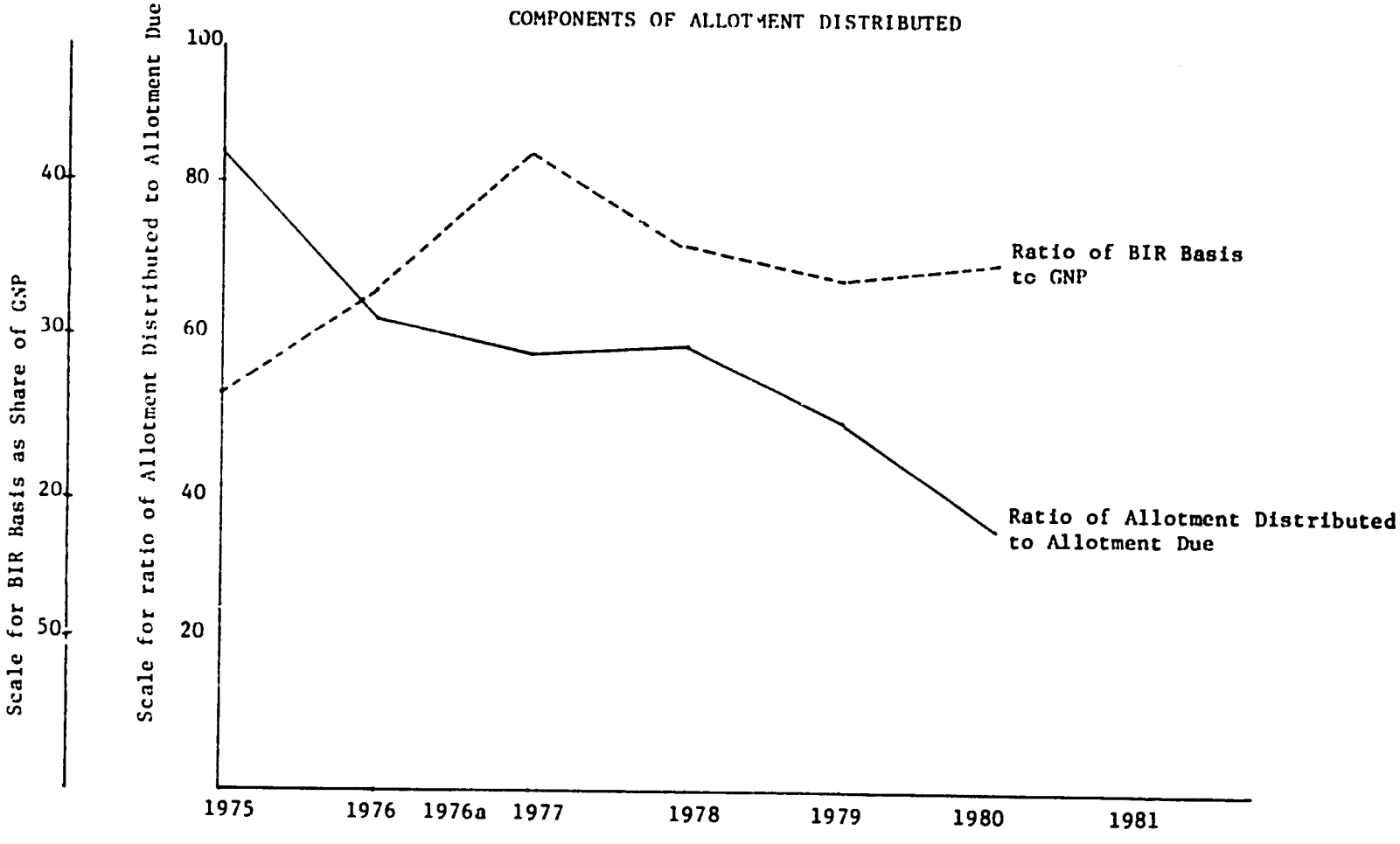
[e] Based on one-half of estimated 1976 GNP.

[f] Not final estimate.

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

FIGURE V-1

COMPONENTS OF ALLOTMENT DISTRIBUTED



The second component of the elasticity, internal tax revenue collections, has not shown the elastic growth that one might expect. The BIR basis has grown with an erratic pattern relative to GNP, peaking in 1977 and declining somewhat thereafter (see Figure V-1).

The result of these factors has been relatively little growth in the BIR Allotment in recent years. As a share of GNP the Allotment declined from 0.44 percent in 1975 to 0.24 percent in 1980, implying an income elasticity of 0.14. Between 1978 and 1980, there was no increase at all in the BIR Allotment; in fact, it declined significantly in real per capita terms. However, it is interesting to note that if issued at its full authorized level, the income elasticity of the BIR would have been unity over this period.

Even if the BIR Allotment had been fully distributed, the elasticity would not have been unity in every jurisdiction. Indeed, the distribution is on a basis of population, which is changed every fifth year, and land area. Hence, when the nationwide distribution is increased, say in response to an increase in GNP, every recipient receives a proportionate increase. For those jurisdictions with personal incomes growing faster than the national average, the system is income inelastic. For those with relatively slow personal income growth, it is income elastic. Depending on one's view of what causes expenditure needs to rise, the Allotment distribution system is a success/failure in getting the pesos to where the needs are.

Closely related to the elasticity maxim for evaluating the BIR Allotment is certainty. Efficient local government budgeting and financial planning requires some reasonable estimate of how much can be expected from

each revenue source. Capital budgeting requires even longer term revenue projections. Such projections have not been possible with the BIR Allotment in recent years, because distributions have been primarily determined by ad hoc government policy. One could safely conclude that the yield of virtually any local government tax could be more easily estimated.

In sum, the BIR Allotment does not get good marks with respect to either its elasticity or its certainty features. Revenues do not grow in proportion to GNP or inflation, hence, have not provided a growing base which local governments can use to finance their growing expenditure needs. By the same token, the Allotment is not certain in amount from year to year, largely because it is heavily influenced by discretionary government decisions. Rather than being a true shared tax, as provided by law, it would appear that the amounts actually distributed are based on ad hoc year-to-year decisions. While this may increase the flexibility of the Central Government in controlling the total flow of resources, it leaves local governments in a position of being unable to effectively plan their budgets for much longer than a one-year period.

The Specific Tax Allotment

The second major program of intergovernmental assistance to local governments is based on PD 436 (April 13, 1974) which amended the Internal Revenue Code as it pertained to specific taxes on a variety of petroleum products. More important for this discussion, it earmarked a designated

portion of these taxes for sharing with local governments. The basis for the Specific Tax Allotment is the designated tax collection in the second preceding year, e.g., the basis for the Allotment in 1979 is the designated tax collection in 1977.

The sharing scheme is:

a. 20 percent to provinces
b. 30 percent to municipalities
c. 50 percent to cities

with the allocations based on the same weighted three-factor formula as used for the BIR Allotment:

a. 70 percent according to population
b. 20 percent according to land area
c. 10 percent according to equal shares.

The entire allocation is to the Infrastructure Fund (earlier the Road and Bridge Fund).

As in the case of the BIR Allotment, barangays were included in the allocation scheme in 1974 with the issuance of PD 558 (September 21, 1974) By this PD, one-fourth (25 percent) of the total specific tax was to be retained in a special fund allocated by the President to barangays for road and bridge construction, improvement and maintenance. These provisions of PDs 436 and 558 have apparently not been altered. However, the specific tax rates were increased substantially under PD 1122 (April 21, 1977) and again under EO 550 (August 1, 1979). These changes result in a marked increase in the size of the Specific Tax Allotment Fund.

Specific Tax Allotment Objectives

One might evaluate the Specific Tax Allotment in much the same way as the BIR Allotment. Is it fairly distributed? Does it stimulate additional capital spending? Is it certain in amount and does it respond to increasing income and prices? PD 436 seems to emphasize the objective of meeting expenditure needs, i.e.,

> "...local government revenues are found to be inadequate for purposes of financing the maintenance and repair of existing roads and bridges, as well as new construction and improvement projects,..."

Equity, or equalization objectives are also considered

> "...it is the policy to provide the local governments with sufficient resources in areas of governmental operations that cannot be supported by local funds."

Equity

To determine whether the distribution of the Specific Tax Allotment is meeting equity objectives, we might carry out an experiment similar to that carried out above for the BIR Allotment. At question is how strong is the correlation between the per capita distribution of the Specific Tax Allotment and

a. per capita personal income,
b. per capita expenditures,
c. population,
d. per capita assessed value.

The simple correlations in Table V-6 give some idea of the distributional features of the Specific Tax Allotment system. Among chartered cities there appears to be some pattern to the distribution. It is equalizing--cities with a lower per capita personal income get more--and smaller

TABLE V-6

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

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

SOURCE: Computed by authors.

cities get more. The patterns are similar but not as strong in the case of municipalities The Specific Tax Allotment seems to behave more like a grant system, i.e., the city and municipal components are more alike in their distribution than in the case of the BIR.

Fiscal Stimulation

It seems clear that the major goal of the Specific Tax Allotment is to stimulate spending on infrastructure projects. Though the system carries no matching or maintenance of effort clause, it may well achieve this stimulation because the Allotment is earmarked to the Infrastructure Fund and because capital projects often require supplementary local government expenditures, e.g., road and bridge maintenance, the construction of a new market may require road improvements, etc. On the other hand, three factors might dampen or even negate this stimulation effect:

- the possibility that higher Specific Tax Allotments will induce local governments to reduce transfers from the General to the Infrastructure Fund.
- the possibility that the local government would substitute higher Infrastructure Fund expenditures for lower General Fund economic development expenditures, thereby not increasing [illegible] capital expenditures.
- the possibility that part of the Specific Tax Allotment will simply be banked in the form of increased cash balances.

To investigate these possibilities, we return to our earlier analysis of the stimulative effects of grants, which considered both the Specific Tax Allotment and the BIR Allotment (see pp. V-12-26). As in the BIR Allotment analysis, the problem here is the low level of significance of the

results. Some interesting conclusions, however, may be drawn from the estimates presented in Table V-2 and V-3. First, there is some basis for arguing that the Specific Tax Allotment is stimulative of local government expenditures, certainly it is more stimulative than the BIR Allotment (see Table V-3). Second, higher Specific Tax Allotments seem to result in higher General Fund expenditures, likely because transfers to the Infrastructure Fund are less needed. As a result, Specific Tax Allotments may be more stimulative of General Fund expenditures than are the BIR Allotments.[1]

Finally, Specific Tax Allotments would appear to be stimulative of economic development expenditures. The process, however, is interesting. A peso more of Allotment, on average, means a peso more of Infrastructure Fund spending, but it also means higher spending in the General Fund--₱2.34 by our estimates. About ₱1.28 of this amount shows up in increased economic development expenditures in the General Fund. In total, then, a ₱1 higher Allotment is associated with a ₱2.18 higher level of economic development expenditures.

Elasticity

The Specific Tax Allotment is not like an elastic tax, i.e., since it is not *ad valorem* it will not respond to income growth or inflation. Revenues will grow only in response to discretionary changes and to increases in the *volume* of consumption, and volume has been relatively flat. Revenues from the Specific Tax Allotment remained approximately constant for 1976-1978 but increased markedly in 1979 because of specific tax rate increases

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[1]We do face some of the same significance problems as in the case of the BIR analysis above, and they raise the same kind of concerns. Still, these results are somewhat better. From equations (8) and (10),

$$\partial \hat{GF}_p/\partial STA_p = \partial \hat{GF}_p/\partial \hat{IF}_p \cdot \partial \hat{IF}_p/\partial STA_p = (2.69)(0.87) = 2.34$$

$$\partial \hat{IF}_p/\partial STA_p = \partial \hat{IF}_p/\partial STA_p + (\partial \hat{IF}_p/\partial \hat{GF}_p)\cdot(\partial \hat{GF}_p/\partial STA_p)$$
$$= 1.60^* + (0.177^*)(-3.97^*) = 0.89$$

under PD 1122 in 1977. The rates were increased in 1979 under EO 550, which implies a further revenue increase in 1981 (see Table V-7).

The rationale for tying the Specific Tax Allotment to petroleum taxes is understandable: the original intent was to use the funds for road construction and maintenance, and petroleum consumption seemed a reasonable basis for identifying beneficiaries. However, the program has since expanded to a more general infrastructure type of assistance and is an important source of local government revenues. The specific tax does not provide any growth in this important tax base. In any case, changes in petroleum tax rates are more likely to be dictated by energy policy than by the financial needs of local governments. Tying the distribution of grants to energy policy would seem to lead inevitably to anomalies such as the current situation where increased specific tax rates on petroleum products could potentially lead to an enormous revenue windfall for local governments.

National Tax Allotment

In addition to the establishment of the General and Specific Tax Allotments, PD 144 also created an additional Local Government Fund consisting of 5 percent of the BIR revenues (over and above the 20 percent set aside for General Allotment). This was to be used for project grants with projects approved by a committee (specified in LOI 636) consisting of the Minister of Finance, the Minister of the Budget and the Minister of Local Government and Community Development.

(cont) Using one-tail tests, all components noted with * were significant at the 0.1 level or better (though the usual problems with t-statistics in second stage equations are present).

TABLE V-7

GROWTH IN SPECIFIC TAX ALLOTMENT
(in millions of pesos)

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

na: not available.

[a]Budgeted.

[b]Projected.

[c]Preliminary.

[d]Six month transition.

[e]Not final estimate.

SOURCE: Computed by authors.

This Fund amounts to earmarking an additional share of BIR collections for local governments but leaving the distribution--amount and purpose--to the discretion of the Office of the President. In amount, the National Tax Allotment to the Local Government Fund is not insignificant (see Table V-8). Indeed, it approaches half the size of the BIR General Allotment in some years. But in the two years for which we have data on the extent to which this grant has actually been distributed to local governments, it appears that, again, only a small proportion of the total amount due was actually released.

An evaluation of the National Tax Allotment is not easily done. The primary objective would seem to be to increase presidential discretion to finance certain projects in certain regions--perhaps those which are in accord with national goals. On the other hand, this program provides no formal inducement for local governments to mobilize additional resources, nor does it give an incentive to improve financial management.

The most important question to be asked here is whether the objectives of this program are important enough to justify such a large share of total grants to local governments.

The Issue of Barangay Shares

The series of PDs that have redefined intergovernmental relations in the Philippines have made increasing amounts of resources available to the barangay unit of local government. PD 144 designated 10 percent of real property tax collections for barangays and provided for a contribution by local governments of up to ₱500 to each barangay within its boundaries;

TABLE V-8

GROWTH IN NATIONAL TAX ALLOTMENT
(in millions of pesos)

Year	Amount	As a Percent of GNP	As a Percent of Actual BIR Allotment	Amount of Actual Release	Actual Release as a Percent of Total due
1981[a]	618.2				
1980	475.1	0.17[b]	72.11	20.0	4.2
1979	379.7	0.17[c]	57.63	52.0	13.7
1978	318.3	0.18	48.31	na	na
1977	324.9	0.21	49.31		
1976a[e]	120.4				
1976	219.6	0.17[d]	40.10		
1975	150.0	0.13	29.68		

na: not available.

[a]Budgeted.

[b]Projected GNP (see Table V-5).

[c]Preliminary GNP (see Table V-5).

[d]Not final estimate.

[e]July-December, 1976.

SOURCE: Obtained from Bureau of the Treasury, Final Cash Operations Statements, (annual).

PD 549 required that 10 percent of the BIR General Allotment go to the barangay unit; and PD 558 allocated 25 percent of the Specific Tax Allotment to the Barangay Fund.

The amounts involved are substantial, as may be seen from Table V-9. However, the actual cash distribution of these amounts and the discretion that barangay's may exert in spending these funds may make the role of the barangay substantially less than is indicated by these amounts. The 10 percent property tax share has been distributed for barangay use, and there are no major restrictions on the use of these funds. Use of the ₱500 contribution to the Barangay Development Fund requires approval of the MLGCD. In the case of the barangay share under both the Specific and General Allotment, the distribution is administered by the Office of the President. The purpose of the BIR General Allotment distribution is community development projects and the Specific Tax Allotment distribution is for road and bridge (later infrastructure) construction, improvement, and maintenance.

Data have been obtained and tabulated by the NTRC on the extent to which the barangay shares of the BIR General Allotment and Specific Tax Allotments have been appropriated but not necessarily cash supported, i.e., not released. These data (shown in Table V-9) suggest that during the period 1977-1980 less than 20 percent of the appropriated amounts have actually been transferred to the barangay level in any given year. For the four year period 1977-1980 only 11.7 percent of the total appropriated amount has been cash supported.

TABLE V-9

BARANGAY SHARES AND ACTUAL DISTRIBUTION OF BIR AND SPECIFIC TAX ALLOTMENT PROGRAMS: 1975-1981
(in millions of pesos)

Period	BIR General Allotment[a] Amount Due[d]	Specific Tax Allotment[b] Amount Due[d]	Amount of Actual Release[c]	Actual as Percent of Total Due
1981	241.1	293.9	NA	----
1980	185.3	225.7	42.5	10.3
1979	148.1	175.0	25.2[f]	7.8
1978	124.1	38.4	27.0[g]	16.6
1977	126.7	38.4	30.0	18.2
1976	65.0	39.4	80.0	76.6
1976a[e]	46.9	18.3	NA	----
1975	65.0	33.0	NA	----

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[a]10 percent Barangay Development Fund (PD 559).

[b]25 percent Barangay Development Fund (PD 558).

[c]These are the combined actual releases for Barangay Development Fund from BIR General and Specific Tax Allotment.

[d]Appropriated but not cash supported.

[e]Six month transition.

[f]₱25.2 (2.6 not yet released plus 22.6 with advice of allotment for actual release).

[g]₱27.0 (26.1 not yet released plus 0.9 with advice of allotment for actual release).

SOURCE: Budget Operation Division, Ministry of the Budget, Tax Statistics Staff, NTRC, January 23, 1981.

These data would seem to suggest that while support of barangays as a new and important level of government in the Philippines is a policy initiative, there has been less than full-fledged actual financial support provided for this initiative. Whether there will ultimately be a carrying through with these financial commitments is also, of course, impossible to predict.

Is the growing fiscal importance of barangays an improvement in intergovernmental relations in the Philippines? Ideally, we would study many of the same issues as above, e.g., does this arrangement promote the mobilization of more local resources, does it result in more capital expenditures, etc.? Partly because of data limitations, such questions just can't be studied. We may, however, consider the conceptual advantages and disadvantages to this form of decentralization. There are two important advantages to a more active participation of barangays in financing and delivering public services. The first is that local government is moved closer to the people and a greater sense of involvement and participation is created. This results in a better allocation of resources--surely barrio officials are better able to determine some local project needs than are provincial and/or national officials. However, one would like to know the mechanism by which barangay level decisions are made--does a greater amount of local involvement in decision-making really occur at the barangay level? How is the MLGCD role worked out? There needs to be further research on these questions. The second advantage is that this greater participation and a 10 percent property tax share to the barangay may increase the rate of tax collections, since local

officials can see some concrete benefits from convincing residents to pay property taxes. Moreover, the support of the barangay captain is more enthusiastically enlisted when it is known that this barangay share of collections will be retained. How the barangay captains are and can be more effectively involved is another question that begs for more research. In that sense, increased barangay involvement may result in a greater mobilization of local revenues.

There are disadvantages to increased barangay participation. Whether or not equity is a problem (do the poorer barangay get relatively more or less?) isn't known because the methods of allocating the General and Specific Tax Allotment shares are ad hoc and we were not able to obtain the actual distributions. The property tax share is based on origin of collections and so one would expect a counterequalizing influence, i.e., wealthier barangay in general and those in the poblacion in particular, will benefit most. Perhaps the biggest problem is the capacity of the barangay to absorb these revenue increases efficiently. The barangay budget process,while not investigated specifically in this study, is unlikely to be highly developed. Moreover, there does not seem to be a mechanism or technical expertise to handle large sums of money. Technical project planning and financial management are shortcomings that might be dealt with by assigning responsibility to a higher level of government, but this begins to defeat the whole purpose of barangay involvement. Finally, there is the question of coordination of barangay project activities with the development plans of the city or municipality.

Evaluation of the Philippine Allotment System

It isn't surprising, or even undesirable, for different grant programs to have different strengths and failings. No one program is going to accomplish many different objectives at the same time. However, it is important to examine the workings of the system as a whole: are allocations being made among grant programs in about the desirable proportions? Is the program as a whole equitable? Do the several individual components reinforce each other to increase revenue mobilization by local governments, or are there offsetting effects?

To analyze the workings of the Philippine grant system, we make use of the knowledge that every grant program has two discretionary dimensions: (a) determination of the total amount to be allocated and (b) determination of the distribution of this amount amongst local governments.[1] The matrix in Table V-10 suggests the possible combinations that a country may follow in structuring its grant system. The columns describe the methods of determining the total grant fund and the rows describe the methods of distribution among local governments. For example, a type C grant is one in which the total grant fund is determined on a shared tax basis (e.g., as a percent of BIR collections) and the distribution among local governments is made by formula.

Many combinations of these choices are used in developing countries.[2] Programs of the A and C type would give local governments more control and

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

[2] A more complete review of the issues and practices surrounding intergovernmental fiscal relations in developing countries can be found in Roy Bahl, "Intergovernmental Fiscal Transfers in Developing Countries," Local Revenue Administration Project, The Maxwell School (Syracuse, New York: Syracuse University, forthcoming).

TABLE V-10

POSSIBILITIES FOR STRUCTURING A GRANT SYSTEM

Methods of Distribution Among Local Governments	Methods of Determining the Grant Fund: Shared Tax	Ad Hoc	Cost Reimbursement	Revenue Totals
Origin of Collection	A (L = 1.5%) (A = 3.2%)	...	...	L = 1.5 A = 3.2
Ad Hoc	B (L = 27.0%)	E (A = 5.9%)	H	L = 27.0 A = 5.9
Formula	C (L = 71.4%) (A = 40.5%)	F (A = 50.5%)	...	L = 71.4 A = 91.0
Cost Reimbursement	D	G	I	
(Column Totals)	(L = 100.0) (A = 43.7%)	(L = 0) (A = 56.4)		

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

collected in the local area or according to some predetermined formula. Program E would provide maximum Central Government control in that the total grant fund would be determined by the Central Government and subject to change as the need arose, as would the distribution across local units. Programs B, F, and H are also relatively centralized options.

In the Philippines, the *legal* structure of the grant system provides for a great deal more local government autonomy than the system actually practices. In theory, it is a mixture of B and C type programs, but in practice it is a much more centralized combination of C, E, and F. The first column in Table V-11 shows the typology of Philippine grants according to their legal definition and the second according to actual practice.[1] Columns (3) - (6) of Table V-11 compare amounts due with actual distribution, and show that only about half of these funds were distributed in 1979. With these data we may compare the legal grant system with the grant system in practice, by entering legal and actual distributions in Table V-10.

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

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[1]We include as grants all intergovernmental transfers: the three Allotment programs, the barangay share of the local property tax and the local government grant to the barangay.

autonomy in that the total grant distribution is a fixed share of some national tax and the share of each local government is determined on some objective basis, i.e., according to how much is collected in the local area or according to some predetermined formula. Program E would provide maximum Central Government control in that both the total grant fund and the distribution among local units would be determined subjectively by the Central Government. Programs B, F, and H are also relatively centralized options.

In the Philippines, the legal structure of the grant system provides for a great deal more local government autonomy than the system actually practices. In theory, it is a mixture of B and C type programs, but in practice it is a much more centralized combination of C, E, and F. The first column in Table V-11 shows the typology of Philippine grants[1] according to their legal definition, and the second column according to actual practice. Columns (3)-(6) of Table V-11 compare amounts due with actual distribution, and show that only about half of these funds were distributed in 1979. With these data we may compare distributions under the legal grant system with those under the practiced grant system (note the legal and actual distributions in parenthesis in Table V-10).

By law, all grants are to be distributed as shared taxes (column 1 of Table V-10) and 71 percent of this amount is to be distributed amongst local governments on a formula basis (row 3). In fact, only 43.7 percent is distributed as a shared tax but 91 percent of that total is distributed on a formula basis. In other words, the government has chosen to distribute only about half of total entitlements, but to do that primarily on a formula

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[1]We include as grants all intergovernmental transfers: the three Allotment programs, the barangay share of the local property tax and the local government grant to the barangay

TABLE V-11

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

Program	Legal Definition	Actual Practice	1979 Amounts Due	Percent of Total	Amounts Distributed	Percent of Total Distribution
Barangay Share of Local Property Tax Collections	A	A	40.0[a]	1.5	40.0	3.2
Barangay Share of BIR General Allotment[d]	B	E	148.1	5.7	25.2[e]	1.9
Barangay Share of Specific Tax Allotment[d]	B	E	175.0	6.7	25.2[e]	4.0
National Tax Allotment	B	E	379.7	14.6	52.0	4.0
Province, City and Municipal Shares of BIR General Allotment	C	F	1332.6	51.2	658.9	50.5
Province, City and Municipal Shares of Specific Tax Allotment	C	C	525.1	20.2	528.9	40.5
Total			2600.5	100.0	1305.0	100.0

[a] 1977 amount is latest available.

[b] Excludes local government contributions to barangay.

[c] Actual amounts distributed are not known.

[d] Amounts due.

[e] ₱25.2 (2.6 not yet released plus 22.6 with advice of Allotment for actual release).

SOURCE: Computed by authors.

basis. Even here, however, the formulae have been frequently adjusted or constrained by PD.

One important concession to the formula distribution intent of the Philippine grant system came about with the increased allocation to the barangays. Paradoxically, this program to move government closer to the people actually resulted in a greater degree of centralization of the grant system--since it places a substantially greater amount of grant distribution under presidential discretion. If these amounts are increasingly distributed, they will reduce the share of grants distributed on a formula basis (they will be "E-TYPE" grants in Table V-10).

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

Elasticity

Grants are not an income elastic revenue source for local governments. They have declined as a share of GNP in recent years and this decline is in part responsible for the declining share of local governments in total government finances in the Philippines. In theory, however, the grant system has a much greater responsiveness to GNP than it has in practice. The problem has come about because of Central Government policies.

Legally, all grants are somehow tied to tax collections. In the case where the basis is lagged BIR collections, this would seem to have the decided advantage of a steady growth in the overall grant amount and a

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

responsiveness of grants to real income growth and inflation. This potential advantage has been lost--perhaps because of higher priority national economic objectives--by Central Government limits on the actual distribution. As a result, the BIR Allotment share of GNP has fallen from 0.44 percent in 1975 to 0.24 percent in 1980, i.e., the General Allotment has behaved as an inelastic tax. The sharing of the tax on petroleum products does not result in an automatic growth in the grant fund because the tax rates are specific and the volume of petroleum consumption has not been increasing. Discretionary increases in the tax rates have been necessary to stimulate growth in the Specific Tax Allotment amount. The barangay shares of both Allotments, and the National Tax Allotment, are shares of BIR collections and thus are responsive to inflation and real income growth, but again, only a small proportion of these has been distributed. Finally, there is the barangay share of the local property tax, which is fixed in proportion and actually distributed, but which is tied to a basically income inelastic tax. We have estimated that the most elastic component of the grant system--the BIR Allotment--has a statutory elasticity of about unity. From this, we can guess that the statutory elasticity of the total grant system is something less.

The income elasticity of grant receipts to individual jurisdictions will vary, depending on the rate of personal income growth in the community relative to the growth in lagged BIR collections. Since the system allocates increments more or less in proportion to the existing distribution, communities with more rapid income growth would face a lower grant income elasticity. For those grants allocated on an ad hoc basis, the income

elasticity for individual jurisdictions depends very much on the equalization objectives of the government. The more equalizing the distribution, the less elastic the system for jurisdictions with more rapid income growth.

Data are just not available to allow us to sum this discussion up by presenting an aggregate estimate of the income elasticity of the grant system. However, the bottom line would seem to be that the grant share of total local government financing has been declining and that grants have been declining as a share of GNP. The grant system would not appear to be providing an adequately growing source of revenue for Philippine local governments.

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

Equity

Again, the absence of data on actual grant distribution makes it difficult to determine whether grants are distributed, in aggregate, on an equalizing basis, i.e., whether poorer jurisdictions receive larger grant amounts. The analysis above suggests that the BIR General Allotment is

probably counter-equalizing with respect to its distribution among municipalities, but appears to be neutral in terms of its distribution among chartered cities. The Specific Tax Allotment, on the other hand, appears to be distributed on a mildly equalizing basis--for both cities and municipalities. These two programs, which account for about 60 percent of all grants in the system and about 90 percent of all grants distributed, would seem to have offsetting effects. There are no data on the distribution of the barangay shares or the National Tax Allotment

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

That the Philippine grant system has not done a very good job of distributing grant funds on an equalizing basis may not be a flaw in government policy. One could argue that the objective of equalization may only be accomplished at the sacrifice of not using the grant system as a tool to mobilize more local government revenues. It is the local governments with greater fiscal capacity that have the leverage to use grant funds to increase local resource mobilization. Indeed, some local governments may not even be able to absorb increased grant flows. If one believes that the fiscal stimulation objective is paramount, then he could argue that equalization issues ought to be left to the national tax system and to the distribution of Central Government expenditures. One policy instrument--in this case, grants--is not going to be effectively used to address all problems.

Stimulation of Tax Effort

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

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

Again, local jurisdictions might respond to the grant stimulus in different ways, and the estimates we have made are of the average behavior. We can speculate, however, about how different types of communities might respond. Where income is higher and the local budget is larger, the stimulative effect may be greater. Such communities have many potential advantages in leveraging grant funds: they can more easily raise additional taxes for maintenance and supplementary expenditures; they have a greater capacity to borrow; and they have better technical and financial management ability to absorb increased grants.

Economic Development Expenditures

Does the grant system stimulate economic development expenditures by local governments? Have the substantial earmarking provisions worked--20 percent of the General Allotment, all of the Specific Allotment and all of the ad hoc grants are earmarked for capital expenditures of one kind or another--or have they been finessed by local governments? In analyzing the effects of the grant system, we might also ask whether these provisions have been offsetting, i.e., would not an increased flow of funds for barangay projects tend to slow economic development expenditures from the General Allotment? It is possible that by earmarking 75 percent of all grants for capital projects, the system has been overloaded, i.e., the local government sector simply cannot absorb that kind of increase in resources available for capital projects. The buildup of local government cash balances may be some evidence of this effect, though our sample is quite limited for drawing general conclusions.

These results do suggest, however, that the Specific Tax Allotment does lead to more economic development expenditures than otherwise may have occurred. This happens in two ways. First, the Specific Tax Allotment paid to the Infrastructure Fund is spent. Second, a higher level of grants to the Infrastructure Fund dampens the transfer from the General Fund to the Infrastructure Fund and results in more economic development expenditures in the General Fund. Our results suggest that a single grant program of the same amount--such as the BIR--would not have accomplished as much stimulation of economic development expenditures.

Since very little of the barangay aid or the National Tax Allotment have been distributed, we can say little about actual effects on economic development expenditures. Potential effects will depend largely on whether steps are taken to insure that these funds are not used as substitutes for other sources of funding.

Financial Management

The Philippine grant system does not provide incentives for effective financial management. A grant system which does not require a local contribution is not as likely to induce local governments to be as accountable for how they spend the funds as is a system which requires some payment on the part of local governments. Philippine grants are general purpose and in that respect provide no incentive for local governments to behave in a more efficient manner.

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

Central Government Flexibility

A final criteria in evaluating the grant system is the flexibility which the National Government has in adjusting the system to meet the exigencies of national economic and social objectives. Particularly important here is the question of how easily can the National Government shift the regional distribution of funds, or slow the total flow to the local sector to accommodate more pressing national needs. The law would suggest that the government has a great deal of control over the former via the *ad hoc* distributions of the National Tax Allotment and the barangay shares, but relatively little control over the latter because of the shared tax bases of determining the grant funds.

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

Recommendations for Change

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

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

we would recommend that grant reform focus on strengthening the financial performance capabilities of local governments rather than on redistributing income.

We recommend a rather major reform of the Allotment system, along the lines of the following:

a. a combining of the various Allotment programs into a unified system;

b. the provision of incentives and financial resources to stimulate development spending;

c. the provision of incentives to stimulate the mobilization of additional local revenues, and,

d. a rethinking of the proper role of the barangay in financing and delivering local government services.

We emphasize that we have only begun to work out the details of these reforms. There must be a follow-up analysis. Still, even from this cursory analysis, we would argue that these reforms are feasible.

Consolidating Grant Programs

The present system, which includes the General BIR Allotment, the National Tax Allotment and the Specific Tax Allotment, is unduly fragmented. The National Tax Allotment, a discretionary fund which has not been fully used, should be abolished as a separate program. It may have served a purpose in earlier times, but would no longer appear to have a good reason for existence.

There is no longer a need to tie the Specific Tax Allotment to petroleum taxes. Indeed, 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 no longer possible to justify petroleum taxes as a charge to beneficiaries. More-

over, because petroleum taxes are specific rather than ad valorem, the grant has a low income elasticity and is not responsive to inflation. The growth in petroleum tax revenues, and hence in the Specific Tax Allotment, has come about in recent years 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 more guided by energy policy than by local government financial needs. It makes very 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.

This brings us to a recommendation that a consolidated Allotment system be created in place of the BIR, Specific Tax, and National Tax Allotment programs. At 1979 Statutory levels for each program, this would imply a grant amount equivalent to about 30 percent of BIR collections (lagged three years).[1] Whatever share of BIR revenues is chosen, however, should be held to rigidly. The partial distributions of recent years have defeated many of the objectives of the grant system. The consolidated system, in keeping with the present distribution of Allotments could earmark two-thirds of the total for the Infrastructure Fund. This would protect the more stimulative features of the Specific Tax Allotment and the objective of promoting capital expenditures.

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

We suspect that a full distribution of these grant funds may be substantially more than local governments can absorb, at least in the very short-run. A full distribution in 1979 would have been about twice the actual distribution, and since two-thirds of the total is earmarked for capital projects, one possibility is that local government cash balances would increase. Though more research is necessary on the absorptive 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. We would make two recommendations in this regard. The first is to hold back a share of the grant to capitalize and subsidize a local government credit authority. This proposal is discussed in some detail in Part Three below. A second recommendation is to permit the use of these funds to cover local costs of tax mapping, and as suggested above, to cover a portion of the cost of an additional property tax clerk.

Cost will be a major impediment to this program. A full distribution at 1979 levels would have amounted to an additional ₱1 billion of Central Government expenditures. On the one hand this is a great deal of money, about 3 percent of Central Government expenditures. On the other hand, it represents funds already "assigned" to the local sector. At some point in time it was thought to be a priority use of central funds. Now that some other national emergencies have passed, it may be possible to return to this priority. Even if the ₱1 billion were seen as a net increase in expenditures, it would not have been added to an already onerous tax burden. By comparison with other developing countries, tax effort in the Philippines would appear quite low (see Appendix V-A).

In the last analysis the issue is whether the benefits of the ₱1 billion invested will yield an adequate return in terms of increased revenue generation by local governments and an increased capacity of local governments to finance and deliver public services. The real question, then, is what can ₱1 billion buy in terms of a stronger local government sector?

Mobilizing Additional Local Revenues

As it presently stands, the formula distribution system does not provide a major inducement for increased revenue mobilization. To address this shortcoming, we recommend two changes in the system. First, some measure of tax effort should be introduced into the distribution formula. This could provide a substantial reward for increasing tax collections, and it might also increase the accountability of local governments, because grants would no longer be costless. The problems, of course, are how to measure tax effort, and how much weight to give it in the formula. We recognize that any measure used will be far from flawless, but, it is hard to imagine that it will not move the present system closer to its objective of providing incentives to increase local revenue mobilization. Our experiment reported above (pp. V-26-31) suggests that it has the potential to make matters significantly better.

We further recommend that the Allotment distribution be amended to provide other incentives for improving the capacity of local governments to assess and collect property taxes. As noted above, 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 partially cover the cost of an additional property tax clerk--for a specified short time period--to deal with a backlog of record-keeping problems.

Stimulating Economic Development Expenditures

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

A second, and potentially much more powerful technique is to encourage the use of credit financing by eligible local governments. We develop a recommendation for a local government credit authority in Part Three below.

Barangay Programs

The time is probably right to reassess the role of barangays in the local finance system. Some of the increased barangay involvement is beneficial and clearly should be retained, e.g., the 10 percent property tax share for barangays serves any number of useful purposes. The merit of some other programs, and their cost, would seem to call for a re-evaluation. While it is clear that more input at the barangay level can improve the decision-making process markedly, it is equally clear that the barangay unit is capable of very little technical or financial planning or management.

We have not studied the barangay unit in any detail. However, the earmarking of 12.4 percent of the total BIR and Specific Allotment seems a great deal for a unit of government whose ability to absorb funds is so limited. While we are not prepared to recommend that the barangay shares be dropped, the effectiveness of this use of scarce resources and its overall impacts should be a high priority item in deliberations on inter-governmental reforms.

APPENDIX V-A

TAX EFFORT IN THE PHILIPPINES

Do local governments have a capacity to increase their revenue effort? Certainly administrative and structural changes can bring substantial increases in property taxes, business taxes and market charges. There is no question but that increased revenue mobilization by local governments is feasible. We might also ask whether local revenues might be increased by Central Government increases in tax effort. After all, the Allotments are a major revenue source to local governments and are tied to Central Government tax effort in their overall growth. If Central Government tax effort is "high", one might argue that growth in the Allotments will be pretty much tied to growth in the national economy. In that case, local governments will be much more on their own in terms of the financing of public expenditure growth. If Central Government tax effort is low, the implication is that tax policies at the Central Government level are constraining the growth in local government finances.

The basis for international comparisons of taxable capacity and tax effort is a series of studies carried out by the Fiscal Affairs Department of the International Monetary Fund.[1] Using data extracted from original

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[1] (see p. II-542 draft for cite except Hinrichs).

sources,[1] these studies have followed a relatively uniform approach. Cross section regressions are estimated on the actual tax ratio (T_y) against a set of variables meant to reflect differences in taxable capacity (e_i),

$$T_y = f(e_i) \tag{1}$$

The *estimated value* ($\hat{T}_y$) from (1) is taken to be "normal" taxable capacity and

$$E = \hat{T}_y / T_y \tag{2}$$

is the indicator of tax effort. Whether the terminology has been adjusted or not, rankings of countries by the value of E are used to infer the intensity with which taxable capacity is actually used.

These studies have been roundly criticized for conceptual and econometric errors and for trying to infer more from the results than the data or method really allow.[2] Still, there is need for such comparisons--as evidenced by the question being asked here--and these studies would seem a superior approach to straightforward tax ratio comparisons.

One could easily pull from these studies the hypothesis that taxable capacity increases during the development process. International tax comparisons have shown that the actual tax share of GNP increases with the stage of development--measured alternately as per capita GNP, the percentage of GNP generated outside the agricultural sector, and the percentage of

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[1] It is access to these relatively clear data that explains the IMF monopoly on these studies. Yet the Fund fiscal economists are the first to warn that serious comparability problems remain.

[2] A fair and well done critique is Richard Bird's, "Assessing Tax Performance in Developing Countries: A Critical Review of the Literature," Finanzarchiv 34, No. 2 (1976): 256.

GNP generated in manufacturing.[1] Other factors which have been found to be associated with higher tax ratios (the share of taxes in GNP) are the size of the foreign trade sector,[2] the importance of mining output,[3] and the level of non-mineral export earnings relative to GNP.[4]

Whether tax effort normally increases during the development process is unclear. Bahl's correlation analysis of 1966-1968 data suggests no consistent pattern.[5] Tait et al.[6] show that countries with a high tax ratio tend to have a high tax effort, but neither Tait et al., nor Chelliah et al.[7] were able to confirm a significant relationship between the actual tax ratio and per capita GNP.

Based on these "normal" patterns, one might expect the Philippines actual tax ratio and its taxable capacity to have risen in the past two decades. Growing per capita GNP, exports, and industrialization have

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[1] See, for example, Lotz and Morss, "Measuring Tax Effort in Developing Countries"; Bahl, "A Regression Approach to Tax Effort and Tax Ratio Analytis"; and Harley Henrichs, A General Theory of Tax Structure Change During Economic Development (Cambridge, Mass.: Harvard Law School, 1966).

[2] Tait, et al., "International Comparisons of Taxation for Selected Developing Countries, 1972-1976."

[3] Bahl, "A Representative Tax System Approach to Measuring Tax Effort in Developing Countries."

[4] Chelliah, et al., "Tax Ratios and Tax Effort in Developing Countries, 1969-1971."

[5] Bahl, "A Representative Tax System Approach to Measuring Tax Effort in Developing Countries."

[6] Tait, et al., "International Comparisons of Taxation for Selected Developing Countries, 1972-1976."

[7] Chelliah, et al., "Tax Ratios and Tax Effort in Developing Countries, 1969-1971."

increased the share of the tax bases relative to GNP and made administration and collection problems more manageable. The Philippines tax ratio did rise somewhat during this period, from 7.0 in 1953-55 to 10.1 in 1972-1976. The question remains: "did it rise by as much as one would have expected given the rapid pace of economic development?".

The results of a number of tax effort studies are compared in Table V-A-1. The most recent, which used an average tax ratio between 1972 and 1976 as the dependent variable, is described in row (1). For this period, the Philippines had an actual tax ratio of 10.1 percent which ranked it well below the sample average of 16.1 percent. According to the regression estimate from equation A, the Philippines capacity to tax was a more substantial 14.1 percent of GNP--well above its actual performance. This "shortfall" in taxes, equivalent to 4 percent of GNP, results in a tax effort index of 0.718[1] which is "low"[2] and ranks the Philippines 40 among the 47 countries in this sample.

One might reject this finding on grounds that the equation is not properly specified and as a result it overstates taxable capacity in the Philippines. The argument would not be persuasive. Tait et al., compared tax effort rankings for all specifications shown in Table V-A-1. and found the Philippines to rank below average in every case.[3] The conclusion seems inescapable. At least in the 1972-1976 period, the Philippines exerted a re[illegible]ly low tax effort.

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[1] Compared to an "a[illegible] of unity.

[2] According to the classification offered by Tait et al. in "International Comparisons of Taxation for Selected Developing Countries, 1972-1976."

[3] Ibid., p. 146. A similar analysis and conclusion may be found in Bahl, "A Representative Tax System Approach to Measuring Tax Effort in Developing Countries," pp. 112-113.

TABLE V-A-1

TAXATION "NORMS" IN DEVELOPING COUNTRIES

Measure	Philippines Actual Value	Philippines Estimated Value	Sample Average	Number of Countries in Sample	Philippines Ranking	Equation Source
Ratio of Taxes to GNP						
1) 1972-1976	10.1	14.1	16.1	47	40[b]	A
2) 1969-1971	9.1	13.3	15.1	47	40[b]	B
3) 1966-1968	9.1	11.8	13.6	47	40[b]	D
4) 1966-1968	9.8	13.0	13.6	49	31[b]	C
5) 1962-1964[c]	9.3	11.0		52	44[b]	E
6) 1966-1968[a]	9.8	---	13.8	27	17[b]	D
7) 1953-1955	7.0	---	11.3	27	26[n]	D
Tax Effort						
8) 1972-1976	0.718			47	40	A
9) 1969-1971	0.683			47	41	B,D
10) 1966-1968	0.771			47	37	B
11) 1966-1968	0.756			49	39	C
12) 1962-1964[c]	0.783			52	44	E

Sources and Estimating Equations:

(A) $$T_y = \underset{(6.15)}{9.9949} - \underset{(-0.34)}{0.0008}(y_p - x_p) + \underset{(5.41)}{0.4068}N_y + \underset{(3.12)}{0.1938}X'_y \qquad R^2 = 0.413$$

where

T_y = ratio of taxes to GNP

y_p = per capita GNP

X_p = per capita export income

N_y = share of mining in GNP

X'_y = share of non-mineral exports in GNP

SOURCE: Alan Tait, Wilfred Grantz and Barry Eichengrun, "International Comparisons of Taxation for Selected Developing Countries, 1972-1976," IMF Staff Papers 26, No. 1 (March 1979): 123-156.

TABLE V-A-1 (CONT.)

Sources and Estimating Equations (cont.):

(B) $$T_y = \underset{(7.84)}{11.47} + \underset{(0.38)}{0.001}(Y_p - X_p) + \underset{(5.45)}{0.44}N_y + \underset{(1.17)}{0.05}X'_y \qquad R^2 = 0.376$$

SOURCE: Raja Chelliah, Hessel Baas, and Margaret Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969-1971," IMF Staff Papers 22, No. 1 (March 1975): 187-205.

(C) $$T_y = \underset{(9.682)}{14.95} - \underset{(2.074)}{0.0742}A_y + \underset{(2.678)}{0.2951}N_y \qquad R^2 = 0.411$$

where

A_y = share of agriculture in GDP

SOURCE: Roy Bahl, "A Regression Approach to Tax Effort and Tax Ratio Analysis," IMF Staff Papers 18, No. 3 (November 1971): 570-612.

(D) $$T_y = \underset{(7.30)}{13.98} + \underset{(0.86)}{0.0332}X_y - \underset{(1.636)}{0.0627}A_y + \underset{(3.065)}{0.2666}N_y \qquad R^2 = 0.408$$

SOURCE: Raja Chelliah, "Trends in Taxation in Developing Countries," IMF Staff Papers 18, No. 2 (July 1971): 254-331.

(E) $$T = 10.21 + 0.0085Y_p + 0.0712F/Y$$

where

F/Y = openness, i.e., import plus export income share in GNP

SOURCE: Jørgen Lotz and Elliott Morss, "Measuring Tax Effort in Developing Countries," IMF Staff Papers 14, No. 3 (November 1967): 478-499.

[a]Average of 1965 and 1968 shares.

[b]Rankings of the actual tax ratio.

[c]Years refer to 1964-65.

In fact, the Philippines history as a low taxing country is a long one. A 1953-1955 comparison shows the tax ratio to be only half as large as the average for a sample of 27 countries (row 7). Since that time, the Philippines actual tax ratio rose (column 1), but its taxable capacity rose faster--from 11.9 percent of GNP in 1962-1964 to 14.1 percent in 1972-1976. Relative tax effort actually fell during the 1962-1976 period.

What one may pull from these results is that by comparison with other countries, the Philippines has never taxed itself very heavily.

Part Two

Public Enterprises as an Instrument of Local Government Finance in the Philippines

CHAPTER VI

LOCAL GOVERNMENT PUBLIC ENTERPRISES: WORKABILITY AND CRITERIA FOR USE

A more widespread and intensive use of local government public enterprises--businesses operated by local governments--would be consistent with the decentralization objectives of the Central Government. These enterprises may serve an important social purpose (e.g., public markets) or they may be more strictly commercial ventures. By charging a price for the good or service sold, the LGPE may increase the mobilization of resources from local income while not drawing on the local property or business tax base. If the LGPE is able to recover full costs, it will have expanded services provided in the local area (as in the case of a market or slaughterhouse) without burdening the fiscal position of the local government, and it may be an effective lever for making use of credit financing for capital construction projects. Finally, locally operated and managed undertakings can increase local autonomy by placing more decision-making authority at the local level than would be the case if the enterprise were financed and managed by the Central Government.

With these virtues and the provisions for the use of LPGEs in Philippine law, one may wonder why there has not been more use of this form of financing and delivering services, and why the existing use of LPGEs has not been more successful than it has. In fact, there are a number of reasons:

- the limited extent to which LPGEs can be financially viable, i.e., fully self-supporting
- the failure of the Central Government to provide adequate incentives to induce local governments to make more use of the enterprise form

- management and administrative shortcomings at the local government level
- the failure of Central Government legislation to make adequate provision for the capital financing necessary to construct facilities necessary to the undertaking
- the ambiguity at the Central and local government level about whether the primary objective of a local government enterprise is to provide a service at subsidized rates or to sell a service and recover full costs.

This state of affairs leaves us with a number of questions. If the abovementioned barriers should be removed, how is this to be done and what kinds of incentives should be provided? Is there a potential for more use of LGPEs, and if so, for what activities? How does one go about establishing feasibility, i.e., when is a service better provided through a LGPE than through general local government or even through the private sector? This part of the report addresses these questions.

The focus in this Chapter is on deriving a framework within which to realistically consider the potential for using LGPEs in the Philippines. In the next section we offer a general statement about the conditions necessary for effective use of LGPEs. Attention is then turned to the practice in the Philippines: first to a statement of the types of enterprise activities that can be legally undertaken by local governments in the Philippines and the regulatory setting in which they must operate; and then to a consideration of some factors important to the feasibility of issuing LGPEs in the Philippines. Along the way, we present what meager evidence we are able to marshall on the actual use of LGPEs in the Philippines. With this conceptual framework and background on the setting for using LGPEs

in the Philippines, we turn to analysis of the self-financing and revenue raising potential of LGPEs. This analysis is contained in two chapters. Chapter VII is a cross-section study of the financing and operation of city and municipal public markets. Chapter VIII is focused on a case study of the Provincial Government of Bulacan and on the number of innovative enterprise activities which it has initiated. It is in this limited analytic context that we try to draw out the problems and barriers to more use of LGPEs.

The Appropriate Use of Local Government Public Enterprises

The undertaking by governments of what might be termed enterprises has a long history in the developing countries. These operations have been of two general types. The most common variety relates to goods and services whose provision is characterized by high fixed costs, and the second relates to the provision of a good or service which simply cannot or should not be trusted to the private sector. Public utilities is the example that most quickly comes to mind in the first case. The second category includes production activities whose provision is often trusted to the private sector in developed countries, but whose capital requirements, importance to development or stabilization, or whose social importance dictates the need for a government monopoly in developing countries. This category may also include more purely entrepreneurial activities. Steel, airlines, mining, grain marketing and liquor are rather common examples.

Particularly the first type of activity has been a focus of local government public enterprises in LDCs. Where the benefit zone for a service covers only an area approximately coterminous with the boundaries of the local jurisdiction--e.g., intracity bus service, markets and slaughterhouses, water and sewer--it is not uncommon for a local government enterprise to be set up.[1] Much has been learned about the effectiveness of public undertakings in the context of large national enterprises,[2] but relatively little is known about how well local government public enterprises have worked out in developing countries. This absence of an evaluation forces us to turn to a more normative set of considerations, especially, "how does one identify a candidate service for enterprise financing?" and "under what conditions should it be a local government rather than a Central Government or private sector responsibility?"

The answer to the second of these questions is easier--if the greatest portion of the benefits of a service accrue to the population within the boundaries of a local jurisdiction , then a local government public enterprise is a possibility. To some extent, the market will correct inappropriate LGPE activities. If local governments try to finance a service which has a

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[1] These may be set up as autonomous local authorities, as semi-autonomous local authorities where transfers to and from the local government General Fund are allowed, and as separate self-financing components of the local government budget.

[2] Some good work in this area is Leroy P. Jones, Public Enterprise and Economic Development: The Korean Case (Seoul, Korean Development Institute, 1975). For a review of more recent studies, see Malcolm Gillis, "Role of State Enterprises in Economic Development," Social Research (January 1981).

benefit area that extends beyond the boundaries of the local jurisdiction, equilibrating forces will be set in motion. Consider the case where the service area is regionwide and a single jurisdiction is operating an enterprise at a profit. The profit will induce other local governments to compete and the size of the service area will be reduced. If the service area is regionwide and a single jurisdiction is operating an enterprise at a loss, continuing subsidies from the local or Central Government must be provided, or prices charged for the enterprise service must be increased. If the subsidies do not continue indefinitely, increased prices will probably reduce the service area.[1] Under these conditions, a regionwide venture involving all local jurisdictions within the service area would be more efficient.

The answer to the first question--which services are most appropriate for the enterprise form--is far more difficult to give. The issue is even further complicated since the role of local government public enterprises will vary from country to country depending on local custom and law. Some general guidelines might be offered about the proper use of public enterprises but, again, there are different points of view.

Actual practice is not much help here. Indeed, it is not all that easy to differentiate an enterprise activity from a number of other local government activities which generate revenues by charging a price for the service which they render. A special assessment on property to recover the

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[1] Of course, these equilibrating effects are much more complicated than suggested here; for example, they may also depend heavily on transportation costs.

cost of road or sewer construction and health certification fees are examples where confusion could begin to arise. Our intent is to suggest a program to encourage the practice of using local government public enterprises, not to nitpick about the proper classification of governmental activities, yet some amount of nitpicking is necessary. Neither the practice around the world nor the Philippine law makes it exactly clear which services or financial arrangements are enterprises and which are not. From the following discussion and from an interpretation of the intent of Philippine law and national policy, we offer some guidelines for identifying proper candidates for local government public enterprise financing.

Criteria For Using The Enterprise Form

One question we would like to begin to answer in this study is which public sector activities are the best candidates for provision through local government public enterprises. In truth, there are no clear cut answers to this question, but we may offer some criteria for selection: management and accounting, marketability and pricing, and cost recovery.

Separate Management and Accounts

The operation of a local government enterprise requires the possibility of separate management. If the undertaking can be set off from the other public financing activities of the local government, its pricing policies, production management, personnel management, etc., should also be separable. Such undertakings frequently require specialized, relatively expensive

employees and services, hence another reason for separation from the general public administration. Without some degree of administrative independence, it will not be possible to hold management of the enterprise accountable for the efficiency of its operations and for its financial performance.[1]

The management of the enterprise can be effectively monitored only if there are separate accounts. The separate accounts prerequisite for a LGPE activity might be thought of in terms of the accounting view of the purpose of enterprise accounts in a system of government accounts. In the tradition of generally accepted accounting principles, enterprise funds in the public sector are used to:

> account for operations (a) that are financed and operated in a manner similar to private business enterprises--when the intent of the governing body is that the cost (expenses, including depreciation) of providing goods and services to the general public on an accounting basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.[2]

In this regard the accounting criteria are quite broad and thus provide little guidance as to the type and nature of activities which constitute the public enterprise sector.

Still, the accounting view certainly contributes one necessary condition for the use of a public enterprise. There must be a possibility for a separate income statement and balance sheet for the activity. This view is echoed by legal sanctions in the Philippines in that special accounts within the general fund accounts for local governments are to be maintained for public utilities and other economic enterprises (PD 477, Section 13(A)).

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[1] Of course, separate management does not preclude local government involvement in the Board of Directors, etc.

[2] Municipal Officers Association of the U.S. and Canada, Governmental Accounting, Auditing, and Financial Reporting (Chicago, IL: November 1980), p. 59.

In theory, all local government activities other than general administration could fit this criterion, but for some it would be much less efficient to separate their operations than others. For example, a water supply system and a hospital might lend themselves to separate management and operation but what about the courts or public parks? The latter are highly complementary with other local government activities (e.g., police and fire, public works and maintenance) to make it efficient to separate their operations. Moreover, for some functions, input costs are so entangled with other local government purchases, that separate accounts are impossible. For example, imagine allocating the cost of vehicle maintenance and operation to each department, or prorating the cost of water between parks and streets, or separating out the cost of power used for streetlights. In practice, this criterion will exclude a number of public functions from the feasibility list for LGPEs.

Economic Criteria

The literature in economics would add two further requisites for using the public enterprise form:[1]

1. the activity or operation should be involved in the production, distribution, or provision of goods or services which are marketable

2. The revenues generated by the activity, and the price charged for its use or the consumption of its products, should bear some relation to the costs of operation.

The first criterion implies that the public enterprise form is not appropriate for government activities which do not provide an output as well as those which provide a nonmarketable output--e.g., for public services which cannot feasibly be sold for a price. This would exclude general

[1] See Jones, Ibid., and Gillis, Ibid.

government activities such as tax collection and budgeting as well as services that are not easily divisible into units of consumption, e.g., the provision of fire protection and flood control or the use of a public plaza.

The second criterion requires that it be possible and feasible to price the output and to measure costs of production, and that there is some relation between cost levels and price determination. The marginal cost pricing of water or transportation services would fit this criterion, but the collection of a gasoline tax earmarked for road maintenance would not.

One need only reflect for a moment on these criteria to see that there is a wide variety of activities and undertakings which potentially could qualify as public enterprises. The economic criteria eliminate only those activities which involve the provision of purely social goods and those which are of the nature of administration and administrative support to the government. What remains is that array of undertakings which have the potential for cost recovery, which can be staffed, managed and controlled in a way similar to a private business, and which can impose a cost related price or user charge. In effect, the second criterion eliminates from the public enterprise category only those government activities which are neither revenue generating nor income earning. Thus along with those activities which manage cost recovery, it also admits those which fail to achieve this objective and which may require heavy subsidization.

Cost Recovery

An important reason for using the public enterprise form is to take advantage of the marketability of the good or service, and of the fact that its production costs can be measured. Not to set the price at a level high enough to recover costs would be to throw away these advantages.

Yet we would not agree that a mandatory degree of cost recovery should be required in every case as a condition for using the public enterprise form.[1] Such a requirement would not recognize the range of objectives governments may have in their programs of service delivery. For example, operating one enterprise at a profit, say electricity distribution, to subsidize another (say bus transportation) is not an unheard of practice. Moreover, full cost recovery would not admit the possibility that LGPEs should be subsidized by higher level governments in some cases, because benefits may spill over beyond local boundaries or because of income distribution reasons.

Beyond these rather special cases, local governments should follow pricing policies that will lead to cost recovery. To say that some social objectives are so important that prices should be set below cost recovery levels, is pretty much to admit that the service is more properly financed in the general government sector.

If cost recovery is to be an objective, then some pricing rules must be followed. The basic rule of efficient pricing is that price should be set equal to the current economic cost of the last unit produced, i.e., price should be set equal to marginal cost. With this policy, resources

[1] This is the approach adopted by Jones, Ibid.

will be allocated among productive activities in a manner consistent with the preferences of and benefits received by all consumers. Moreover, in the normal case where unit costs are increasing, a marginal cost price will not only cover all costs but will generate a profit or surplus.

There are two problems with this pricing rule in the case of local government public enterprises. The first is the sheer difficulty in identifying marginal cost, especially in cases where the LGPE is selling a service such as access to a public market. The second problem arises because LGPEs are likely to be capital intensive and face decreasing unit costs of production.[1] In this case, an efficient (marginal cost) price will not lead to cost recovery, and will require a general subsidy.

Regardless of the pricing rule followed, there will be impediments to cost recovery. Some are related to income distribution considerations, e.g., using market fees to maintain low prices for foodstuffs, and in these cases the extent of cost recovery will be determined by government priorities. In other cases, e.g., an inadequate population and income base to support a public market, full cost recovery may not be realized under any pricing rules. In cases such as these, the cost recovery requirements should be developed by the government with a view to determining what cutoff point would make the public enterprise form unacceptable.

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[1] For a discussion of appropriate pricing policies for decreasing cost industries, see, for example, R. Saunders, et al., "Alternative Concepts of Marginal Cost for Public Utility Pricing: Problems of Application in the Water Supply Sector," World Bank Staff Working Paper No. 259 (May 1977), and for electric power, see M. Munasinghe and J. Warford, "Shadow Pricing and Power Tariff Policy," World Bank Staff Working Paper No. 286 (June 1978).

Conclusions: Necessary Characteristics

The above suggests some guidelines for identifying candidates for public enterprise financing. These necessary conditions would seem to include

- the good or service must be marketable
- costs must be taken in account in setting a price for the service
- there must be a "reasonable" degree of cost recovery
- separate management and accounts must be maintained.

Before attempting to identify local government services which more or less meet these criteria,[1] we turn to a consideration of the legal and institutional setting for organizing and operating LGPEs in the Philippines.

Legal Authorization for Enterprise Activities

The basic responsibilities and activities of local governments in the Philippines are set out in the Local Tax Code, PD 231, and in subsequent amendments to it. One stated purpose of the Code is to provide local governments with adequate means to finance the services they provide and to facilitate the progress of the nation's economic development. The types of enterprise activities which local governments may undertake are implied in Article 5, which states that local government may levy fees, tolls, tuitions and charges for public markets and slaughterhouses, public utilities, cemeteries, schools, roads, bridges, canals, and ferries and fisheries.

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[1] The same set of criteria apply to commercial ventures, except that full cost recovery will normally be required.

The Tax Code also empowers local governments to impose fees on a base or subject similar to those authorized in the Code but which may not have been specifically enumerated. Moreover, the Code does not specifically state that there are general or specific types of activities which cannot or should not be undertaken by local governments. What this means is that local governments seem to have broad authorization--explicit or de facto--to use taxes, fees, and charges.[1] This authorization does not guarantee the workability of the enterprise form, but it is a necessary condition.

The Central Government would appear to be trying to stimulate the use of LGPEs. PD 144 established the Local Government Development Fund for the purpose of supplying loan funds for investment-type activities which contribute to national economic development. Local government capital investments were further encouraged by PD 752 which listed a range of utility and communication activities as well as irrigation, agriculture, industrial, home building and other undertakings for which loan funds could be made available. PD 752, like its predecessors, does not identify any specific types of projects or activities which may not be undertaken. The only apparent limitation on the range of activities and enterprises which local governments may undertake is that they be in keeping with the overall development of sustained socio-economic growth. In those cases which are supported by Central Government credit institutions, an additional qualification is that such projects be income generating. Herein lies the binding constraint.

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[1] It should be noted the imposition of any tax, fee, or charge by a local government requires a legislative act, an ordinance passed by the governing Local Board or Council (Section 39).

There is not good evidence available on the extent to which local governments have taken advantage of this authority to use the public enterprise form. There are presently no centrally collected data which describe enterprise activities by each local jurisdiction;[1] however, our impression is that the use has not been very widespread. Most of the activity would seem to be in areas of maintaining, renewing, renovating or extending traditional activities, primarily markets. Local government experience with less traditional activities and with business type ventures appears to be quite rare.[2]

These impressions are reinforced by data we have collected on the use which local governments have made of borrowing to support enterprise activities. Insofar as credit financing is concerned, the range of projects supported by the Central Government has been quite narrow. Between 1975 and 1980 the majority of Central Government loans and loan funds were committed to agricultural development type projects, farm and heavy equipment purchases, and markets.[3]

Local governments have shied away from more innovative activities because of a conservative bent of local government officials, problems of cost recovery, and inadequate capital funds. The range of enterprise activities in which local governments participate is also narrower than it otherwise might be because the Central Government has preempted a major category of enterprise activity. In fact, special Central Government

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[1]The MOF is presently undertaking such a survey.

[2]The enterprise activities of the Province of Bulacan constitute an exception to this generalization. These are considered in some detail in Chapter VIII below.

[3]See Chapter IX.

agencies, i.e., LWUA and NEA, have taken the major responsibility for what in many countries are principally local government enterprise activities, i.e., waterworks and electricity.

Possibilities for Joint Ventures

An analysis of the barriers to increased use of LGPEs will ultimately lead us to the major problem facing smaller jurisdictions--an inadequate market for the service. For example, Legaspi City can support a viable public market because of its concentration of population and income, but Malinao cannot. This problem leads to considering the economic, social and legal feasibility of joint ventures among local governments.

There is no hard evidence, nor even impression, that joint ventures have been undertaken on any significant scale in the Philippines. The absence of takers would not seem to be due to legal impediments. Legally, the joint venture is possible. Revised Administrative Code (RAC), Section 804 stipulates that local governments may consolidate or coordinate their efforts, services, and resources for purposes which are commonly beneficial. While the full range of activities which are permissible under RAC, Section 804 has not been defined, the Code seems to allow for variety in the types of ventures possible and in the type of financing arrangements permitted. For example, the coordination of resources clause would seem to open the possibility of loans between local governments. Intergovernmental loans, of course, are not uncommon among local governments. They generally have taken the form of provincial loans to municipalities and cities, and have been occasioned by "natural disasters," e.g.,

storm damage, fire destruction. However, loans between cities, between municipalities, or between provinces do not appear to have such a history.

Local governments are also empowered to enter into cooperative ventures with the private sector (RAC 782). There has been some experience with such ventures, e.g., Metro Manila has experimented with contract management of public markets. However, this endeavor proved unsuccessful.[1] The enterprise activities of the Province of Bulacan, on the other hand, have involved successful cooperative arrangements with the private sector (see Chapter VIII).

Legal Restrictions on Enterprise Profitability

While income generation does appear to be a goal for local government public enterprises, it is not clear that the government has yet decided to permit local governments to substitute enterprise profits for general taxes. The possibility of enterprise surpluses has been recognized and there exists a general directive concerning the disposition of any surplus which may result from local government undertakings, i.e., they "shall be spent solely for the improvement of the public utility or the economic enterprise concerned" (PD 477, Section 13) or should revert to the General Fund. While it appears that the intent is to allow public enterprises to make profits, it would also appear that there is an intent to limit the use of such profits to the enterprise which generates them. However, there are exceptions.

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[1] Regrettfully, we have no firm information on the performance of this contract management experience. However, the failure of this undertaking is generally attributed to the regulations governing market rental rates and fees and the consequent inability to increase revenues by raising fees and charges.

The revenues resulting from tolls for the use of bridges, roads, canals, and ferries are to be used for the payment of interest, sinking fund charges where applicable, and for the maintenance and repair of the facility. However, when toll revenues exceed the amounts required for such purposes, the local board or council may borrow up to 90 percent of the excess revenues (PD 231, Section 34). The loans are interest free, subject to the approval by the Secretary of Public Works and Communications, and must be for public works purposes. The fact that there are provisions allowing for the use of surplus toll revenues for other types of projects would seem to set a precedent for profitability as a goal of such undertakings.

The same is true for public utilities. Profits which public utilities may legally earn are limited to 10 percent of invested capital (PD 231, Section 32). However, in the event that profits amount to more than 10 percent of invested capital, the utility tariffs are to be adjusted so as to preclude the recurrence of excess profits and the existing excess profits must be spent only for the improvement of the utility.[1]

It is important to note that although not articulated in the Tax Code, there is widespread agreement that public markets are classified as public utilities.[2] It would seem that slaughterhouses should be similarly classified, for two reasons: first because they so frequently are a component

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[1] Provincial Circular 23-73, III-2.

[2] Conversations with officials who participated in the writing of the Local Tax Code verify that the intent was to include public markets within the utility category. That the intent is the practice can be verified by frequent classification of public markets as providers of utility services. See, for example, National Tax Research Center, "Study on User Charges in Metropolitan Manila," Metro Manila Public Finance Studies, Manila, 1977. (Mimeographed).

of the public market operation, and second, because the local government accounting conventions usually do not separate their costs of operation from those of market operations.

The implication of the foregoing is that local government in the Philippines may undertake a variety of enterprise activities. However, while any or all may generate a surplus, the general legal intent appears to call for restricted use of any such surplus. There are exceptions, i.e., profits available for general use are limited to 10 percent on net investment in case of utility services, and the use of profits from tolls for public works. But still, there is no clear specification of what constitutes a utility service. There is an important need for the government to clarify this law and its intent.

Identifying Local Government Public Enterprise Possibilities in the Philippines

The criteria which have been invoked identify a LGPE activity as one which involves the provision of good or service, which for the purpose of cost recovery can be marketed at a price or user charge that is related to the cost occasioned by its production. Having established that potential ranges of enterprise activities which may be undertaken is quite large we turn to the central issue of this Chapter--which activities might be provided through local government enterprises. While there is no "official" statement of these activities, a rather comprehensive list has been derived from the COA's account categories (Table VI-1). As is discussed below, many of these goods and services simply do not satisfy the necessary conditions

TABLE VI-1

POTENTIAL LOCAL GOVERNMENT PUBLIC ENTERPRISE ACTIVITIES IN THE PHILIPPINES

1. Inspections
2. Certifications
3. Issuance of Permits
4. Registrations
5. Licensing
6. Holding Benefits
7. Police and Fire Protection
8. Courts
9. Arrastre and Customs Activities
10. Hospitals
11. Schools
12. Postal and Communication (Telephone)
13. Waterworks
14. Electric Power Systems
15. Telephone Systems
16. Septic Systems
17. Public Markets
18. Slaughterhouses
19. Toll Roads, Bridges and Ferries
20. Cemeteries
21. Farm and Cattle Ranches
22. Rock Quarries
23. Immunization Stations
24. Docks and Wharves
25. Zoos and Other Cultural Institutions
26. Ice Plants
27. Wells
28. Parks, Plazas, and Monuments
29. Airport Landing Fields and Terminals
30. Lighthouses and Beacons
31. Irrigation
32. Canals
33. Other Private Sector Type Activities, e.g., Stores, Restaurants, Manufacturing, and Processing Establishments.[a]

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[a]Examples are illustrative of the range of private sector type activities which could be undertaken as LGPEs.

SOURCE: Commission on Audit, "Local Governments Annual Financial Reporting System, Chart of Accounts as of March 6, 1980." Quezon City: Commission on Audit, 1980. (Computer Printout).

and must be eliminated from consideration. Beyond these there remains a whole spectrum of activities which are usually undertaken by the private sector but which are potential candidates for LGPE activity. But here too, many will not meet the standards which have been established.

Marketability and Pricing

The essence of the marketability issue is that the good or service in question can be sold and that it will be of the greatest immediate and direct benefit to those who purchase it. At the extreme are those activities whose benefits are so widespread that non-consumers cannot be excluded. National defense is an example of such a Central Government service.[1] For such services, it is not possible to charge those who benefit from the advantage they receive. Among the range of activities listed (Table VI-1) only lighthouses are of this variety. Once they are put in place, their benefits accrue to all within the viewing area. This service is not marketable and does not constitute a feasible public enterprise activity.

The other listed activities in Table VI-1 are much less pure public goods, although some are more easily rationed among beneficiaries than are others. Moreover, there are some for which a price or user charge could be imposed, but their external (social) benefits are too important to restrict their use. Included in this class of activities are education (primary schools) and hospitals. Police and fire protection as well as immunization are of the same ilk. The benefits that they provide to society are just too widespread to limit their availability on a willingness to pay basis.

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[1] In formal terms, these are referred to as *pure public goods*. They are not marketable primarily because their output is not in the form of divisible units which can be distributed among consumers. By their nature, if they are made available to one, they are equally available to all desiring to use or consume the good or service.

On the other hand, there are activities which are of primary benefit to the actual users rather than the community, but whose provision through the market is either too difficult or costly.[1] This would include plazas, parks and monuments which would have to be monitored and whose nature would have to be altered, i.e., fenced in, if their use were to be regulated by the charging of fees. These too, would seem to be outside of the range of LGPE activity.

While we might eliminate a number of goods from consideration as public enterprises on these grounds, we may not say that it would be technically impossible to market such activities. Indeed, there is much experience to the contrary. For example, the security compounds in some suburban areas constitute the provision of police-like protection on a charge-for-service basis. Similarly, private parks and gardens are an alternative to public parks and plazas, and public secondary schools have their counterparts in the private sector.

We may exclude one further class of local government activity which involves application of a charge in return for services provided. These include activities or services related to registration, certification and permission, i.e., inspections, certifications, issuance of permits, registrations, licensing, arrastre and customs, benefit holdings and court fees. These activites are undertaken to meet regulatory requirements, not to raise revenues.[2] The distinction is that these are services or activities which are offered to meet a legally imposed condition. While user charges

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[1] Formally, these are classified as nonexcludable goods or services. Provision of these at a price is not feasible because of the high costs of regulating their use or the inability to deny the benefit they provide to those who do not pay.

[2] Provincial Circular 22-73, Section IX-8.

and even cost recovery may be feasible, these cannot be considered to be enterprise activities for they do not involve the pricing and provision of a service offered to consumers.

Beyond these, there remain a number of activities which involve marketable outputs which can be priced and thereby are candidates of a local government public enterprise. By our reckoning, this remaining set is approximately the list in Table VI-2. Of course, the full range of possible local government enterprise activity is much broader as it includes those which are traditionally the domain of the private sector. Which of those are feasible public enterprises depends on factors other than marketability and pricing.

Cost Recovery

The use of public enterprises by local governments and the use of credit to finance capital facilities require some measure of cost recovery. The question is how much cost recovery is enough?[1] We have grouped potential LGPE activities according to degrees of potential cost recovery in Table VI-2. These groupings, and the analysis of cost recovery below are based on a number of considerations: Is the venture purely commercial or are there social goals to be accomplished (and subsidized)? Does high fixed investment preclude a price which is both efficient and cost recovering? Is the size of the market adequate?

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[1] The Local Tax Code enables local governments to set tolls, fees and charges through the enactment of local ordinances which are subject to review by MOF in the case of provinces and cities and the review of provincial treasurers in the case of municipalities. Section 361 of "The Revised Manual of Instructions to Treasurers," indicates that necessary expenses are the primary factors governing the setting of charges and/or fees. The implication is that cost recovery is an inherent consideration in local government pricing policy. For a more detailed discussion see Yoingco and Quintos, Philippine Tax System: Under the New Society (Manila, Philippines: GIC Enterprises Co., Inc., 1979), Chapter 6.

TABLE VI-2

COST RECOVERY PROSPECTS OF POTENTIAL LOCAL GOVERNMENT PUBLIC ENTERPRISE ACTIVITIES

All Areas

Low	High
Schools (secondary)	Public Markets
Zoos and Other Cultural Institutions	Slaughterhouses
Airport Landing Fields and Terminals	Farm and Cattle Ranches
Docks and Wharves	Rock Quarries
Toll Roads, Bridges and Ferries	Ice Plants
Canals	"Other Private Sector-Type Activities" (e.g., stores, restaurants, manufacturing, processing.

Small Areas Only	Large Areas Only
Telephones	Telephones
Waterworks	Waterworks
Electric Power	Electric Power

Before considering these issues, however, it should be noted that when other goals are important enough to override cost recovery, two issues must be dealt with: the source and type of the subsidy. With respect to the first issue, the general principle is that the subsidy should be provided by the government whose goals are being served. That is, if the activity facilitates the achievement of a national goal, the Central Government is the appropriate source of the subsidy. When the goals to be served are those selected by a local jurisdiction or the provincial government, then they should have the responsibility for providing the financial support to accomplish them.

The second issue, the nature of the subsidy, is more difficult and requires a consideration of both capital and operating subsidies. Capital subsidies provide for the initial cost of an undertaking (e.g., construction and planning). They would be appropriate when the establishment of an activity is desirable even though it may not be able to cover full or all costs. Alternatively, operating subsidies are designed to cover the ongoing costs of providing the good of service. They may be appropriate whenever the price level necessary to cover the cost of the materials, labor, etc., employed in producing the output is judged to be too high. As will become obvious below, efficiency as well as other goals may provide the justification for such subsidies.

Private Sector Competition. Because they could be marketed at a price, virtually all of the activities listed in Table VI-2 could be provided by private entrepreneurs. However, some would be more acceptable outside the government sector than would others (e.g., rock quarries vs. schools) and

these we refer to as the commercial enterprises. Many of the commercial ventures listed--e.g., ranches, ice plants, stores--are generally provided in the private sector. One can concoct social goals for nearly any undertaking, but these commercial ventures should appeal to government more in terms of their potential for profitability. As a general principle we would argue that such activities should fully cover operating and capital costs.

There are two good reasons for arguing full cost recovery. The most important is that it is simply difficult to justify a subsidy where the social benefits from the enterprise are so limited. The other is that a requirement of full cost recovery may act as a disciplinary measure. One advantage of the private sector is that the search for profit leads private entrepreneurs to seek the most efficient and least costly means of serving their clientele. These characteristics, efficiency and cost minimization should also be goals in the public sector. Although subsidies may not foster inefficiency, neither do they provide public managers with incentive to seek the most effective way of producing outputs and containing costs.

Efficiency would then argue that full cost recovery would be desirable for all those potential LPGE activities which are commonly provided in the private sector. From our list in Table VI-2, this would certainly include ranches, quarries, ice plants and "other private sector-type activities," i.e., commercial ventures. Our impression is that many undertakings of this type have a high potential for cost recovery.

Benefit Area. A second consideration which helps in classifying activities according to potential for cost recovery has to do with the relation between benefits and pricing, or more precisely with degree to which the activity is beneficial to persons and groups other than those who directly pay for the use of the product or service. The essence of the issue is that with efficient prices, individual purchases will be determined in relation to individual benefits. However, when there are externalities--the activities are also beneficial to society in general--too little of the good or service will be produced.[1] Common examples are immunization against contagious diseases, family or community improvement due to the greater education and/or cultural awareness of just one or a few members of some or all families. Since the benefits from these types of investment spread throughout the community, decisions made by individuals on the basis of their personal benefits may lead to production and consumption levels that are far less than desirable. In this case, subsidies are desirable because lower prices stimulate a greater output.

The activities which are commonly thought to be of this variety would include those related to health and welfare. Thus, it would seem that full cost recovery would be undesirable for hospitals, schools, and perhaps cultural activities such as zoos.

Scale Economies. For certain activities, an efficient (marginal cost) price may result in a loss. This is oftentimes the case with activities which require large initial investment outlays and for which, once the

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[1] While such externalities may be either positive or negative, our focus is on positive externalities which justify subsidies.

facility is in operation, the cost of providing additional units of service are relatively low. The appropriate pricing policy under these conditions is one which encourages consumption or use of the facility and thus reduces the average or per unit cost of providing output (or utilization of the facility). However, the efficient or marginal cost price will, in this case, result in something less than full cost recovery and will require a subsidy. Traditional examples of the types of activities are toll roads, bridges, airport landing fields and terminals and the public utilities, i.e., electric power systems, waterworks and telephones.[1]

Market Size. An important, although too frequently overlooked factor is the dependence of cost recovery on market size. In this regard, perhaps the most important consideration is proximity, i.e., it is just more likely that the volume of activity will be greater and the prospects for cost recovery greater when the LGPE is located near many users. High utilization rates are particularly important to those activities which require large initial investments. This follows from the fact that the larger is the volume, the smaller is the amount of start-up cost which must be covered by each unit of activity. When the initial investment costs are spread over large volume, the price that must be charged to achieve cost recovery can be lower.

This sharing of fixed cost is of importance to virtually all types of activities; however, it is of more importance to some than to others. These considerations suggest that some activities like public utilities, bridges, docks, are quite expensive and will likely be able to recover costs only in the more populated areas. Others, markets and slaughterhouses,

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[1] Cost recovery in such cases is possible through the use of two part tariffs or cross-subsidization, or by simply choosing to underprovide the service.

are not so expensive and thus hold prospects for cost recovery in smaller areas.

One should not assume that the volume at which an enterprise will operate is related solely and directly to the population of the jurisdiction in which it is located. Rather it may be the case that where municipalities are close to one another, the volume of an activity in one may be larger because it draws business from another. In fact, in small jurisdictions, it may be the case that the achievement of anything like an adequate volume may be possible only if the service area encompasses two or more jurisdictions. The implication is that in less populated areas where markets are limited, establishing a LGPE in all jurisdictions may strike a crippling blow to the possibility for cost recovery in some, or perhaps all, areas.

In the most general sense, the market is strongest and prospects for cost recovery are best for activities which are highly desirable, which are located in areas which are densely populated and prosperous and where alternative sources of supply are limited. That is to say that the prospects for cost recovery are best in larger municipalities and cities.

This is not to say that activities which could be structured as LGPE, e.g., markets, should not be placed in all jurisdictions. Cost recovery may not be the only objective or even the most important objective to the service even if cost recovery cannot be achieved. When this is the case, the magnitude and the source of the subsidy depends on the nature of the goal to be accomplished.

The Measurement of Full Costs. Pure cost recovery will be consciously accomplished only when all costs incurred are considered in the calculation of the price or rate to be charged. Wages and salaries, materials and supplies, repair and maintenance, utility services, and the cost of the facilities, i.e., depreciation allowance and amortizations, should all count in the calculation of cost. The determination of these costs is easier and more accurate where there is a separate enterprise account for the activities in question, and where an appropriate share of general overhead is allocated to the enterprise account.[1] Regretfully, complete accounting for enterprise activities is not always practiced, in the Philippines or elsewhere. Moreover, such practices could be quite costly, especially for smaller municipalities. Still, if all costs associated with an enterprise are not considered, then fees or charges set at what might appear to be cost recoverable rates will in fact, be low, losses could actually occur and there may be a hidden subsidy, most likely in the General Fund. General Fund subsidies for local services may well be desirable. However, without a full cost accounting, it is not possible to determine the actual magnitude of the subsidy being provided. In such a case, informed public policy is not a realistic expectation.

The Actual Use of Local Government Public Enterprises

As has been indicated earlier, legal restrictions do not greatly restrict the type and variety of public enterprises and business operations

[1] The accounting for public utility and other economic enterprise operations is accomplished through special accounts to be maintained in the General Fund (PD 477, Article II, Section 13).

which any level of local governments may undertake. However, the variety of activities which have been undertaken cannot be readily identified from the aggregate data which are available. The information that is available indicates that municipal governments account for the major share of what may be called the traditional types of public enterprise, i.e., markets and slaughterhouses, waterworks, cemeteries and electric plants (Table VI-3). In regards to the first three, cities are generally more active than provincial governments. However, in the provision of electricity, provinces are more active than cities (but not municipalities). For other public utility services, primarily telephone services, cities account for virtually all of the activity.

A broader view of local government enterprise operations can be obtained from the available revenue data which are richer in detail than the expenditure data (see Table VI-4). These data indicated that cities are generally more active in enterprise type activities than the provinces. However, it is the municipal level which seems to dominate public enterprise operations among the categories of enterprise type operations, cities are the most active in hospitals and public utilities and telephones (postal and communications) and the residual category of other business operations, which consists primarily of septic systems. Alternatively, provinces appear to be the most active in rentals, general sales and schools (as judged by tuition fees) while municipalities account for most of the revenues from plant and farm product sales. Non-traditional public enterprise operations would not appear to be very important for cities. Finally, it is interest-

TABLE VI-3

EXPENDITURES FOR PUBLIC ENTERPRISE ACTIVITIES BY TYPE OF PUBLIC ENTERPRISE AND LEVEL OF GOVERNMENT: 1977
(in thousands of pesos)

	Operations of Markets and Slaughterhouses	Waterworks	Cemeteries	Electric Plants	Other Public Utilities[a]	Total
Provinces	259	2,784	551	2,268	17	5,879
Cities	27,212	5,175	813	1,918	29,275	64,393
Municipalities	39,475	8,189	1,138	6,490	72	55,361
All Local Units	66,946	16,148	2,502	10,677	29,364	
	Percent Distribution by Level of Government					
Provinces	0.4	17.2	22.0	21.2	0.1	4.7
Cities	40.6	32.0	32.5	18.0	99.7	51.3
Municipalities	59.0	50.7	45.5	60.8	0.2	44.1
All Local Units	100.0	100.0	100.0	100.0	100.0	

[a]Primarily telephones and ice plants.

SOURCE: Commission on Audit, Report on Local Governments, 1977.

TABLE VI-4

REVENUE FROM BUSINESS OPERATIONS BY TYPE AND LEVEL OF GOVERNMENT, PERCENT DISTRIBUTION BY LEVEL AND OF GOVERNMENT AND PERCENT DISTRIBUTION BY TYPE OF BUSINESS OPERATION: 1977
(in thousands of pesos)

	Rentals	Profit From Sales	Commission on Consignments	Sale of Plants and Farm Profucts	Postal and Communication Charges	Hospital Fees
Provinces	961	133	---	215	---	100
Cities	3,941	5	28	36	1,182	1,235
Municipalities	5,813	25	117	263	---	46
All Local Units	10,715	163	145	514	1,182	1,381
	Percent Distribution Level of Governments					
Provinces	8.9	81.6	---	41.8	---	7.2
Cities	36.8	3.1	19.3	7.0	100.0	89.4
Municipalities	54.3	15.3	80.7	51.2	---	3.3
All Local Units	100.0	100.0	100.0	100.0	100.0	100.0

TABLE VI-4 (CONT.)

	Tuition Fees	Receipts From Public Utilities	Receipts From Markets	Receipts From Slaughterhouses	Receipts From Roads, Bridges and Ferries	Receipts From Cemeteries	Receipts From Other Business Operations
Provinces	18,805	6,226	---	404	---	---	1,927
Cities	7,416	24,623	40,465	7,694	99	664	4,266
Municipalities	15,286	14,032	58,035	7,616	720	1,455	5,171
All Local Units	41,507	44,951	98,500	15,714	819	2,119	11,364
	Percent Distribution Level of Governments						
Provinces	45.3	13.9	---	2.6	---	---	17.0
Cities	17.9	54.9	41.1	49.0	17.1	31.3	37.5
Municipalities	36.8	31.2	58.9	48.4	82.9	68.7	45.5
All Local Units	100.0	100.0	100.0	100.0	100.0	100.0	100.0

ing to note that municipalities account for the largest share, 40 percent, of local government income from the listed enterprise type activities. The share of revenues earned by municipalities on consignments, and from markets, slaughterhouses, tolls and cemeteries exceed those of both the cities and the provinces (Table VI-4).

Regretfully, the lack of detail in which data on public enterprise expenditures and receipts are available precludes any clear identification of the range of enterprise activities which has been undertaken by local governments. However, it does seem clear that municipalities play a substantial role in the areas of markets, slaughterhouses, waterworks, electric plants, and bridges, roads, and ferries. Alternatively, cities play the dominant role in other public utilities (telephones) and hospitals while the domain of the provinces has been in rental and profitable sales activities and schools. Given our earlier considerations about the prospects for cost recovery (Table VI-2), it is likely that the municipalities have not fared well in the operations of public enterprises. Indeed, although the data are not wholly adequate for the purpose, the differences between expenditures and income indicates that the provinces have been the most successful in the provision of public utilities while all three have experienced some measure of success with markets and slaughterhouses (Tables VI-3 and VI-4). Regretfully not much more can be said considering the data limitation. More detailed data collection and analysis is required for a correct evaluation.

CHAPTER VII

PROBLEMS AND POTENTIALS OF MARKET ENTERPRISES

Public markets are the most common form of public enterprise activity in the Philippines. Interestingly, markets also come close to fitting most of the criteria suggested above: management and accounts can be separated, the "product" can be marketed to individuals, prices can be related to costs, and there are good possibilities for cost recovery. Even so, the financial success record of market operations has been spotty. To better understand the financial success of market enterprises, and the barriers to improved financial performance, we have undertaken a set of comparative case studies.

A cross section of eleven local government market operations has been chosen for study.[1] While the sample was not drawn on a random basis, it is diverse. Of the eleven cases used,[2] two--a city and a municipality--are in Albay Province; seven--one city and six municipalities--are in

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[1]The basic information and data underlying the analysis were collected during site visits in each of the study areas. We attempted to obtain data on the financial operation of public markets in the locality and also to sample the opinion of local officials about the general circumstances and procedures governing market operations. The interviews were with officials in charge of market operations: the local treasurer and/or members of his/her staff, and market masters in the larger areas. In several instances the local mayors and members of their staff most graciously shared their knowledge and perspectives with us. Numerous officials of Central Government agencies, e.g., the Ministry of Finance, the Commission on Audit, the Land Bank, and the Development Bank of the Philippines, were also interviewed. Their perspectives and the information they provided have been instrumental in the completion of this undertaking.

[2]Two additional areas were included in the original survey. However, the data provided were not sufficient to warrant their inclusion in the analysis the areas were Barotac Viejo, Iloilo and Malinao, Albay.

Iloilo Province; and two municipalities are located in Sorsogon. Thus, one of the cities and three of the municipalities are located in the slow growing Bicol region while one city and six municipalities are located in more prosperous Iloilo Province in the growing Eastern Visayas region. Most of these areas fall within a 30,000-45,000 population range, three are somewhat larger and one has a population in excess of 200,000 (see Table VII-1).

The Fiscal Importance of Market Undertakings

Markets account for a significant share of the fiscal activity of local governments in the Philippines. In one sense, the gross revenue from markets may be compared to total local government taxes because it is claimed from the same underlying tax base, local area personal income.[1] When viewed this way, the very great fiscal importance of markets comes to the fore. The least importance shows up in the case of the two chartered cities, Iloilo and Legaspi, where slightly less than 10 percent of total revenues is generated by market activities. This relatively low share is probably due to the greater breadth of taxing powers of cities. In most of the municipalities, the contribution of markets to total revenues ranges upward from about 15 percent. In two areas, Tabaco and Gubat, market activities account for roughly one-third of total revenues. What one can say from this rough profile is that there is a great deal of variation in the importance of market activities relative to total budgetary activities and that this variation is not all due to population size. This matter will be considered in some detail below.

[1] Though some larger markets draw from a much larger area, i.e., they may also tap the taxable capacity of smaller, nearby jurisdictions.

TABLE VII-1

POPULATION, LOCAL GOVERNMENT TOTAL REVENUES, AND GROSS REVENUES FROM THE OPERATION OF MARKETS, SELECTED AREAS: 1978
(in thousands of pesos)

Local Jurisdiction	Population	Total Revenues	Gross Revenue From Operation of Public Markets	Market Revenues As a Percent of Total Revenues	Market Revenues As a Percent of Locally Raised Revenues[a]	Market Revenues As a Percent of Local Taxes[b]
Barotac Nuevo	32,926	883	187	21.18	31.27	52.67
Dumangas	38,457	632	96	15.19	21.72	40.68
Iloilo City	210,423	17,391	1,670	9.60	11.71	16.06
Miagao	40,501	693	102	14.72	21.42	53.40
Oton	36,120	567	51	8.99	13.21	36.43
Passi	47,017	1,204	191	15.86	31.36	87.21
Tigbauan	27,443	406	77	18.97	29.84	45.29
Legaspi City[c]	79,613	5,674	544	9.59	11.38	18.29
Tabaco[c]	67,814	1,356	426	31.42	44.51	100.47
Gubat[c]	37,724	650	234	36.00	55.19	178.62
Sorsogon[c]	52,075	1,025	153	14.93	19.82	38.44

[a]Locally raised revenue is revenue from taxation plus non-tax revenue net of Allotments and aids and contributions.

[b]Local taxes is revenue from taxation net of BIR Allotments.

[c]Computed using 1977 figures.

SOURCES: (1) Population for 1975 is from several special releases of the Office of Executive Director, National Census and Statistics Office. (2) Fiscal data are from selected local government financial reports to the Commission on Audit.

The possibilities for using market charges are further underscored by comparisons of gross market revenues with local governments revenues raised from other sources. Again, there is a good deal of variation. However, even in those areas where the contributions of markets to locally raised revenues are smallest--Iloilo City, Oton and Legaspi--they amount to something more than one of every ten pesos. More commonly, markets account for upwards of 20 percent of locally raised revenues and in two areas, Tabaco and Gubat, the percentage is closer to 50 percent. An equally revealing comparison is that of market revenues to taxation. In Passi and Tabaco, gross revenues obtained from markets and from taxation are about the same while in Gubat, gross revenues obtained from the market exceed those from taxation by a rather substantial margin.

The statistics tell us little about the contribution of markets to the general financing of local government services, i.e., the level of market revenues alone does not indicate whether the market enterprise is operating in surplus or deficit.[1] Still, the point here is that market undertakings are a major activity of local governments and involve rather substantial amounts of resources.

Physical Condition of Markets

The market structures in these eleven areas are not of recent vintage. In no case was the original market facility constructed after 1965 and in seven areas the construction was pre-1950. That so many of these markets

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[1] This matter is addressed on pp. 44-47 below.

are over 30 years old, while none are less than 15 years old, would seem to indicate either a state of dilapidation or that markets as originally constructed are quite durable. It does seem to indicate, however, the kind of conservation of physical facilities that one would expect in a capital-short country.

There have been some investments in expanding and rehabilitating these structures, i.e., none of these markets still serve in their original condition. The need for repairs, renovations and reconstructions are recurrent while improvement and expansion have been necessary to accommodate the needs of growing populations and/or developing hinterlands. In many areas, particularly those with older facilities, capital improvements have been undertaken a number of times, and have been undertaken recently (see Table VII-2).

The durability of the market facilities considered here would seem to indicate that they can be quite long-lived, barring of course, their destruction by natural disasters or accidents. Improvements in construction materials and design could make newly constructed market facilities even more durable. When asked about their views on the durability of new market structures, the local officials interviewed generally responded that they believed the life span of market facilities to be somewhere between 30 and 50 years (Table VII-2).

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[1] Of the thirteen areas visited, recent fires destroyed the one in Barotac Viejo (not included in the study) and did extensive damage to the one in Passi.

TABLE VII-2

SELECTED CHARACTERISTICS OF MARKETS, SELECTED LOCAL GOVERNMENTS: 1980

Local Jurisdiction	Date of Original Construction	Expected Life of the Market	Date of Most Recent Improvements
Barotac Nuevo	1949	40	1979
Dumangas	1954	30	1963
Iloilo City	1947	20	1979
Miagao	1949	50	1977
Oton	1946	50	1974
Passi	1945	40	1979
Tigbauan	1922	100	1979
Legaspi City	1963	20	n.a.
Tabaco	1946	50	1965
Gubat	1945	20	n.a.
Sorsogon	1965	30	1979

n.a. = Not available.

[a]From the question posed to municipal or city treasurers, "What is the estimated life span of the building?

SOURCE: Case Study survey data.

Financing Capital Improvements

Dilapidated physical facilities may be the result of a shortage of capital facility financing available to local governments. This is indeed the case for public markets though it is unclear whether the basic problem is that many local governments are not creditworthy enough to be eligible for a loan, whether the terms are too stringent and/or costly, whether local officials are simply too conservative to take on debt obligations, or whether local governments are uninformed about the channels of financing open to them.

The general perception of local officials is that there are three basic sources of funds to finance local market construction and improvement: Central and provincial government subsidies, borrowing, and accumulated surplus. To these must be added a fourth lease contract, which, though used by some local governments, apparently has not even been considered by most.

Local officials quite reasonably prefer direct subsidies as a means of financing construction and reconstruction of markets. Generally they are aware of the availability of lending programs of the Central Government institution; however, they consider the terms of such credit to be particularly burdensome and prefer to avoid committing future revenues to the amortization of loans. Beyond this and perhaps of even greater importance, is that local officials in many areas appear to be uncertain about whether their markets would or could be operated in such a wage as to generate sufficient revenues to cover operating costs and debt payments as well. As we shall see, there is good reason for such doubt.

Central and Provincial Government Subsidies

Only two of the eleven areas surveyed here received provincial or Central Government assistance. This is not surprising since this is primarily emergency assistance, e.g., to reconstruct a market facility which has been destroyed or badly damaged by fire. It is frequently the case that even under such emergency circumstances, the funds provided are formally a loan rather than a grant-in-aid. However, there is a perception on the part of local officials that even when structured as a loan, the funds can be treated as a grant-in-aid, i.e., that the repayment obligation is not binding. While this is the preferred means of obtaining funds for investing in markets, and it is easy to understand a preference for free money, there is a recognition by local officials that such assistance is likely to be made available only in particular circumstances.

Borrowing

A second source of financing is the loan programs of the three major lending institutions for local governments: Development Bank of the Philippines, Land Bank of the Philippines and the Government Service Insurance System.[1] Loans from DBP or GSIS have funded the construction or improvement of markets in virtually all the studied areas, though in most cases the loans were pre-1960. Since then, the experience with market loans has been quite limited. In fact, only three of these jurisdictions have borrowed for market construction since 1968, and all three loans were from DBP.

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[1]These institutions and their practices are discussed at greater length in Part Three below.

Generally local officials are aware that these programs are the major sources of investment funds, but they view them with skepticism. In part, local officials perceive the process of securing a loan as one involving a great deal of study and document preparation, and requiring dealings with loan offices which are geographically remote and not well acquainted with their particular circumstance. Moreover, the development of feasibility studies, and persistence during their review, are activities with which local government administrators and their staffs have little experience. One must also recognize the fact that local government officials are motivated by political goals and are more interested in investing their energy in projects which they may see develop in a relatively short period of time. Long delays in obtaining funds for market construction are especially off-putting.

As great a problem, from the point of view of local officials, are the loan terms--too short a maturity and too high an interest rate. If, as is generally the case, the length of the repayment period, i.e., ten to fifteen years, is far shorter than the expected life of the facility to be constructed, amortization will be higher than need be. In this case, dissatisfaction with the "high" amortization could be interpreted as a desire or preference for loan periods which coincide more closely with the useful life of the facility. Longer maturities would lessen the debt service drain on annual local government revenues and increase the credit strength (repayment potential) of local governments applying for loans. Interest rates are also a problem. Local officials, like everyone else these days, feel that interest rates are too high. In the case of local

government officials in the Philippines, one has to consider the frame of reference. The interest rates associated with the municipal credit programs of the Central Government lending institutions range between 14 and 18 percent. In comparison with those available in the private sector, these rates cannot be considered high. However, municipal funds are typically held by the provincial government in noninterest-bearing accounts, often with the same institution (DBP, LBP) who now stands ready to lend at what in comparison seems an exhorbitant rate. The resistance of the local official to borrow because interest rates are "too high" is probably irrational, but his objection to this sequence of events is understandable.

Accumulated Surpluses

The third source of finance for market improvements is the cash surpluses accumulated by local governments. But accumulation of enough free reserves to finance a major improvement is not easily done, and therefore is not a financing source open to every local government.[1] Of the eleven areas studied, only four have financed major improvements from local funds. Still, to most local government officials, the accumulation of surpluses for the financing of improvements is appealing if for no other reason than that they can avoid the problems, red tape, delay and uncertainty associated with the loan application process. It is also appealing to the conservative fiscal bent of many local officials, who see pay-as-you-go financing as a way of avoiding local fiscal crises and perhaps even some personal liability.

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[1] Some local governments have been able to accomulate rather sizeable surpluses. For an example, see Chapter VIII.

The question arises as to how one justifies the use of a General Fund surplus for market activities. The justification has to do with the service objective of public markets. In this view, and it is widely held, the objective of public markets is to facilitate the provision of foodstuffs and other essential commodities at prices affordable by the general public. It is on these grounds that many municipal officials are not perturbed by the prospect of deficits from the market undertaking, i.e., of needed subsidies from general revenues.

There is more to be said about the surpluses and deficits, e.g., the potential profitability of markets, but it will come later. However, it should be noted here that in a decentralized system, differences in the objectives and policies of local governments are to be expected. That some local governments subsidize markets as a means of achieving social objectives while others consider markets as a means of raising revenues to be spent for other purposes, is a reflection of the diversity of a decentralized system. Indeed, it is a textbook example of what the strategy of decentralizing the provision of government services is all about.

Lease-Contract Arrangements

The fourth source of funds for investments in the improvement and expansion of markets involves a lease/construction arrangement between the local government and market vendors. The essence of this arrangement is that in accordance with approved plans and specifications and under the supervision of the municipal government, market vendors (at their own expense) construct the stalls or booths they are to occupy. In return,

the vendor is awarded a lease at reduced rental fees for a specified period. At the end of this period the stall or booth becomes the property of the local government and is subject to the prevailing rental and fee charges. Where these arrangements have been undertaken, Tigbauan and Legaspi City in our survey, the exact terms varied rather greatly as regards the duration of the lease and the amount of reduction in market fees. In both cases, these arrangements seem to provide an effective means of securing investment in market facilities without direct spending on the part of the local government. This is not to say that the investments are made without cost to the local government. The cost to the local government is the difference between the fees it could have collected if the regular rentals were imposed at their full rates and the reduced rates which are collected. Of course, the local government saves on construction costs, hence we should deduct the annual opportunity cost of the capital not tied up, from the rent-loss cost.[1] Whether this arrangement proves profitable to local governments is not yet clear--such programs have only recently been initiated.

The Determinants of Revenues from Market Activities

All market undertakings are not equally successful in terms of cost recovery. The "problem" could lie with excessive costs--a possibility discussed in the next section--or with inadequate revenues. If the problem is on the revenue side, it may be with an inadequate pricing or market fee policy, or it may lie with an inadequate volume of business in the

[1] Regretfully, the data required to make such adjustments are not available.

market. The revenue shortfall possibilities are explored here for our sample of eleven jurisdictions.

Pricing Policies

As noted above, the prices charged for market activities, and perhaps the profitability of the market undertaking, may be effected by Central Government restrictions or by equity considerations. In the Philippine setting, the former would not seem to be a good excuse for pricing well below a cost recovery level, though equity considerations appear to have had a dampening effect on market fees in some of the jurisdictions surveyed. However, neither equity considerations nor the fear of reducing stall occupancies would appear to be good reasons for pricing well below average costs.

Legal Restrictions and Actual Pricing Policies. The Local Tax Code specifies that market stall fees must be set per meter of space per month/day and that higher rates be set for more favorable locations. Occupancy and entrance fees are no more clearly defined in the Local Tax Code except for a provision that entrance fees may be imposed on any convenient unit of measure, e.g., weight or bundle, and they may not exceed the occupancy fee. The Code also specifies, and it is the practice, that the schedule of market fees is established after public hearing by the Local Council, and the ordinance setting the fees is subject to review by the provincial treasurer in the case of municipalities and the Ministry of Finance in the case of cities.

In general, the markets surveyed here conformed to the specifications of the Local Tax Code. However, among the eleven areas, there is a sub-

stantial variation: some prescribed a limited range of stall rental fees (Sorsogon and Passi), one relied heavily on entrance fees (Oton), while some opted for a combination of rental, entrance, and occupancy fees which in one case (Tigbauan), involved a large number of different rates.

Revisions of market fees and rental schedules do not appear to be frequent (see Table VII-3). In five of the eleven areas, the ordinance governing market fees and rentals in 1980 was four or more years old. The other six had revised their ordinance in 1978 or 1979. This small sample would suggest that the market rental and fee ordinance is revised every four or five years. Revisions appear to be hastened by growth in the volume of market activities.

Pricing Policies and Equity Considerations. Recommendations for fee increases are generally made by the treasurer and mayor, in light of discussions with vendors or vendor associations. However, in a variety of instances, the levels finally passed by the Sangguniang Bayan (the local council) were reported to be below those recommended by the treasurer and/or the mayor. The reason given for the lower rates was the fear that higher fees would be passed on to consumers and that this would be inequitable. This difference in opinion between treasurers and mayors on one hand, and the local council on the other may reflect different views about the proper role of local markets. The belief that market fees should be higher seems more important among those whose concern is with fiscal position--mayors, treasurers, the Ministry of Finance, the Ministry of Local Government and Community Development.[1] Alternatively, those most directly

[1] For a statement of these views see Ministry of Local Government and Community Development, Public Markets Manual for Local Units, Manila, The Philippines, undated.

TABLE VII-3

MARKET RENTAL RATES FOR SELECTED COMMODITIES,
SELECTED LOCAL GOVERNMENTS: 1980
(pesos per square meter per day)

Local Jurisdiction	Meat	Fish	Dry Goods	Vegetables	Fruit	Cereal	Dried Fish	Grocery
Barotac Nuevo	1.00	0.50	1.00	0.50	1.00	1.00	1.00	1.00
Dumangas	2.00	0.50	1.00	0.50	0.50	1.00	0.50	0.40
Iloilo City	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Miagao	0.33	0.75	0.33	0.33	0.33	0.33	0.33	0.08
Oton	1.50	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Passi	2.00	2.00[b]	2.00	0.50[b]	0.50[b]	3.00	1.50[b]	2.00
Tigbauan	2.00	1.00	2.00	1.00	1.00	2.00	0.50	2.00
Legaspi City	1.20	0.80	0.24	0.10	0.24	0.24	0.40	0.24
Tabaco	0.23	1.25[c]	0.26	0.24	0.24	0.23	0.24	0.26
Gubat	2.75	1.93	1.10	1.10	1.00	1.10	1.93[d]	1.10
Sorsogon	1.50	1.40	1.50	1.40	1.40	1.50	n.a.	1.50

	General Merchandise	Eatery	Others	Date of Present Market Fee Ordinance	Date of Penultimate Market Fee Ordinance
Barotac Nuevo	1.67[a]	1.00	1.33	1979	n.a.
Dumangas	n.a.	0.40	1.00	1974	1964
Iloilo City	n.a.	n.a.	n.a.	1975	n.a.
Miagao	0.33	0.17	0.11	1979	n.a.
Oton	3.00	3.00	3.00	1976	n.a.
Passi	2.00	2.00	2.00	1975	n.a.
Tigbauan	2.00	0.50	2.00	1979	1974
Legaspi City	0.28	0.16	0.24	1976	1974
Tabaco	0.26	0.24	n.a.	1979	1974
Gubat	1.10	n.a.	0.49	1979	1976
Sorsogon	1.50	1.70	1.50	1978	n.a.

n.a. = Not available.

[a]Monthly rate per square meter per stall divided by 30.

[b]Market occupancy fee, rate per square meter per day

[c]Includes differential rent since fish stalls are located in the best location.

[d]Assumed the same as rental fee for fresh fish stalls.

NOTE: When multiple rates are given for the same stall type, the lower rate is used. The differences in rates are usually based on location--i.e., corner vs. inner stall.

SOURCE: Case Study survey data.

responsible to local constituencies, the members of local councils and committees, favor lower market rentals and fees. That these groups would have different objectives probably is a reflection of the honest differences among groups with different concerns and responsibilities. However, it is the local councils who have the responsibility for the setting of market fees. At least in our small sample, the price stability and equity concerns seem to have been dominant.

The structure of market fees also reflects equity considerations. Rental rates for meat, fish and dry good stalls are consistently among the highest while those for fruits and vegetables are generally the lowest (see Table VII-3). There are no available data on the consumption of the various class of goods sold in the markets, but it seems reasonable to assume that expenditures for meats, fish and dry goods are likely to be larger on the part of higher income groups. Alternatively, the more plentiful and less luxuri us foodstuffs such as fruits and vegetables, probably constitute a larger part of the diets of low income households and are of less importance in the budgets of higher income families. If this is indeed an accurate description of consumption patterns, then the general structure of market fees and rental rates would appear to have been influenced by equity considerations.

These results make it pretty clear that equity considerations, or what are thought to be equity considerations, play an important role in the determination of market fees and charges. A reasonable argument can be made that this concern is misplaced and that increases in market fees would have no appreciable effect on very low income families. Whether the

burden of market fees and fee increases is shifted to consumers is a matter of conjecture. However, given the relatively low market rates (Table VII-3), it is unlikely that an increase would have a significant effect on the prices charged in the market. For example, if the stall fee for a meat vendor were ₱2.00 per square meter per day for a stall of four square meters, a 10 percent increase in the rental fee would increase his cost by only ₱.80 per day.[1] This would seem to be a small amount, indeed it would be less than one-half of 1 percent of revenues if the vendor had sales of no more than ₱160 per day. For lower fee rates, e.g., ₱1 per meter per day and smaller stalls, e.g., three square meters, the corresponding amounts are thirty centavos per day which would be one-half of 1 percent of revenues if sales were as low as ₱60 per day.

The implication is that sales volumes and vendor revenues would have to be extremely low for a market fee increase to amount to even as much as one-half of 1 percent of revenues. These amounts are illustrative and in fact are based on rental fees that are higher than the average actually charged in the markets surveyed here. The point is that given the general level of market fees, it is likely that fees could be raised and market revenues increased with little or no appreciable effect on prices, even if full forward shifting occurred. Moreover, judging by the occupancy rates and treasurers' statements about the number of transient vendors, there appears to be a fair amount of competition among sellers, particularly

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[1] These examples are taken from the market in Passi which revised its fee rates in 1979 to levels that are relatively high in comparison with the other markets considered here.

on market days. A number of sellers vying for customers is itself a condition which tends to limit a seller's ability to pass such costs on to consumers in the form of high prices. All in all, the concern with the effects of rental increases on food prices and on the distribution of income may be overblown.

Pricing and Occupancy. Another constraint to increasing market fees is the fear that occupancy rates would fall, i.e., some vendors would take their business elsewhere. For this to be a valid concern, profit margins would have to be quite small or a competitive private sector market would have to exist. While we have no estimates of the income earned by market occupants, it would seem that existing market fees are not so high as to make market occupancy an unprofitable venture. Certainly for the markets considered here, all or most fixed stalls are occupied (Table VII-4) indicating some profitability to the activity. Moreover, some officials interviewed believed that at least in some of the populated areas, market stallholders earn substantial profits. This they deduce from a knowledge of attempts to entice stallholders to illegally sublease their premises in return for substantial renumeration.

Another fact which would lead one to expect that the holding of market leases is relatively profitable is the long-time lag between fee revisions. In a period of even moderate inflation, this lag may result in a substantial windfall to the stallholder.

Together, the foregoing would seem to imply that those who operate in the municipal markets, or at least in the larger ones, do so because it is a remunerative venture. Moreover, as was suggested above, it would

TABLE VII-4

PER CAPITA MARKET REVENUES, AVERAGE STALL FEES, STALL OCCUPANCY RATES AND MARKET PROXIMITY, SELECTED LOCAL GOVERNMENTS

Local Jurisdiction	Per Capita Market Revenue (in pesos)	Average Stall Fees[a] (in pesos)	Stall Occupancy Rates[b]	Number of Smaller Markets Within 20 Kilometers	Number Larger Markets Within 20 Kilometers
Barotac Nuevo	5.68	₱1.00	99.2	n.a.	n.a.
Dumangas	2.50	0.78	100.0	0	2
Iloilo City	7.94	n.a.	100.0	5	0
Miagao	2.52	0.31	100.0	2	1
Oton	1.41	1.50	84.8	n.a.	n.a.
Passi	4.06	1.77	98.5	3	0
Tigbauan	2.81	1.45	100.0	1	1
Legaspi City	6.07	0.37	100.0	1	0
Tabaco	6.28	0.34	100.0	2	0
Gubat	6.20	1.36	n.a.	2	1
Sorsogon	2.92	1.49	n.a.	n.a.	n.a.

n.a. = Not available.

[a]Average stall fee (ASF) for i^{th} jurisdiction is computed as follows: $ASF_i = (\sum_{j=1}^{m} r_{ij})/n_{ij}$ where n_{ij} = number of commodity classification rates considered (see Table VII-3) and r_{ij} = the market rental rate for j^{th} commodity in the ith local jurisdiction.

[b]Stall occupancy rate is defined as the number of fixed stalls occupied as a percent of the total number of fixed stalls.

SOURCE: Case Study survey data.

seem that the local governments could obtain substantial revenue increments by market fee increases without posing great threats of price increases to consumers. This implies that the brunt of market fee increases would fall on the vendors, i.e., it would make net earnings by vendors lower than they otherwise would have been. However, it is doubtful that this burden would be onerous. As was indicated above, a fee increase as large as 10 percent would probably not amount to more than a few pesos per day increase in vendor costs. Indeed it is likely that fee increases would be substantially less for most vendors in most areas. Thus, it would seem that fee increments, even as large as 10 percent, could be borne without placing major hardships on market occupants.[1]

The Volume of Sales

Price increases are the discretionary action that may be taken by local authorities to increase revenues or to hold them down. The volume of sales is the other determinant of total revenues, but growth in this volume is determined largely by external factors. If the minimum volume isn't there, the market simply won't make it as a financially viable proposition, no matter what are the pricing policies.

The most readily available measure of the size of the consuming market is area population. This measure of market size is flawed depending on whether a market draws on a larger (smaller) population than that of their jurisdiction. If there were an exact correspondence, then we might expect that the differences in per capita market revenues among the sample municipalities would be proportional to differences in the average levels of

[1]The exception to these arguments may be small areas, where price increases could cause vendors to seek substitute locations in nearby, large markets.

market fees. In the areas under consideration, this correspondence does not exist (Table VII-4). The indication is that the volume of market activities cannot be gauged solely in terms of the population of the municipality in which it is located.

This raises the interesting question of what makes the influence zone of one market greater than the influence zone of another. In one instance, Passi, local officials attributed recent increases in the volume of activities to the municipality's barangay roads project, which improved access from the municipality's rural areas. This certainly increased the market's accessibility to the rural population but more important, it enabled previously isolated rural farmers to market their produce at lower prices. The combination of a greater supply of market goods and lower prices is believed to have attracted an increase in shoppers from other areas.

Volume, not pricing, is the key to the success of municipal markets. The municipal officials surveyed on this issue responded that the volume of market activities depends greatly on whether the local market is able to draw consumers from other municipalities. We have no direct information on the commuting range for market activities, but indirect evidence suggests what might be expected, that larger and more accessible markets do relatively better. If vendors come to the more popular markets in relatively greater numbers, greater revenues due to increased entrance and occupancy fees will result. Thus, we might use [illegible] market revenues as a

rough gauge of drawing power. Those areas which are in proximity (within 20 km.) to larger markets--Dumangas, Miagao, and Tigbauan--produce low levels of revenues relative to municipal population.[1] Those markets which produce large amounts of revenues relative to the population of the municipality in which they are located are within 20 km. of smaller markets. It should be noted that this relationship between per capita revenues and proximity to other markets cannot be attributed to differences in market fee rates. In fact, in some areas, like Legaspi City and Tabaco, per capita revenues are high although market charges are low. Alternatively, in Oton, Passi and Sorsogon, market fees are fairly high but per capita revenues are not. The clear implication, therefore, is that the influence of larger markets is spread over broad areas creating a degree of competition among markets. Whether the competition is such that some smaller markets are rendered unprofitable cannot be determined from the data we have available. However, it does appear that markets in adjacent jurisdictions compete with each other and this gives rise to the possibility that some, the smaller ones, may have difficulty in making the market a profitable undertaking.

Expenditure Levels and Worker Productivity

There is a substantial variation in the level of expenditures among the markets included in this survey (see Table VII-5). While it is clear that expenditures for the larger markets are larger, size alone cannot

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[1] In actuality, the influence zone of a market depends not only on the size (attraction) of the market but the access to it. The more highly developed the road system, the wider will be a larger market's zone of influence. Interestingly, a smaller market may be harmed by a good road system, because it may be brought within the zone of influence of a larger market.

TABLE VII-5

MARKET EXPENDITURES, TOTAL AND BY TYPE, SELECTED LOCAL GOVERNMENTS: 1979
(in thousands of pesos)

Local Jurisdiction	Total Expenditures (1)	Expenditures on Current Operations			Capital Outlays (5)
		Total (2)	Personal Services (3)	Maintenance and Repairs (4)	
Barotac Nuevo	222.7	143.1	87.2	55.9	79.6
Dumangas	212.8	206.1	35.9	170.2	6.7
Iloilo City	2237.1	1215.7	702.7	513.0	1021.4
Miagao	36.5	35.6	22.4	13.2	0.9
Oton	71.8	71.8	57.8	14.0	0.0
Passi	374.4	238.5	165.3	73.2	135.9
Tigbauan	105.3	52.2	40.8	11.4	53.1
Legaspi City	405.6	355.0	164.5	190.5	50.6
Tabaco	232.3	230.7	177.4	53.3	1.6
Gubat	98.7	95.7	84.2	11.5	3.0
Sorsogon	1705.4	173.6	119.5	54.1	1531.8

Notes: (i) Column (1) is the sum of Columns (3), (4) and (5). Column (2) is the sum of columns (3) and (4).

(ii) Includes expenditures for travel and transportation, supplies and materials, printing and binding, freight and delivery service, repair of equipment, rental of building and grounds, maintenance and repair of fixed property, illumination and power service, communications, adjudications, contracts, losses, discretionary, and other services.

SOURCE: Case Study survey data.

account for all of the variation. It follows that we must ask about those factors which determine the level of market expenditures, and therefore affect profitability.

Current Operating Expenditures

The quest for a more efficient market operation inevitably leads to a questioning of whether market employees are overpaid relative to the work they perform. The latter has not been seen as a major problem as the standards for rates of public employee compensation are set nationally. In fact, it has been suggested that higher wages and salaries for market personnel is a step which could lead to improved market efficiency.[1] A more general concern, and one that seems to have been expressed in a number of market studies, is that employment levels may be too high and that market employees are not put to effective use.[2] Both questions ultimately lead us to the difficult problem of the productivity of market employees, and of the efficiency of market operations.

Employee Compensation Rates. An examination of the rates of employee compensation (Table VII-6) reveals a consistent pattern. Compensation rates are higher in the cities and larger municipalities and lower in smaller municipalities. In part, these differences reflect the fact that compensation rates are set in relation to the type and class of the governmental unit; but a more important reason for the variation in compensation rates is the composition of employment. In the cities and larger municipalities, although located within the treasurer's office, markets are

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[1] Orlando R. Garcia, Market Administration Study, Goa, Camarines Sur, study undertaken in cooperation with the Department of Local Government and Community Development and the Local Counterpart Committee of the Municipality of Goa, Camarines Sur, February 1975.

[2] Ibid.

TABLE VII-6

NUMBER OF MARKET WORKERS, PERSONAL SERVICE EXPENDITURE PER WORKER, REVENUE PER WORKER AND PRODUCTIVITY INDEX, SELECTED AREAS: 1979

	Number of Workers	Personal Service Expenditure Per Worker	Market Revenue Per Worker	Productivity Index
Barotac Nuevo	16	₱ 2,325	₱17,275	172.75
Dumangas	10	3,590	9,170	117.56
Iloilo City	99	7,091	18,896	n.a.
Miagao	8	2,800	14,012	452.00
Oton	n.a.	n.a.	n.a.	n.a.
Passi	29	5,700	10,769	60.84
Tigbauan	n.a.	n.a.	n.a.	n.a.
Legaspi City	23	7,152	26,400	713.52
Tabaco	28	6,336	20,475	602.23
Gubat	11	4,927	23,682	174.13
Sorsogon	18	6,639	14,244	95.60

n.a. = Not available.

SOURCE: Case Study survey data.

supervised by a separate administration which is basically self-contained. In these cases, the market plantilla includes administrative positions of higher salary grades, e.g., market master, higher level staff positions, e.g., senior level collectors, as well as a number of skilled clerical positions, e.g., bookkeepers and accountants. In the smaller areas, market administration is a function of the treasurer who, along with his staff, discharges the supervision and clerical duties of the market operation. As a result, in smaller markets, staff listed on the plantilla of the treasurer's office perform many of the administrative and support tasks necessary for the operation of a market, while the market plantilla consists primarily of staff positions (e.g., collectors, cleaners) that are of the lower salary grades.

Thus, the composition of market plantillas provides the explanation for a large part of the variation in average compensation levels. In addition, there is the problem that reported compositions of market employment may be quite badly flawed and comparisons may be misleading. In part because of this data problem, we do not directly consider the compensation issue any further.

Employee Effectiveness. A frequent practice is to gauge the effectiveness of the market plantilla in terms of market revenues per employee. This is a very rough measure since the ratio may vary because some jurisdictions charge higher market fees because of a more efficient utilization of the work force, or because of scale economies, i.e., a work force is inherently more productive in larger markets. The last two issues, management efficiency and scale economies are the ones on which we want to focus here.

In general, revenues per employee are low in the smaller markets and higher in the larger markets (see Table VII-6). On a weekly basis, market revenues per employee range around an amount of roughly ₱330 (as in the case of Barotac Nuevo and Sorsogon) to ₱544 in Legaspi to about ₱200 in Passi and Dumangas. On average, the amounts are surprisingly low. However, when compared with the rates of employee compensation, the revenue ratios do not appear so low. In fact, revenues per employee in most cases are two, three or four times larger than per employee personal service costs. If anything, these differences would seem to imply that expenditures on market personnel are monies well spent.

Be that as it may, there remains the possibility that some markets operate more efficiently than others, that fewer employees may be required to perform a given amount of work. This is a particularly difficult proposition to evaluate because there is no flawless way of separating the effects of market charges from the effects of employee efficiency on revenue productivity. However, by dividing market revenues per employee by average stall fees,[1] it is possible to construct a *productivity index* which identifies employee productivity in a more or less standardized form (Table VII-6). That is, the index gives a rough approximation of the number of employees required to earn a fixed amount of revenues in a standardized market size. A low index, therefore, indicates low productivity and a high index indicates high productivity.[2]

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[1] The productivity index is calculated from revenue data reported in Table VII-6 and stall fees reported in Table VII-4.

[2] As analysts, we would feel more comfortable substituting the terms "relative understaffing and overstaffing" for high and low productivity.

Limitations notwithstanding,[1] the distribution of this index suggests a separation of these case study areas into two groups, one which is characterized by relatively high productivity and the other by relatively low productivity. In the former group are areas with relatively large market plantillas, Iloilo City, Legaspi City, and Tabaco. The areas in which the productivity indexes are low are those with the smaller market plantillas, Barotac Nuevo, Dumangas, Gubat, and Sorsogon.

Economies of Scale. The productivity indexes in Table VII-6 enable us to roughly group jurisdictions as "high" vs. "low". Between these groups, the difference in the indexes is quite large and would suggest the possibility that the number of employees required to operate markets increases less than in proportion to the volume of market activities. That is to say, there may be scale economies to be realized in the operation of public markets. Areas with a population of less than 40,000, Barotac Nuevo, Dumangas, and Gubat, all score low on the productivity indexes while higher productivity indexes are associated with the larger areas, Legaspi City, Tabaco, Miagao and Passi. The one exception to this pattern is Sorsogon's low productivity which can be traced to the interruption of its market activities by the major renovation of its facilities.[2]

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[1] The most important problems are: (a) that a high productivity index may also be due to higher non-stall fee revenues, hence, the relative size of the index is less due to the number of stalls per employee, and (b) stalls may be of different sizes. The latter should be adjusted for in the fee.

[2] It could be argued that because the productivity index is based on plantilla assignments, it may lead to an understatement of employee productivity in the smaller markets. While this cannot be denied it is unlikely to alter the conclusion stated previously, for two reasons. The first is the "understaffing" of administrative positions which makes the indexes higher than they should be. The second is that market plantillas would have to overstate actual work requirements in small markets by three or four times before the productivity differences became sufficiently small to negate the earlier mentioned conclusion about scale economies.

Though we certainly recognize the problems of working with such a small sample size, we might stretch the analysis here to ask the threshold size for an efficient market undertaking. These data would suggest a hypothesis that the critical market size for the realization of scale economies would be one necessary to service a population of roughly 40,000. Obviously, the issue calls for a great deal more research.

The hypothesis that there are scale economies, or at least a threshold size for an efficient market undertaking, is sensible on a priori grounds. The point is simply that small municipalities have markets that are too small to make full use of some employees' time but are large enough to require a permanent staff. Take the case of clerical, record-keeping and administrative duties. While such tasks are necessary for market operations they require much less than the fulltime efforts of a clerk, bookkeeper, and market master in smaller markets. A similar problem emerges for the day-to-day market operation tasks, e.g., fee collecting, cleaning, maintenance. Bigger markets simply require fewer collectors, janitors, etc. per unit of volume.

Another possible explanation for scale economies is better organization and management in larger municipalities. This seems unlikely. In larger areas, the market plantillas tend to include the management and clerical staff involved in market administration duties while in smaller areas these employees are usually assigned to the staff of the treasurer's office. This understates market employment in smaller jurisdictions and therefore overstates their productivity index. The scale economies conclusions from Table VII-6 would, if anything, be reinforced by this consideration.

These considerations lead to the tentative conclusion that scale economies in market operations may exist and they may be the result of something more than the administrative and management improvements which may be facilitated by larger operations. This is to say, the higher levels of productivity and the attendent lower employment requirements which characterize markets in larger areas must be due to the technological efficiencies which follow from the larger scale of operations.

Accounting Issues. The measurement of current expenditures for markets is complicated, especially in smaller areas. The problem has to do with the plantilla assignment of market workers. In smaller areas, administrative duties may be performed by employees who perform similar activities (e.g., accounting) for the treasurer's office. If the time of these employees is assigned fully to the treasurer's office, the market plantilla will understate the actual number of market employees. It follows that current expenditures will also be understated.[1]

A related problem likely results in an overstatement of expenditures. Tasks such as fee collecting, cleaning and maintenance are more specifically related to market operations and are more likely performed by staff assigned to the market plantilla. While the rush of activity during market days requires a substantial number of employees to collect entrance and occupancy fees, there are but one or at most two market days per week. On other days, the level of market activities is substantially less, requiring less effort from market collectors, cleaners, etc. It would indeed be surprising to

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[1] To be sure such an arrangement may be quite efficient since these duties are not very time-consuming and can easily be handled by those providing similar services for the local government.

find that market employees were equally active on market and non-market days. It is more likely, and indeed our case studies confirm the fact, that in smaller areas the market plantilla assignment of collectors and the like is designed to accommodate the peak levels of activity that occur on market days but some market employees undertake other general government tasks on non-market days. Because these employees are attributed fully to markets, an overstatement of market staffing occurs.

To the extent that employees spend their time performing services not related to the market, the cost of their services should not be attributed to the cost of market operations. A more appropriate accounting system would charge the wage, salary and other costs associated with employees listed on the market plantilla against the market, and against other appropriate accounts, in proportion to time spent on market and other activities. Similarly, to the extent that employees of other parts of the local government spend time on market related tasks, their costs should be assigned to the market account. Herein lies a major problem with treating the market operation in smaller areas as an enterprise rather than as a part of general government. These accounting reforms would strain the technical capacities and workloads of the treasurer's office in many of the smaller municipalities.

Alternatively, in larger areas such as Iloilo City, markets and market activities are substantially larger than in the smaller municipalities. Markets in these areas are more self-contained and are less likely to rely on employees of other parts of the local government for administration and

support services. Moreover, larger urban communities oftentimes have multiple market days and shopping tends to be more regular. As a result, they do not experience the large difference in activities between market and non-market days that occurs in smaller communities. Thus, the use of the market workforce in the larger areas is more regular and it is much less likely that market workers are involved with tasks not directly related to the markets. As a result, in areas with large markets--e.g., Iloilo City, Tabaco, and Legaspi City--employment practices and the recording of costs more accurately reflect work assignments. Because of this, separate accounts for markets are more feasible in larger areas.

A criterion for managing and monitoring the operations of an enterprise and for making appropriate pricing decisions is that there be a separate enterprise account which reports only and all costs associated with the operation. This suggests that the possibility of operating and accounting for markets as a separate enterprise is realistic only in larger areas. In the smaller areas, market activities are not of a magnitude to enable the kind of formal separation from general government that is necessary.

As was discussed in the previous Chapter, appropriate budgeting and economic efficiency are among the criteria relevant to public enterprise activity. On these grounds it would appear that serious consideration of the operation of public markets as a separate public enterprise activity should be limited to larger areas. In smaller areas, market operations should continue in much the same manner as in the past, i.e., as a service responsibility of municipal governments which is financed partially by benefit charges.

Capital Expenditures

The second major component of market expenditures is capital outlays. The problem with comparing capital expenditures across jurisdictions is that they are "lumpy". That is, they are large in years of construction and small at other times. Some of the areas surveyed in 1979 were involved in the construction or major renovation of market facilities (Table VII-1) and thus their reported capital expenditures are higher than might normally be the case. This, of course, will give a distorted picture of annual capital costs and profitability. From an analytical point of view, we are interested in measuring capital costs as the use or depletion of resources which result from market operations during a given year. Moreover, annual capital outlays as reported in market accounts do not provide a measure of the opportunity cost of capital investments, i.e., the amounts of revenues which would be available for other uses if financial resources were not tied up in market facilities.[1] These values are related to the annual costs of "using up" the market facilities. This problem leads us to develop a method of estimating annual capital costs.

Capital Costs and Capital Outlays. The estimation of capital consumption is an intricate and difficult task which extends well beyond our immediate concern. However, it is possible to obtain a rough indication of the variations in annual capital costs among these jurisdictions. To determine annual capital costs, we have made use of estimates of the book values of market structures and a set of assumptions about depreciation

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[1] This issue is treated at much greater length in Chapter VIII.

rates. The data in Table VII-7 contrast reported capital expenditures with estimates of the annual amounts by which the book value of the market structure depreciates, assuming a twenty-year useful life, and an interest rate of 14 percent. That is, we have estimated capital cost as the annual amount of money that would be required to repay a loan in the amount of the book value of the market structure at the indicated terms. These are probably quite low estimates of capital cost, for two reasons: First, our assumed borrowing rate of 14 percent is quite low. Second, the loan amounts required are based on teh book value of existing structures and, as such, represent the original cost of construction rather than current replacement costs.

Given the concern with the extent to which public markets recover costs, accurate estimation of capital costs is essential. Our calculations, conservative as they are, might be used to indicate the importance of capital costs in market operations. To obtain such a measure we divide our estimate of capital costs by the sum of the operating costs and estimated capital costs. This yields a measure of the capital share of the total costs of market operations, which may be compared with the ratio of capital expenditures actually reported in the government accounts (Table VII-8). Note first that the share of capital expenditures as reported in local government budgets is, with only three exceptions (Iloilo City, Passi, and Sorsogon), lower than our estimate of capital share of market costs. The implication is that generally local government accounts understate the importance of capital as a determinant of the costs of local markets. Note too, that when measured in terms of local government budget

TABLE VII-7

ESTIMATED BOOK VALUE OF MARKET STRUCTURES, CAPITAL OUTLAY AND ESTIMATED CAPITAL COSTS, SELECTED AREAS: 1979
(in thousands of pesos)

Local Jurisdiction	Estimated Book Value of Market Structures	Capital Outlay	Annual Capital Cost
Barotac Nuevo	469	79.5	70.8
Dumangas	124	6.7	18.7
Iloilo City	2899	1021.4	588.7
Miagao	294[a]	0.9	44.4
Oton	162	0.0	24.4
Passi	243	135.9	36.7
Tigbauan	475	53.1	71.7
Legaspi City	n.a.	50.6	---
Tabaco	1255[b]	1.6	189.5
Gubat	800[c]	3.0	120.8
Sorsogon	1580[d]	1531.8	238.6

n.a. = Not available

[a]Computed from the Commission on Audit Financial Report, 1978, unadjusted and undepreciated.

[b]Based on the Government Service Insurance System loan in 1965.

[c]Based on the Development Bank of the Philippines loan of ₱800,000 for market construction and improvement.

[d]Major reconstruction valued at ₱1,004 million was done in 1979.

SOURCES: Columns (1) and (2), unless otherwise noted are from the Case Study survey data. Capital outlays are those capital expenditures reported in the market accounts. Estimated capital costs are calculated as the annual amortization payment required to pay off a 14 percent, 20 year loan in the amount of the book value of the market structure.

TABLE VII-8

RATIO OF CAPITAL EXPENDITURES TO TOTAL EXPENDITURES, AS REPORTED IN LOCAL GOVERNMENT BUDGETS AND AS ESTIMATED: 1979

Local Jurisdiction	Budget Reports	Estimated
Barotac Nuevo	25.1	33.1
Dumangas	3.1	8.3
Iloilo City	45.7	32.6
Miagao	.3	55.5
Oton	0	25.3
Passi	36.3	13.3
Tigbauan	50.4	57.8
Legaspi City	12.5	--
Tabaco	.7	45.1
Gubat	.3	55.9
Sorsogon	89.8	57.9

SOURCE: Tables VII-5 and VII-7.

data, markets in most areas (seven) do not appear to be capital intensive (i.e., capital outlays account for less than 25 percent of total expenditures). However, when measured in terms of annual capital costs, the capital share would appear to exceed 40 percent. These considerations lead to the corclusion that actual capital costs are probably higher than usually thought and that markets are probably more capital intensive than has been generally assumed.

One consequence of underestimating capital costs and therefore overestimating profitability warrants special mention. Central Government regulations limit the profits of "utility" services to an amount equal to 10 percent of net investment. Surplus in excess of that amount is to be plowed back into the service either for price reductions or for the improvement of the facility. If markets are governed by this regulation, an interesting situation could arise. The 'excess' profits--resulting from improper cost measurement--could put pressure on local officials to maintain market charges and fees at levels which are already too low. Instead of stimulating cost recovery by permitting rate increases, this regulation may well add to the deficit.

It might also be noted that as the cost of constructing or improving markets tends to be paid during the relatively short period in which construction actually takes place, costs reported in a market's accounts will be high and profits low during the construction period. It appears that this is the reason for the high capital outlay and apparent low profitability in the four areas (Barotac Nuevo, Iloilo City, Passi, and Sorsogon)

when major market investments have been underway. Once construction is completed and construction costs are paid, capital outlays will fall and reported profits will be higher. Thus, it would be expected that those markets which are currently making large capital outlays, as they cease to do, will find their reported profits and profit rates increasing. Thus, they too may eventually be subject to pressures to maintain market fees and rates at low levels.

Measuring Capital Costs. The above considerations shed some light on the shortcomings of current procedures for measuring capital costs. As noted above, a more appropriate measure of the cost of using capital is some estimate of the value of resources which are used up by the operation of the market. We have suggested that one approach is to measure the cost of replacing the market structure, an approach which is akin to the general accounting convention of establishing depreciation and investment reserve accounts.

This approach, though it may require some rather crude assumptions, clearly identifies the determinants of what investing in a market may cost a local government. The initial cost is, of course, the outlay required to build a facility. Certainly the larger and more elaborate the building or the improvements attached to it, the greater the capital costs. Construction expenditures, however, do not give a full measure of capital costs, for the very act of tying up resources in a structure means that the local government must forego the opportunities to use them for other purposes. That is to say, by tying up resources in a market, the local government's

ability to spend on other activities or to reduce tax loads is reduced, not just during the period of construction but in the future. One way to see this drain is to consider the implications of funding the construction by means of credit financing. In this case, the recurrent amortization payments reduce the amounts of revenues available for other uses.

The extent to which amortization payments are a drain on local tax resources depends on the length of the amortization periods and the rate of interest charged, as well as on the amount borrowed. We have constructed different estimates of capital costs based on different loan assumptions. In one set, we have assumed an interest rate of 14 percent and three repayment periods--10, 15, and 20 years. In the second set, we have assumed an interest rate of 18 percent and the same repayment periods (Table VII-9). Thus, there are six different estimates of capital cost.

One interesting result of these calculations is the sensitivity of annual payments to the maturity period and to the interest rate. Lower interest rates and longer repayment periods reduce the annual repayment costs. In the case of Sorsogon, for example, at an 18 percent interest rate for a 15 year period, annual capital costs are estimated at ₱310.3 thousand. Alternatively, at a lower interest rate, 14 percent, for a period which more closely approximates the life span of a market building, 20 years, the capital cost is ₱238.6 thousand. The difference, ₱71.7 thousand, is a rather substantial amount and shows the potential impact on local treasuries of alternative capital costs. Even at relatively favorable terms (14 percent and 20 years), amortization payments can amount to as much as 50 percent of market expenditures. Given this finding one might be tempted to question the advisability of policies which are designed to

TABLE VII-9

AMORTIZATION PAYMENT REQUIRED TO REPRODUCE BOOK VALUE
OF CURRENT MARKET STRUCTURE, SELECTED LOCAL AREAS
(in thousands of pesos)

Local Jurisdiction	Rate of Interest = 14%			Rate of Interest = 18%		
	n = 10	n = 15	n = 20	n = 10	n = 15	n = 20
Barotac Nuevo	89.9	76.4	70.8	104.4	92.1	87.6
Dumangas	23.7	20.2	18.7	27.6	24.4	23.2
Iloilo City	747.5	634.8	588.7	867.6	765.8	728.4
Miagao	56.4	47.9	44.4	65.4	57.7	54.9
Oton	31.0	26.4	24.4	36.0	31.8	30.3
Passi	46.6	39.6	36.7	54.1	47.7	45.4
Tigbauan	9[illegible].1	77.3	71.7	105.7	93.3	88.7
Legaspi City	---	---	---	---	---	---
Tabaco	240.6	204.3	189.5	279.2	246.5	234.4
Gubat	153.4	130.2	120.8	178.0	157.1	149.4
Sorsogon	302.9	257.2	238.6	351.6	310.3	295.2

Note: n is the number of annuity periods (years). The values of market structures considered in the computation are from Column (2) of Table VII-7.

SOURCE: Computed by authors.

stimulate local government investments in public markets unless pricing policies are to be adjusted or further subsidies provided.

The Profitability of Markets

Can markets be operated by local governments on a self-financing basis? If so, under what conditions, with what policy changes from present practice, and for what types of local governments? With the cost and revenue analyses presented above as background, we may address these questions for the eleven jurisdictions included in our survey.

On first blush it would appear that as a general proposition the operation of markets as profit generating or even as cost recovering activities is doubtful (Table VII-10). When profits are calculated from the revenues and cost data reported in the local budgets, only five of the areas surveyed report current revenues in excess of current operating expenditures and capital outlays, while the remaining six show a deficit. While these data would seem to imply that the operations of markets are about as likely to require a subsidy as to produce a surplus, such a conclusion may be misleading. There are at least two problems. The first if defining "profitability" or cost recovery. Should market charges be adequate to cover all current and capital costs, or should capital cost be viewed as an appropriate subsidy from the local government? The second is the bothersome problem of measuring capital costs.

TABLE VII-10

REPORTED OVERALL SURPLUS, AND SURPLUS ON CURRENT ACCOUNTS OF MARKETS, SELECTED LOCAL GOVERNMENTS: 1979
(in thousands of pesos)

Local Jurisdiction	Reported Surplus[a]	Surplus on Current Account[b]
Barotac Nuevo	53.7	133.3
Dumangas	-121.1	-114.4
Iloilo City	-204.4	817.0
Miagao	75.6	76.5
Oton	-22.6	-22.6
Passi	-62.1	73.8
Tigbauan	-19.6	33.5
Legaspi City	245.1	295.7
Tabaco	340.7	342.3
Gubat	169.3	172.3
Sorsogon	-1395.7	136.1

[a]Revenues from market operations less total (current and capital) expenditures.

[b]Revenues from market operations less operating expenditures.

SOURCE: Revenues from market operations is from Case Study data. Total expenditures and total expenditures on current operations are from Table VII-5.

Current Account Position

The first step in measuring cost recovery is to consider the relation between market revenues and the cost associated with the operation of markets. The question here is whether market revenues are sufficient to cover costs of operation. If the circumstances are such that they cannot, then continued operation will require an operating subsidy from general revenues--an actual cash drain on general revenues. If operating costs are covered, then there exists the prospect that at least a part of capital costs may be covered.

An analysis of the current account position shows that nine of the eleven markets studied generated revenues which exceeded current operating expenditures (Table VII-10). Generally, the current account surpluses are quite large. This finding is a bit of a surprise for some of the smaller areas, in light of the findings above concerning possible scale economies and low employee productivity. Indeed, given current levels of rental rates and stall occupancy fees, most markets would continue to show a current account surplus even if current expenditures were to be as much as 50 to 100 percent more than those reported.

Something might be learned by considering the reasons for operating deficits in Oton and Dumangas. Oton imposes relatively high market fees but has a relatively low stall occupancy rate (Table VII-4). The problem is pretty clearly a deficient volume of market activity, probably caused more by proximity to larger markets in Iloilo City than by high fees. If the basic problem is proximity, and if the Oton market is simply not competitive, revisions in the fee structure will not likely bring an operating surplus.

The opposite situation exists in Dumangas--the occupancy rate is high but market fees are low. It would be tempting to take this as an indication that a revision of the fee structure could produce enough new revenues to cover the operating deficit. However, the deficit is so large that fees would have to be more than doubled for the current volume of activities to produce revenues sufficient to cover costs. Here too, it would appear that volume or lack of it is the underlying cause of poor revenue performance.

Two conclusions emerge from the above considerations. The first is that markets generally have the potential to cover operating costs and at least a portion of capital costs. General operating subsidies would not seem warranted.[1] The second is that in areas which do not cover operating costs, the problem tends to lie with inadequate volume and probably more with proximity to larger markets than with a fee structure that is out of line.

Overall Surplus/Deficit

What portion of capital costs can markets be expected to recover? We might answer this question from the sample of the jurisdictions under study here by comparing the current account surplus in Table VII-10 with estimated annual capital costs (Table VII-9). The results, for a low and high capital cost scenario, are described in columns (1) and (2) of Table VII-11. For example, the current account surplus of ₱133.3 thousand in Barotac Nuevo (Table VII-10) is larger than any of our estimates of capital costs (Table VII-9). Thus, this market generated revenues sufficient to cover its current operating and capital cost with ₱62.5 thousand left over under our low cost scenario. The surplus amounts to a return equivalent of 13.3 percent of the book value of the original investment, and a little more than

[1] Such subsidies can be a substantial drain on general revenues. We estimate here that the Dumangas deficit is equivalent to about 15 percent of general revenues.

TABLE VII-11

PROFITABILITY OF MARKETS UNDER SELECTED ASSUMPTIONS ABOUT INTEREST RATE AND ASSET LIFE

	Overall Surplus (in thousands)		Percent Return on Book Value of Asset	
	Low Capital Cost[a]	High Capital Cost[b]	Low Capital Cost	High Capital Cost
Barotac Nuevo	62.5	41.2	13.3	8.8
Dumangas	-133.1	-138.8	-107.3	-111.9
Iloilo City	228.3	51.2	7.9	1.8
Miagao	32.1	18.8	10.9	6.4
Oton	-47.0	-54.4	-29.0	-33.6
Passi	37.1	26.1	15.2	10.7
Tigbauan	-38.2	-59.8	-8.0	-12.6
Tabaco	152.8	95.8	12.2	7.6
Gubat	51.5	15.2	6.4	1.9
Sorsogon	-102.5	-174.2	-6.5	-11.0

[a]Interest rate of 14 percent and loan maturity of 20 years.

[b]Interest rate of 18 percent and loan maturity of 15 years.

SOURCE: Tables VII-7, 9, 10.

7 percent of total current revenues of the municipality.[1] That is to say, it is a profitable undertaking.

More generally, the results of these comparisons are less encouraging. They indicate that even under the better of the terms--20 year loans at a 14 percent interest rate--only six of the ten market operations could show an overall surplus. Two of the other four where comparisons are possible, Dumangas and Oton, did not generate revenues sufficient to cover even operating costs and thus required an operating subsidy. Two others, Tigbauan and Sorsogon, did generate a current account surplus, but it was far from adequate to cover amortization payments, even under the low capital cost assumption. These two areas may be particular cases as their revenues were below "normal" during this period because they were involved in market renovation and expansion.[2]

Among those markets which appear to be profitable, there are some with relatively high market fee rates (Barotac Nuevo, Passi and Gubat) and some whose market rates are low (Miagao and Tabaco). Some are in large jurisdictions (Iloilo City and Tabaco) and others are in smaller municipalities, and employee productivity is high in some (Miagao, Tabaco and Gubat) and is low in others (Barotac Nuevo and Passi). In sum, it is difficult to find an explanation for variations in profitability. However, there are two elements common to at least some of the profitable undertakings. One is their proximity to smaller markets, a consideration which would seem to suggest that

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[1] Based on 1978 revenues as reported in Table VII-2.

[2] Construction activities in Sorsogon impeded the market's operation and no doubt reduced revenues. In Tigbauan, their program of stall rental moratoriums on those stalls constructed by private parties also lowered revenues and will continue to do so as long as the moratorium is in effect.

larger markets capture the volume necessary for profitability by attracting clientele from areas with small markets. The other is the fact that four of the six have enacted a new fee schedule in 1979. This raises the question of whether the profitability of markets might be generally enhanced by higher fees. In the case of markets which are not profitable, we would have to conclude in the negative because the fee increases would have to be very large and, if anything, would exacerbate the volume problem. The case with those markets which are profitable may be different. As was argued earlier a general fee increase, even as large as 10 percent would not likely have a noticeable effect on the prices charged by market vendors or on their incomes. Moreover, price increases of this magnitude are not likely to drive vendors to competing, smaller markets. Thus, a fee increase would probably not have much of an effect on market volumes hence would be translated into greater surplus. Profitable markets might be made even more profitable. Whether increased profitability would be desirable is a policy issue not to be resolved here. What it boils down to is whether the government sees markets as a method for mobilizing additional resources, or as an institution whose primary function is to provide a public service.

The rates of profitability, the overall surplus as a percent of book value of the asset, varies too widely to suggest an "average" performance (see Table VII-11). However, these comparisons do show that the rate of profitability is quite sensitive to variations in annual capital costs. This suggests the importance of capital subsidies, such as are proposed in Chapter X, to stimulating "profitable" public enterprise investments.

Summary and Policy Implications

The question raised in this chapter is whether public markets can be operated by local governments as fully self-financing public enterprises. Our answer has to be very tentative because our sample is so small, but it would appear that most market operations can cover variable costs and many can also cover capital costs, but without capital subsidies, full cost recovery would not appear likely for many. The critical difference would appear to be size of the market with those smaller markets that lie in the commuting range of larger markets being particularly disadvantaged.

Public policy cannot be formulated on a basis of a few case studies, and we aren't willing to offer concrete recommendations in this area. A more comprehensive analysis is essential. On the other hand, some fundamental problems and directions for reform programs did clearly emerge in the course of this case study. In addition to the "small area" problem mentioned above, we would classify these as accounting and measurement needs, revenue policy, cost and volume considerations and credit policy.

The Small Area Problem

In some cases, small public markets will not make it as financially viable public enterprises. Their operating costs are relatively high because of the diseconomies of small scale operations; their pricing policies may be constrained by the possibility that shoppers and vendors may shift to nearby larger markets; their volume is limited by their own small population and their inability to draw substantially from their hinterland population; and their ability to make use of credit financing is limited. Even

their capacity to measure market profitability is sorely limited (see below).

This line of reasoning leads toward a conclusion that the enterprise form is not suitable for small municipalities. The question arises then, how small is too small? A much more inclusive sample than this will be necessary to provide an answer. It is another of those issues that needs more research.

Measuring and Accounting for Market Activities

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. Before one can pass judgement on the merits of subsidies or pricing adjustments, he must understand the extent to which true costs are being covered. The existing accounting system simply doesn't provide this information. The first problem arises because of what may be considered to be the special circumstances of small governments. The second is a more fundamental problem of accounting practice in the Philippines (and just about everywhere else), the failure to properly measure capital costs.

The Small Area Problem. Accounting for market expenditures in small areas is problematic because the levels of market activities are such as to 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 workforce is assigned other tasks on non-market days. In addition, in small markets, the level of activities are not large enough to warrant

a full time administrative staff. Thus, 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 which actually reflects the uses of an employee's time. If the cost of operation cannot be measured, then of course cost recovery cannot be approximated. In effect, any monitoring of the financial success of small markets may be ruled out.

By contrast, in larger jurisdictions where the volume of market activities is larger, the market plantilla, as well as the market administration, tend to be fully occupied in market activities. This makes possible the identification of the costs of administering markets and thus facilitates enterprise accounting. The problem, therefore, would seem to lie with the smaller jurisdictions. It is not only the cost of the accounting but the strong interdependency between the market undertaking and other government activities. The public market may be much more a general government function in smaller than larger jurisdictions.

Measuring Capital Costs. Current practice, for governments of all sizes, is to report capital expenditures on a cash flow basis, i.e., budgets record the annual costs of construction, repair and renovation. Since 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 which, when accumulated during the life time 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. This is but one approach to measuring capital costs, and there are others. We recommend that the Central Government move to adopt a standard practice in accounting for the annual capital costs of local government market facilities.

Revenue Policy. One important barrier to full cost recovery has to do with pricing policy, prices are set too low and revised too infrequently. This practice is partly due to a concern with the cost of foodstuff 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 by more frequent increases in market rental rates and fees, and that this could be done with little effect on the prices of goods sold in the market. Moreover, we see no reason why low income persons would suffer disproportionately from such increases. We recommend that local governments be encouraged to increase market fees and to make regular fee revisions in line with rising costs of operation.

Economies of Scale. The capital intensive nature of public markets works against smaller markets by keeping their per capita (and presumably per unit) costs high, i.e., there appear to be economies of scale in the operation of public markets. Our very limited and very crude analysis has indicated that these efficiencies become effective when markets service a population of around 40,000. This is not to say that municipalities with

populations above this level 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.

Other Barriers to Profitability. The key to the profitability of public markets seems to be volume. Our findings have suggested 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 which link urban areas with their rural hinterland may 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.

Credit Policy. In establishing a credit policy for public markets, what might be reasonable expectations? Our limited 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. What might be done?

First, we recommend that markets should be permitted and encouraged to increase stall rental fees, and to institute a program of regular revisions. Second, capital subsidies should be provided in the form of lower interest costs than the present 14 to 18 percent. Third, loan maturities should be extended to better match the long life of market facilities. Both of the latter possibilities are taken up in Chapter X below.

CHAPTER VIII

THE SUCCESS WITH LOCAL GOVERNMENT BUSINESS ENTERPRISES: THE CASE OF BULACAN

The two preceding chapters have shown that legal authority exists to establish local government public enterprises and to operate them with some autonomy. The evidence also suggests that such undertakings can, in some instances, generate income adequate to cover costs. Thus far, our focus has been on a more traditional form of public enterprises, markets, which also serve a social purpose and for which a partial subsidy might be justified. We now turn attention to the feasibility of commercial enterprises, i.e., local government businesses. The question to be answered is whether such businesses can be operated at a financial profit. If the answer is affirmative, these profits may be viewed as a tax, i.e., as a method for mobilizing additional resources for governmental purposes. If local government businesses do not cover costs, and if they do not serve important social purposes, they are not an appropriate activity for local governments. This Chapter is an analysis of the financial success with four such undertakings.

Though local government commercial ventures do exist in the Philippines, even a summary data are scarce. We have chosen to concentrate on a case study of the financial success of four commercial enterprises operated by the Provincial Government of Bulacan: Hiyas ng Bulakan Convention Center (HBCC), Hiyas Galeria, Hiyas Cafetorium, and the Hiyas Agro-Commodities Center (HACC). The first three enterprises can be considered non-traditional

since they are not usually undertaken by local governments in the Philippines. The fourth, the provincial slaughterhouse (a major component of the Hiyas Agro-Commodities Center) is a traditional local government undertaking but in Bulacan it is managed in a non-traditional way. Indeed, all of these enterprises can be characterized by their unusual management, and/or operational arrangements.

We seek to accomplish three objectives with these case studies. The first is to deal with the question of whether commercial enterprises can be profitably undertaken by local governments. The second is to show that there are alternative ways of operating and financing public enterprise activities. The third is to assess the transferability of the Bulacan experience, or at least to determine whether there are important lessons to be learned.

Case studies have the advantage of allowing one to study the detail of a particular operation--some of the generalizations that necessarily come from cross-section work can be avoided. On the other hand, case studies have the weakness that their results cannot easily be generalized. In the case of Bulacan, one may suspect that it is too wealthy a province to permit much generalization, i.e., the Bulacan experience may only work where fiscal resources are substantial and where there is a proximity to a large population. We explore this important caveat below by examining Bulacan's economic and demographic characteristics and its fiscal performance during the last three years.

The remainder of this Chapter is an analysis of the objectives and successes of the Bulacan enterprises. We have also included a rather lengthy discussion of the method used to evaluate these commercial enterprises, because of the complexity of the evaluation issue. As we shall see, whether or not an undertaking is judged profitable depends very much on how we ask the question. The discussion is labored at some points, and the reader wishing to take the arguments on faith may skip to the case studies.

The Bulacan Setting

Considering the very low level of public enterprise activity in the Philippines, the magnitude and variety of Bulacan's undertakings are quite impressive. They are impressive not only in terms of the amount of internal funding that was generated to cover the capital cost of these projects, but also in terms of the pace at which the four enterprises were developed. In the aggregate, the construction and equipment costs involved were approximately ₱10.2 million--₱2.163 million for the Hiyas Agro-Commodities Center, ₱6.919 million for the Convention Center, and ₱1.158 million for the Hiyas Galeria and the Hiyas Cafetorium. These four enterprises were established within a span of four years: Hiyas Galeria in 1973, the Hiyas Cafetorium in 1975, the Hiyas ng Bulakan Convention Center in 1976, and finally the Hiyas Agro-Commodities Center in 1977.

Bulacan's close physical and economic ties to Metropolitan Manila and its strong fiscal condition are considerations that may limit the transferability of its enterprise experience. Linked via the North Diversion Road, its provincial capital, Malolos, is only about 45 kilometers or an hour of driving time from downtown Manila.

Demographic and Economic Structure

Bulacan has a population of 1.05 million, roughly 2.5 percent of the national population, a land area of 2,672 square kilometers and a population density of 313 persons per square kilometer (population for 1975). While its population density is much lower than that of Metropolitan Manila (7,814), it is much higher than the national average (140). Between 1970 and 1977, its population growth was at an annual rate of 4.66 percent, well above the national average of 2.7 and the Metropolitan Manila growth rate of 3.5 (Table VIII-1). A closer look at the demographic data, however, suggests that population density varies widely within the province. Malolos, the capital town, has a population density of 1,240 per square kilometer and there are densely populated areas located at the fringes of Metropolitan Manila, e.g., Obando (612 persons per square kilometer), Meycauayan (2,724) and Bocaue (1,141). While there is considerable variation among these border towns, they have in common a population density that is at least twice that of the province as a whole. This indicates that towns located at the fringes of Metropolitan Manila are attracting substantial numbers of commuter-residents.

In addition to the spillover effect, the very rapid population growth of Bulacan--higher than Metropolitan Manila's growth rate of 3.5 percent--can also be attributed to its fast growing manufacturing base. While it

TABLE VIII-1

SELECTED ECONOMIC-DEMOGRAPHIC CHARACTERISTICS OF
FOUR PHILIPPINE PROVINCES, METROPOLITAN MANILA, PHILIPPINES: 1975

Local Jurisdiction	Region	Per Capita Income	Per Household Income	Percent Of Urban Population	Population Growth Rate[e]	Population Density (Persons per sq. km.)
Albay	V[a]	₱ 830	₱ 5,132	12.0	1.58	286
Bulacan	III[b]	1,035	6,262	36.0	4.66	313
Iloilo City	VI[c]	995	5,947	25.8	2.37	247
Sorsogon	V[a]	980	5,900	17.2	---	---
Metropolitan Manila		2,125	11,244	100.0	3.5[f]	7,814
All Philippines		1,111	6,587	31.6	2.7[d]	140

[a]High poverty, high agricultural employment, high off-farm employment, moderate agricultural productivity. Source: National Economic and Development Authority, Regional Development: Issues and Strategies, Regional Planning Studies Series, 1 (Manila, 1978).

[b]Low poverty, low agricultural employment, high off-farm employment, high agricultural productivity.

[c]Low poverty, high agricultural employment, high off-farm employment, high agricultural productivity.

[d]Growth rate from 1970-77. Source: 1979 World Bank Atlas.

[e]Per annum during intercensal years.

[f]Population growth rate from 1970 to 1975. Growth rate from 1960 to 1970 is 4.9.

SOURCE: National Census and Statistics Office (NCSO), several issues of Special Release by the Office of the Executive Director, 1980.

is true that Bulacan is situated in a region which is traditionally agricultural--a region which the National Economic and Development Authority characterized as "low poverty, low agricultural employment, high off-farm employment, and high agricultural productivity"[1]--the number of large and small manufacturing establishments in Bulacan has grown in recent years at a rate considerably higher than the national average. The growth rate of large manufacturing firms in Bulacan during the period 1967 to 1972 is quite impressive: 49.5 percent compared to the national average of 12.7 percent. Equally impressive is the fact that while the population of Bulacan represents roughly 2.5 percent of total population, the province accounts for 6.5 percent of the country's large manufacturing establishments (Table VIII-2).

While Bulacan is comparatively less developed and urbanized than Metropolitan Manila, it is the most prosperous and urbanized among the four provinces we visited. In 1975 it had a per household income of ₱6,252, slightly lower than the national average of ₱6,587. The percentage of urban population to total population for Bulacan is 36.0, slightly above the national average of 31.6 (Table VIII-1).

The question at hand is whether this size, growth, and proximity to Manila creates a unique situation in Bulacan. In particular, does it offer a potential market for enterprise products that exists in few other places in the country? In the cases of the Convention Center and slaughterhouse, this "proximity effect" has created a somewhat unique situation.

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[1]National Economic and Development Authority, Regional Development: Issues and Strategies, Regional Planning Studies Series, 1 (Manila, 1978), p. 135.

TABLE VIII-2

LARGE AND SMALL MANUFACTURING ESTABLISHMENTS
IN SELECTED PHILIPPINE PROVINCES AND MANILA: 1972

Jurisdiction	Number of Establishments			Percent Distribution		Growth Rate 1967-72 (Percent)	
	Total	Large	Small	Large	Small	Large	Small
Albay	1,569	46	1,523	1.0	2.4	-12.5	52.8
Bulacan	2,072	290	1,782	6.5	2.8	49.5	55.9
Iloilo City	3,193	75	3,118	1.7	4.9	-21.9	31.5
Sorsogon	529	9	520	0.2	0.8	50.0	178.1
Manila	4,680	578	4,102	12.9	6.5	n.c.	n.c.
National Average[a]	924	57	866	---	---	12.2[b]	53.7[b]

[a]Total number of manufacturing firms, excluding those in Manila, divided by 68, the number of Philippine provinces included in the Census.

[b]Including Metropolitan Manila.

n.c.: Not comparable; the 1972 data exclude suburbs while the 1967 data include them.

SOURCE: National Census and Statistics Office, 1972 Census of Establishments, Vol. III (Manufacturing).

Fiscal Performance

If fiscal performance is graded according to how well a government lives within its means, the Province of Bulacan will get high marks. Total revenues have increased by about 12 percent per year and the provincial government has shown an unusual ability to accumulate a surplus. From 1976 to 1979, Bulacan accumulated an average surplus (gross fund balance at the end of fiscal year) of ₱1.3 million in its General Fund and ₱725 thousand in its Infrastructure Fund. For the combined General and Infrastructure Funds, balances at the end of the fiscal year have remained at about 5.2 percent of total revenue from 1977 to 1979 (Table VIII-3).

What accounts for the differences between Bulacan's fiscal performance and that of other provinces in the country? On the revenue side, one may note the marked differences in sources of financing (Table VIII-4). Bulacan relies on locally raised revenues for more than half (51.4 percent) of total revenues. Other provinces--Albay, Iloilo, and Sorsogon and, in fact, all Philippine provinces taken as a group--rely more heavily on intergovernmental grants than does Bulacan.

Income from enterprises accounts for only 5.7 percent of provincial revenues nationwide and only 5.1 and 8.1 percent in Albay and Sorsogon, respectively. On the other hand, for Bulacan and Iloilo, public enterprise income is considerably more important, i.e., at least one of every five pesos collected is due to some type of public enterprise activity.

TABLE VIII-3

GROSS FUND SURPLUS OF THE PROVINCIAL GOVERNMENT OF BULACAN
BY MAJOR FUNDS: 1977-79
(in thousands of pesos)

	1977		1978		1979	
Budget Item	General Fund	Infrastructure Fund	General Fund	Infrastructure Fund	General Fund	Infrastructure Fund
Gross Fund Balance at Beginning of Fiscal Year	1,360.3	1,291.9	1,258.0	449.3	1,029.4	185.3
Income	20,029.4	8,772.8	22,964.1	16,897.1	26,852.8	13,476.4
Total Funds Available for Expenditures	21,389.7	10,064.7	24,222.1	17,346.4	27,882.2	13,661.7
Expenditures	20,133.8	9,615.4	23,192.7	17,161.1	26,187.3	12,688.4
Gross Fund Balance at End of Fiscal Year	1,255.9	449.3	1,029.4	185.3	1,694.8	973.2

Average Gross Fund Surplus

	1976-79	1977-79
General Fund	1,335.1	1,326.7
Infrastructure Fund	724.9	535.9
Total	2,060.0	1,862.6

SOURCE: Data supplied by Ministry of Finance.

TABLE VIII-4

REVENUES OF SELECTED PROVINCIAL GOVERNMENTS, BY MAJOR SOURCE: 1977

Local Jurisdiction	Total Revenues[a]	Total Locally Raised Revenues[b]	Intergovernmental Grants[c]	Total Income From Business Operations
	Revenues (General Fund, thousands of pesos)			
Albay	6,830	1,248	4,312	347
Bulacan	17,765	9,131	6,676	3,897
Iloilo	13,117	5,194	7,732	3,050
Sorsogon	4,396	1,226	3,170	357
All Philippine Provinces	501,062	187,192	261,234	28,771
	Percent Distribution of Revenues			
Albay		18.2	63.1	5.1
Bulacan		51.4	37.6	21.9
Iloilo		39.6	58.9	23.2
Sorsogon		27.9	72.1	8.1
All Philippine Provinces		37.4	52.1	5.7
	Per Capita Revenue (in pesos)			
Albay	10.38	1.90	6.55	0.53
Bulacan	19.95	10.25	7.50	4.38
Iloilo	12.10	4.79	7.13	2.81
Sorsogon	9.89	2.76	7.13	0.80
All Philippine Provinces	15.02	5.61	7.83	0.86

[a] Includes own source revenues but excludes borrowing.

[b] Includes total local tax revenues, charges, capital revenue, and total income from business operations.

[c] Includes BIR Allotment and national aids.

SOURCES: Fiscal data: Commission on Audit, Report on Local Governments, 1977. Population: for the four provinces, from the National Census and Statistics Office, Special Releases (1980); the population for all provinces is from the COA Report, which is based on NCSO preliminary estimates. Population figures are for 1975.

Bulacan's per capita tax collections are high by comparison with the other three provinces surveyed and with the overall provincial average. This is true both in terms of locally raised taxes and income from business operations. Its per capita intergovernmental grant of ₱7.50 is less than the national average of ₱7.83, although it is slightly higher than the other three provinces in our sample.

Not surprisingly, the level of expenditures is closely related to the level of resources raised, i.e., Bulacan collects the highest tax per capita of the four provinces surveyed and its per capita expenditures are also the highest. In terms of the functional distribution of expenditures, the spending pattern of Bulacan is not markedly different. Bulacan allocates roughly one-third of total expenditures to each of the major functions: 36.5 percent for general government, 32.6 percent for public welfare and internal safety, and 30.8 percent for economic development. This closely approximates the average distribution of expenditures for all Philippine provinces (Table VIII-5).

In per capita terms, Bulacan spends far more than the three other provinces surveyed. Bulacan's per capita spending of ₱7.29 for public welfare and internal safety is considerably higher than that in Albay (₱1.54), Iloilo (₱4.45), and Sorsogon (₱3.40) (Table VIII-5). This, in all likelihood, is in response to the pressing problems usually associated with urbanization. Most impressive, however, is the high per capita amount and percent distribution allocated to economic development expenditures.[1]

[1] The trend in expenditures for economic development, however, must be interpreted with some care because: (1) economic development spending tends to be lumpy, i.e., characterized by abnormally large expenditures in single years, and (2) many economic development projects are financed out of the Infrastructure Fund. For example, while the Provincial Government of Albay spent ₱3.5 million for economic development out of the General Fund in 1977, its development spending was down to ₱370 thousand in 1979.

TABLE VIII-5

EXPENDITURES OF SELECTED PROVINCIAL GOVERNMENTS BY MAJOR FUNCTIONS, IN PER CAPITA TERMS AND AS A PERCENT OF TOTAL EXPENDITURES: 1977

Local Jurisdiction	Total[b]	General Government	Public Welfare and Internal Safety	Economic Development	Public Service
	Expenditures (in thousands of pesos)[a]				
Albay	6,501	2,003	1,014	3,484	0
Bulacan	19,903	7,269	6,488	6,121	24
Iloilo	11,753	4,355	4,824	2,574	0
Sorsogon	4,199	1,721	1,514	964	0
All Philippine Provinces	583,553	200,276	233,476	147,374	2,428
	Percent Distribution of Expenditures				
Albay		30.8	15.6	53.6	0.0
Bulacan		36.5	32.6	30.8	0.01
Iloilo		37.1	41.0	21.9	0.0
Sorsogon		41.0	36.0	23.0	0.0
All Philippine Provinces		34.3	40.0	25.2	0.04
	Per Capita Expenditures (in pesos)				
Albay	9.88	3.04	1.54	5.29	--
Bulacan	22.36	8.16	7.29	6.88	0.03
Iloilo	10.84	4.02	4.45	2.37	--
Sorsogon	9.44	3.87	3.40	2.17	--
All Philippine Provinces	17.54	6.01	7.00	4.41	0.07

[a]Includes expenditures from General Fund only.

[b]Excludes the 2 percent budgetary reserve.

SOURCE: See Table VIII-4.

Bulacan Enterprises: General Features

Before turning to the individual case study analyses, it is useful to review the similarities of these four non-traditional enterprises. There are five important facts to be noted about these undertakings.

First, the funds used for the construction of structures which house the enterprises were provided from accumulated budgetary surpluses. One can cite several reasons why funding projects out of budgetary surplus seems a reasonable approach for fiscally-able local governments. First, credit financing is not costless. Aside from the interest payments, costs are involved in the preparation of a formal feasibility study--a requirement not mandatory for internally funded projects.[1] In addition, loans from any of the several public financial institutions involve considerable bureaucratic delay, hence more costs in terms of time and effort. Moreover, some local government officials feel that the process of credit financing decreases local autonomy. The process of credit application leads not only to the lending institution's evaluation of the financial worthiness of the project and the local government, but also to a review and approval by a number of national government agencies--the Ministry of Finance, the Commission on Audit, the Ministry of Local Government and Community Development, and in some cases, the Ministry of Public Works, Ministry of Human Settlements, and the National Economic and Development Authority. Finally, a pay-as-you-go approach is in keeping with the conservative financial management bent of local government officials.[2]

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[1] Our interviews suggest that the costs involved in preparing a feasibility study, using an outside consulting firm, can be anywhere between 3 and 7 percent of the costs of the project.

[2] For a detailed discussion of the loan approval process, and other attitudinal reasons for local officials' preference for internal funding of capital projects, see Chapter IX.

Second, the managers of the enterprises, with the exception of Hiyas Galeria, are hired on a contractual basis. This arrangement was initiated because it was believed that government set salary limit of ₱800 per month was not sufficient to attract competent managers for the enterprises. Organizationally, the four enterprises have varying degrees of autonomy, ranging from an autonomously-run, operating-contract arrangement (Hiyas Cafetorium) to a departmentally-managed arrangement (Hiyas Galeria). All operate, however, under the umbrella of a management committee consisting of the governor, the provincial treasurer, the provincial assessor, and the superintendent of the Hiyas Complex.

Third, no formal financial feasibility studies were prepared prior to the undertaking of these enterprises. One possible exception is the HACC slaughterhouse where the physical plan was prepared by the National Meat Inspection Board. The absence of feasibility studies is not at all surprising since they are simply not mandatory for projects financed from internally raised funds.

Fourth, the net profits of the individual enterprises, with the exception of the Hiyas Cafetorium, revert to the provincial treasury. The case of the Cafetorium is not altogether different as the provincial government retains authority to determine the uses to which Cafetorium surpluses may be put.

Fifth, with the exception of slaughter fees imposed at the Hiyas Agro-Commodities Center, the prices charged at these Bulacan enterprises have not been submitted for formal review by the provincial board to the Ministry of Finance. This is a practice which would seem to be at variance with the stipulation of the Local Tax Code.

Performance Evaluation

Before presenting these four case studies, one may legitimately ask how is "performance" to be measured, i.e., how will we know if an undertaking has been successful? The answer is not unambiguous. It depends on whether one evaluates economic or financial profitability, whether a short- or long-run view is taken, and on the measurement of costs and benefits. These considerations are taken up below, perhaps in more detail than the policy-oriented reader needs.[1]

Financial versus Economic Profitability

There are two ways of evaluating the performance of these enterprises: financial profitability and economic profitability. Financial profitability is concerned with the present value of the stream of cash flows--revenues less current operating costs--over the lifetime of the project or enterprise, in relation to the initial capital outlay. The enterprise is deemed profitable if, at an appropriate discount rate, the present value of the enterprise's cash flow at market prices exceeds the initial capital outlay.[2]

In contrast, economic profitability is concerned with the value of all benefits attributable to the project in relation to the value of all costs (opportunities foregone) as a consequence of undertaking the project. In practice, economic profitability adjusts the cash flows by applying "shadow"

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[1]The reader may skip to page 20 without loss of continuity.

[2]The discounted present value of the stream of net cash flows, hereinafter referred to as discounted cash flow (DCF), is computed as follows:

$$DCF = \frac{R_1-C_1}{(1+r)^1} + \frac{R_2-C_2}{(1+r)^2} + \ldots + \frac{R_t-C_t}{(1+r)^t}$$

or more compactly,

$$\sum_{t=1}^{n} \frac{R_t-C_t}{(1+r)^t}$$

where R_t and C_t are revenues and current operating costs of the enterprise at period t, respectively, n is the time-horizon of the project in years, and r is the rate of discount.

or efficiency prices[1] to inputs and outputs, when appropriate, and by including indirect benefits and costs, i.e., those that are attributable to the project, but are not consequences of its primary objective, are also considered. For example, improved health and increased worker productivity are some indirect benefits that may result from a sewerage project, and make its overall "profitability" much greater than its financial profitability. An economic measure of returns would also attempt to value and include intangible benefits such as reduction in loss of life or aesthetic benefits for which there is no market valuation.

The primary concern of this study is financial profitability. While the importance of indirect social benefits are acknowledged where appropriate, these considerations do not enter into our calculations of profitability. In point of fact, there is no overwhelming evidence that these enterprises, with the exception perhaps of the slaughterhouse, are serving any significant social objectives. They are engaged in activities which could be undertaken by the private sector and in three cases are in direct competition with the private sector.

Even if we wanted to expand the analysis to consider social effects and indirect costs and benefits, it is not likely that we could find adequate data. This is especially problematic and especially important in cases where profitability should be adjusted to reflect whether these enterprises are substitutive (in the sense of drawing off business from the private sector) or stimulative (in the sense of creating new jobs or

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[1] Shadow price, in contrast to market or observed price, is what economists may calculate as the price of the commodity or factor (e.g., land, labor and capital) under ideal, competitive conditions. Alternatively, it may be viewed as the true scarcity of any given resource.

inducing other productive activities). In general, we assume--and with reasonable justification--that some of these enterprise activities are substitutive. Hence, the Cafetorium enterprise may generate revenue from increased sales of meals, but if other local restaurants now serve fewer meals as a result, the net revenues assigned to the enterprise are equal to its gross sales minus the reduction in sales from other restaurants. We will do little more here than acknowledge the problem.

The one sense in which we do consider economic criteria is in attempting to approximate the annual cost of capital to the local governments. In all other respects, we pretty much stick to the financial criteria.

In the short-run, we might evaluate an enterprise according to its coverage of costs. Three different criteria might be considered.[1]

(1) Full cost recovery: If the objective of the enterprise is revenue generation, then total revenues for each year should exceed total costs for that year. Total costs include current operating costs (labor, maintenance, repair, supplies, etc.) and an annual allocation of cost of capital ("user" cost, i.e., depreciation and opportunity cost of capital). If total revenues equal total costs each and every year, then a "no-profit-no-loss" position is achieved.

(2) Current cost recovery: If the objective is for the public enterprise to cover its current operating costs, i.e., not to be a drain on the treasury on a fiscal year-to-fiscal year basis, then year by year revenues must equal annual current operating costs. This, however, implies a subsidy equivalent to the "user" cost of capital.

(3) Predetermined Subsidy Reimbursement Rules: If the objective of the enterprise is to fulfill a given social objective, then a carefully designed set of rules for deficit reimbursement should be defined in advance. One such rule is that the total subsidy should not exceed the valuation attached to a given social objective.

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[1]These decision criteria for performance evaluation are more formally presented in Appendix VIII-A.

The third criterion deserves some elaboration since it offers some justification for financial deficits. Once a social valuation is determined for a project, one possible rule is that the subsidy should not exceed this valuation. Limiting the amount of subsidy in advance has the advantage that it sets the record straight on which deficits can be reimbursed and which cannot. For example, if the cost of meals to government officials is to be subsidized from provincial revenues but all other costs are to be recoverable by Cafetorium enterprise revenues, some clear guidelines for pricing are provided. As a United Nations report states: "The very expectation that the treasury will cover the actual deficit is apt to induce a pattern of behavior which is least oriented to its elimination."[1]

To evaluate the long-run impact of these enterprises to the Province of Bulacan, the net present value (NPV)[2] of the enterprises will be estimated. In addition to the NPV, we will estimate their internal rate of return.[3] The performance criteria, based on financial profitability, are as follows:

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[1] United Nations, Measures for Improving Performance of Public Enterprises in Developing Countries, (New York: United Nations, 1973), p. 57.

[2] Net present value is defined as the difference between the discounted value of the stream of cash flows (revenues minus current operating costs) and the initial capital outlay. Formally it is given by:

$$-K_o + DCF$$

or, using, the definition of DCF in footnote (2), p. 15,

$$-K_o + \sum_{t=1}^{n} \frac{R_t - C_t}{(1+r)^t}$$

where K_o is the initial capital outlay, R_t and C_t are revenues and current operating costs of the enterprise at period t, respectively, n is the time-horizon of the project in years, and r is the rate of discount.

[3] Internal rate of return is that rate of discount which makes the net present value (NPV) exactly equal to zero. For an elaboration of this concept, see E.J. Mishan, Cost Benefit Analysis, (New York: Praeger Publishers, 1976), pp. 183-186.

(1) NPV--the enterprise is profitable if the discounted cash flow (DCF) exceeds the initial capital outlay or, alternatively, if the net present value (NPV) is greater than zero.

(2) IRR--the enterprise should be undertaken if the IRR exceeds some predetermined rate of interest.

It should be noted that if the problem posed is whether to proceed or not with a given project or enterprise, the NPV and IRR criteria would give the same result if the same rate of discount (say, the social rate of time preference (STP) i.e., the valuation of present consumption relative to future consumption) is used. That is, if NPV is computed using, and IRR is compared with, STP. However, if the problem is how to choose among a set of mutually exclusive projects, given some budgetary constraint, the conventional wisdom is to choose from a set of projects whose IRR exceeds the appropriate discount rate, the one with the highest NPV.[1]

The criteria used here apply on the assumption that there is no budgetary constraint, and that projects or enterprises are not mutually exclusive. It is, therefore, recognizably less stringent. Assuming, the same discount rate is used, both the NPV and IRR criteria would give the same answer to the following question: Assuming that the enterprise is debt-financed at existing market rates of interest, would it be profitable to undertake this project?

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[1] For the mathematically inclined worrywarts, one problem with IRR as a decision criterion is its non-uniqueness--i.e., if the stream of net benefits (or cash flows) is not "well-behaved", there may be several internal rates of return.

There is one final remark. The IRR and NPV may or may not be the same if these enterprises were undertaken in the private sector. It would be reasonable to argue that private firms would have a higher IRR and NPV because of their profit-maximizing behavior, i.e., because the net revenue flow would be greater. Evidences of poor management of public enterprises, due partly to lack of cost minimizing behavior of public enterprise managers, are well documented.[1] Moreover, since public enterprises are in general limited in their response to market factors by laws, regulations, and policies on various aspects of public enterprise operation, the observed IRR and NPV may be somewhat understated. This latter point will be carefully examined in the individual case studies.

Methodology

The evaluation criteria suggested above raise two major estimation problems: (1) how to compute the annual cost of capital which is required for the short-run analysis, and (2) how to estimate the net cash flow of any given enterprise. Implicit in both problems is the need for information on initial capital outlay. For convenience, and in the absence of a good estimate of the replacement costs, we take the historical book value of fixed assets (including structure and facility but excluding land) as the initial investment. Because of inflation, the historical book value will drastically underestimate the true worth of the structure and facilities.

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[1] See, for example, Armeane Choksi, "State Intervention in the Industrialization of Developing Countries: Selected Issues," World Bank Staff Working Paper No. 341, July 1979 and Malcolm Gillis, "The Role of Economic Enterprises in Economic Development (A Survey)," Social Research (January 1981) and studies cited therein.

Estimating Capital Costs. In real terms, the cost of capital to be covered should include depreciation and the opportunity cost of financing the project from internal sources.[1] The usual procedure of assuming straight-line depreciation, and ignoring the opportunity cost of financing, would grossly underestimate the cost of capital.

To make a more appropriate estimate of capital costs, we assume that the investment required to cover the costs of the facilities was financed through a loan. It is then asked: What is the yearly return from the enterprise necessary to repay a loan equivalent to the investment at a given interest rate for a given number of years? The answer, simply stated, is the annual amortization required to replace the fixed asset evaluated at its historical book value. We employ alternative assumptions: (a) that the period of the loan or else the life span of the structure and facilities, is alternatively 10, 15, and 25 years; and (b) that the interest rate is alternatively 14 or 18 percent. The former is the current interest rate charged by the Land Bank of the Philippines, the latter by the Development Bank of the Philippines.[2]

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[1] In broad terms, the opportunity cost of any good or resource is its value in terms of some feasible alternatives. In particular, the opportunity cost of public funds, including budgetary surplus, may be expressed in terms of returns to other public investment projects or government programs foregone. Or, it may be in terms of returns to resources withdrawn from the private sector through taxation.

Let us take a specific case. [illegible], the opportunity cost of the funds used for the Hiyas Convention Center is the interest foregone had the fund been deposited with the Philippine National Bank or any other financial institutions--a guaranteed return of 14 percent. But there are certainly other investment projects or government programs with higher rates of return. For example, the money could have been used for the expansion of the HACC slaughterhouse, manufacture of farm equipment, or the construction of feeder roads. Alternatively, one may ask what the residents of Bulacan could have done with the budgetary surplus if it were returned to them by reducing taxes. When viewed this way, the opportunity cost is the return to private investment, which is probably much higher than 14 percent.

[2] For details on existing lending rates and repayment periods for loans to local governments, see Chapter IX.

The estimates of the annual amortization required to reproduce the existing fixed assets based on historical book value is presented in Table VIII-6. Hence, for the Convention Center, under the most conservative assumptions (a 14 percent rate of interest and a 25 year loan maturity), an annual capital cost of ₱883 thousand results. Under the least favorable terms, the annual capital cost is ₱1.305 million or 47.8 percent higher. To give some idea of magnitudes, these amounts are 58.0 and 85.8 percent, respectively, of total operating costs.

The local official may raise the question of how can there be an annual capital cost when the project was financed from surplus? The answer is that there still is a using up of the facility on a year-to-year basis, and this depreciation has to be covered in the pricing structure if the activity is to continue in the long-run. Viewed another way, there is a need to replace the original internal funds used in the construction. The fact that cash flow commitments are less because no loan was involved is not relevant to measuring profitability.

Estimating Cash Flow. The possibilities for measuring net present value and internal rate of return are limited by inadequate data on cash flow. No feasibility studies were prepared prior to the undertaking of these enterprises and, in any case, it is doubtful whether such feasibility studies would have adequately dealt with the usual problems of demand estimation and forecasting. It is therefore assumed in this estimation that the observed cash flow for the last three years will closely approximate the future net benefits of the project. We used alternatively the three-year

TABLE VIII-6

ESTIMATED AMORTIZATION REQUIRED TO REPLACE BOOK VALUE OF FIXED ASSETS, EXCLUDING LAND, SELECTED PUBLIC ENTERPRISES: 1980
(in thousands of pesos)

Enterprise	Book Value of Fixed Assets Excluding Land	Rate of Interest = 14 Percent			Rate of Interest = 18 Percent		
		n=10	n=15	n=25	n=10	n=15	n=25
Hiyas Agro-Commodities Center	2,163	363	309	276	408	360	335
Hiyas ng Bulakan Convention Center	6,919	1,164	988	883	1,305	1,152	1,073
Hiyas Galeria[a]	1,158	117	99	89	131	116	72
Hiyas Cafetorium[a]		78	66	59	87	77	108

Note: n is the number of annuity periods (years).

[a]The two enterprises are situated in the same building. No separate figures for the value of fixed assets are available. We assume on the basis of observed space occupied by the two enterprises, that Hiyas Galeria accounts for 60 percent of the building while Hiyas Cafetorium accounts for the remainder Accordingly, the estimated amortization is assigned on the basis of that assumption.

SOURCE: Book value of fixed assets (excluding land) is based on data supplied by the Office of the Provincial Treasurer, Province of Bulacan.

average cash flow and the "best year" cash flow: the former to minimize the bias from abnormal years, the latter in recognition of the fact that these enterprises are rather new, and that they are still essentially operating in the "learning-by-doing" phase.

In effect, what we propose to do is recreate the financial appraisal process using observed data on revenues and costs during the last three years. This approach was ruled out in the case of Hivas Galeria since the financial data for this enterprise are for 1979 only. In any case, its performance during the last three years will probably not be a good indication of future performance. Its level of operation has been unsteady and it was closed during the major part of 1978.

Profitability and Government Policies

One important lesson from these case studies is that Central Government policies have an important effect on the profitability of local government enterprises. At least in these cases, Central Government policy decisions may determine whether the activity is able to cover costs. Particularly important are government rules and regulations and policies related to taxation and tariff, wages and employment, auditing and accounting, and disposition of surplus. These policies may unduly restrict its flexibility, and, for example, the poor performance of an enterprise may be less due to its own inefficiency than to the wage structure set by the Central Government. On the other hand, some laws and regulations may help project a distorted picture of profitability. For example, failure

to take account of the opportunity cost of capital and depreciation of existing fixed assets in the prescribed accounting process may show huge "observed" accounting profits, even though the true financial picture may be one of deficit.

The general approach taken in the Bulacan case is to identify some general areas where government policies may affect revenues, costs, and therefore, profitability. On the revenue issue, the issues which arise are related to pricing policy and price determination, and to the level or volume of enterprise activity. On pricing, the following questions may be raised: Is the official pricing policy consistent with the public enterprise's financial independence? Is the price structure flexible enough to allow frequent price adjustments, thus continuing to reflect real costs during inflation? Assuming that under the existing price structure the enterprise is not recovering even its current costs, are there significant political and administrative constraints which would deter the enterprise from increasing prices? On the level of enterprise activity, the following questions may be asked: Are there existing national laws, decrees, or executive fiats, other than those which are price-related, which limit or expand the levels of enterprise activity? If so, what has been the local enterprise's response to these policies?

On the factors affecting costs, attention may be focused on wage and employment policy and accounting practices. On wage and employment policy, some questions which need to be addressed are: Do national policies

limit the enterprise's independence with respect to its hiring policy? If so, what has been the local enterprise's response? How are wages set? On accounting practices, the questions which may be raised are: On the basis of conventional government accounting practices, are all costs considered? Does it include depreciation, debt service charges, or allowance for replacement and expansion? How is land valued or is it valued at all? Is there a separate set of accounts maintained for the enterprise? Do the existing rules of deficit financing encourage cost-minimizing behavior among enterprise managers?

On profitability, the following questions may be addressed: If the enterprise is surplus generating, can it be attributed to efficiency or to propitious market conditions (monopoly position, proximity to metropolitan areas, etc.)? Alternatively, if the enterprise is chronically losing (or receiving government subsidy) can it be due to inefficiency or to some government policies (e.g., nationally set price schedules or wage scales)? Is the existing organizational structure flexible enough to allow the enterprise to adapt to changing economic conditions?

Hiyas Galeria

Hiyas Galeria was the first of the four enterprises established. It is primarily a business venture whose success may be measured by its profitability. Not surprisingly, the Galeria management has undertaken policies to increase profits by attempting to stimulate volume and

control costs. It also serves some broader purposes: It is a promotional center for native handicrafts such as brass ornaments, furniture, cabinets, leathercrafts, textiles, needlecrafts, etc., and it is a broker for Bulacan craftsmen.

Capital Costs

The building in which Hiyas Galeria is situated was constructed using the Provincial Engineering Office as the contractor. During the construction phase, temporary workers were hired on contractual basis. It is likely that only larger governments could pursue this construction arrangement, because they are more likely than smaller governments to be staffed with competent technicians and to have the necessary equipment and machineries necessary for such a task.

This type of construction arrangement, according to the provincial governor, saved the Province considerable public funds. Since the construction of the building was financed out of current surplus, there are no costs of capital to be covered by the cash flow generated from sales, hence the profitability of a positive cash flow from the undertaking is quite high. In real terms, however, the cost of capital to be covered includes the annual depreciation on the building and the opportunity cost of the local government's capital which is tied up in the project.[1]

Pricing and Volume Considerations

Sales in the Galeria are made on consignment basis with a 10 percent markup on producer supply price. Total sales for the year ending December 31, 1979 were about ₱1.395 million.[2] Deducting the total payments to

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[1] This would also include the cost of the services provided by the Provincial Engineering Office, assuming that the internal resources would otherwise have been fully employed, i.e., that there was no idle capacity in the Provincial Engineering Office.

[2] To give some perspective, this amount is equivalent to about 5 percent of the General Fund expenditures of the provincial government.

consignors, amounting to ₱1.263 million, the commission earned (or total revenue) for 1979 was about ₱132,000.[1]

A variety of efforts have been considered and/or undertaken to stimulate the volume of sales. First, a liberal credit policy was extended to provincial government employees and employees of the Central Government working in Bulacan. This program has been in operation for some time and allows for charges with no interest of up to 50 percent of the employee's monthly salary, repayable weekly over a 12 week period. A second policy is a special promotional sales campaign during the Christmas season. These policies show the business-type approach to the Galeria, but essentially play to a limited market and may or may not ensure long-term financial viability.

Promotion of exports has also been considered. Although there have been discussions with exporters, the large quantities of goods necessary to make this a workable proposition have not been available to the Galeria. The problem appears to be one of working capital. That is, the craftsmen who supply the Galeria do not have the resources necessary to commit themselves to the process of accumulating stocks for export. Simply stated, their operations are small and their financial circumstances require rapid turnover.

In an attempt to alleviate this problem, the Galeria has considered a working capital lending program. In fact, they have established a ₱100,000 fund in the provincial treasury for this purpose. Since there is a legal

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[1] The financial data are for 1979 only, as reported in the Commission on Audit report. The data on Galeria financial operations was not provided directly, despite repeated requests during our visits.

prohibition of local government loans to individuals, but not of joint ventures between local government and cooperatives, the Galeria and the provincial government have initiated the organization of a local handicraft producer cooperative. The intent of this action is to establish a mechanism which would allow the province to provide short-term working capital loans. It is estimated that the potential membership of the cooperative is in excess of 250 local handicraft producers. The legality of this arrangement, in particular the loan program, is (or was at the time of our visit) yet to be determined. Regardless of the outcome of these considerations, the fact that they have been pursued is testimony to the progressive and energetic nature of the provincial government.

Operating and Capital Costs

This enterprise is operated as a regular government department. The Galeria superintendent is not hired on contractual basis. His salary plus the salaries and wages of some 30 other employees involved in sales, inventory, stock, and accounting are paid out of the provincial budget. The total cost of maintenance and repair and other miscellaneous expense for the year ending December 31, 1979 was ₱27,830 while the salaries and wages totalled ₱178,680, for a total current operating budget of over ₱200,000.[1] This does not include depreciation or any allowance for the replacement of existing structure. Our estimate of annual capital cost is between ₱89,000 and ₱131,000, depending on the interest rate and asset life assumed (see Table VIII-6).

[1] Our figure on salaries and wages is for 1980, as provided by the provincial budget officer. We have no information on salaries and wages for prior years. The figure for the maintenance and repair is from the Income Statement submitted by the Galeria accountant to the Commission on Audit for the year ending December 31, 1979.

Profitability

With an operating budget in 1979 of over ₱200,000 and net profit from sales of ₱104,431, the Galeria is clearly not covering even its current expenditures. Putting it another way, it received an operating subsidy of about ₱95,000 and a total (operating and capital) subsidy of between ₱184,000 and ₱226,000 in 1979. These results are consistent with the overall impression given by local officials that this enterprise has not been financially self-supporting.

Conclusions

On the basis of the above analysis, and some very limited data, three general conclusions might be drawn out. First, Biyas Galeria has not been covering its current costs, and therefore has been a drain on the provincial treasury of Bulacan. It can be reasonably argued, and in fact has been argued by Bulacan local officials, that the objective of this enterprise is not to generate revenue but rather to promote cottage industries in Bulacan. This, in turn, raises two questions. One is whether the province sees this objective as being worth about ₱200,000 (a rough estimate of the Galeria deficit) per year in general revenue subsidy. The other is whether the Galeria has made a net contribution to stimulating cottage industry in any case. Assuming a competitive environment, it can be reasonably argued that products placed at the Galeria would have been sold elsewhere if it had not been established.

Second, the poor financial performance of this enterprise appears to be influenced considerably by some factors exogenous to internal management: the 10 percent markup pricing rule (assuming that pricing decisions are beyond the Galeria superintendent's discretion), the legal restrictions on extending loans to individual producers, and the wage and employment structure.

Pricing policy would seem to offer a possibility for improving financial performance. If the 10 percent markup pricing rule is maintained, the Galeria would be able to cover current costs only if the value of handicrafts and other related products supplied is increased by 75.8 percent. Alternatively, for the current value of commodities supplied (₱1.263 million), to cover current costs (₱221.9 thousand), a markup of 17.58 percent is necessary to break even. This figure supports the view of the manager of the Hiyas Galeria that between 18 to 20 percent markup on producer price would be necessary to make the enterprise self-supporting. This view, of course, is accurate only on the assumption that the present level of sales will be maintained even though prices rise substantially. In an industry as competitive as handicrafts, this may not happen. An increase in prices could reduce quantity demanded perhaps so much so that total sales would decline and, as a result, the commission earned by the enterprise will fall.

This is where the policies designed to stimulate demand may fit in. Since the financial viability to the Galeria depends on the volume of new products that pass through the Galeria, the credit purchase program and

occasional promotional sales might be designed to maintain the same level of enterprise activity. That is, it is possible to think of a scenario where, with the help of the credit program to government employees, the markup can be increased and total sales can be maintained. The credit program therefore is a tool to create a captive market.

The above discussion brings us to the final remark. The liberal credit extended to provincial and (selected) national employees is a good example of cross-subsidization, a phenomenon that is quite often observed in public enterprise operations both in developed and developing countries. The budgetary deficit of Hiyas Galeria is financed from the general treasury (and as will be shown later, conceivably from the surplus of the other enterprises), while the interest-free credit is available only to a select group of government employees. In effect, taxpayers at large and the users of the other enterprises, are subsidizing the group of government employees who are charging their purchases from the Galeria.

Assuming other things constant, would the deficit of this enterprise be greater if the credit program is discontinued? A definitive answer calls for far more study than we have given this issue. However, intuitively, one can argue that there will be a reduction in sales and consequently an increase in budgetary subsidy. On the other hand, it can be argued that to the extent that there will be no reduction in sales--that is, assuming that the more overriding constraint is increased supply of cottage industry products as stated by the Galeria superintendent--then the deficit would likely be smaller. The key is the potential savings in labor costs, i.e., the release of employees

who are directly concerned with credit processing and collection. The amount saved may or may not be substantial. The point remains, however, that discontinuing the credit purchase program will not necessarily increase this enterprise's deficit.

Hiyas Cafetorium

Located at the Hiyas Complex and along the MacArthur highway, the major thoroughfare linking Manila with most of northern Luzon, the Hiyas Cafetorium caters to tourists, domestic travelers, and employees. In addition to being open to the public, it provides first class dining facilities and discounted rates to government officials. Of the four public enterprises operated by the province of Bulacan, it is the most autonomous, being run on a contract management basis.

The primary objective of the Cafetorium is financial profitability. It is clearly a business proposition. On the other hand, there are important non-pecuniary benefits which should not be overlooked. Hiyas Cafetorium has been an informal meeting place of government employees. It can be reasonably argued, as some provincial officials do, that the frequent interaction among government officials has improved their knowledge of the operation of the provincial government, hence, their performance. This can be viewed as one of the desirable results of its establishment, yet it would seem improbable that this contact advantage would be wholly lost but for the Cafetorium.

Established in April 1975, Hiyas Cafetorium is located in a building housing the Hiyas Galeria and an ice cream parlor.[1] The building was constructed by the provincial government, using internal funds, at an estimated cost of ₱1.2 million.

Revenue Performance and Policy

Over a three year period, revenues have fluctuated from ₱1.169 million in 1977 to ₱699.9 thousand in 1978 and the ₱816.9 thousand in 1979 (Table VIII-7). Because of this short history and these rather dramatic fluctuations, it is difficult to make any kind of statement about this enterprise's revenue performance.

Operating and Capital Costs

The largest single item of expenditures for the Hiyas Cafetorium is the purchase of intermediate inputs, which has constituted about 63 percent of total expenditures during the three year period. Salaries and wages accounted for about one-fifth of total expenditures (Table VIII-7).

Hiyas Cafetorium is under an operating contract arrangement. As the recent Commission on Audit (COA) report states: "The operation of the Cafetorium is being undertaken independently and is operating [in a] private business-like manner."[2] This arrangement was created to avoid government wage rate and benefit regulation. As a result, there is no plantilla of personnel to be found anywhere in the provincial budget.

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[1] The ice cream parlor is run by a private concessionaire and pays a monthly rent of ₱100.00 to Hiyas Cafetorium.

[2] Commission on Audit, Report of the Financial Audit of the Province of Bulacan for the Calendar Year Ended December 31, 1979, February 27, 1980.

TABLE VIII-7

HIYAS CAFETORIUM: SHORT-RUN PERFORMANCE INDICES: 1977-79
(in pesos)

	Basic Data		
	1977	1978	1979
(1) Gross Sales	1,169,358	699,906	816,976
(2) Total Expenditures[a]	1,084,942	631,597	779,649
(3) Intermediate Inputs	722,612	373,763	493,589
(4) Salaries and Wages	196,165	134,953	154,893
(5) Maintenance and Repairs[b]	166,165	122,881	131,167
(6) Current Account Surplus[c]	84,416	68,309	37,327
(7) Estimated Annual Cost of Capital[d]	59,000	59,000	59,000
(8) Full Accounting Surplus (Deficit)[e]	25,416	9,309	-21,773
	Expenditure Items as a Percentage of Total Expenditures		
Intermediate Inputs	66.6	59.2	63.3
Salaries and Wages	18.1	21.4	19.9
Maintenance and Repairs	15.3	19.5	16.8
	Other Measures of Financial Performance		
Total Expenditures as a Percentage of Gross Sales	92.8	90.2	95.4
Current Accounts Surplus as a Percentage of Gross Sales	7.2	9.8	4.6

[a] (3) + (4) + (5).

[b] Includes gas, fuel, and transportation expenses, supplies, cleaning and paper, miscellaneous expenses, representation expenses, employer E.C.C., Medicare and Social Security System contributions, telephone expenses, and electric expenses.

[c] (1) - (2).

[d] See Table VIII-6.

[e] (1) - [(2) - (7)] = (6) - (7).

SOURCE: Computed by authors from Income Statements submitted by Hiyas Cafetorium to the Commission on Audit.

In what ways is the operating contract arrangement cost-reducing, and by how much? By avoiding the wage and employment restrictions that apply to regular agencies of the local governments, workers are employed according to the level of activity of the Cafetorium and are paid at wages approximating the market wage rates. The provincial government is also able to save on labor-related costs such as life, retirement, and medicare contributions.

The social security program in the Philippines is administered by two major agencies. The Government Service Insurance System (GSIS) has jurisdiction over public sector employees while the Social Security System (SSS) is responsible for the employees of organized, private industries. The program for public sector (national and local governments and public corporations) employees is much more comprehensive and pays higher benefits than does the SSS program. Consequently, it is much more expensive from the point of view of the contributing local government. For the Hiyas Cafetorium, which by virtue of the operating contract arrangement is considered a non-governmental entity, its Social Security contribution as a percentage of salaries and wages was 5.3 percent in 1977, 5.5 percent in 1978 and 6.1 percent in 1979. This is considerably less than what the other enterprises have to pay. For example, in 1979 the contributions for life insurance, retirement and medicare as a percentage of salaries and wages was 12.5 percent for HACC, 14.6 percent for HBCC, and 13.8 percent for the Hiyas Galeria. Assuming a 6 percent difference in Social Security contribution, this translates into savings of ₱9,885 in 1977, ₱6,932 in 1978 and ₱8,106 in 1979.[1] These are small by comparison to total operating costs, but serve to illustrate the kinds of cost-saving management options that are available.

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[1] Of course whether these "savings" are a national advantage depends on whether the issue is viewed by the Cafetorium management or by the public employees who receive the lower benefit levels.

Financial Profitability

The current account surplus has declined: ₱84,416 in 1977, ₱68,309 in 1978, and ₱37,327 in 1979 (see Table VIII-7). As a percentage of gross sales, the current account surplus was 7.2 in 1977, rose to 9.8 in 1978, and then dipped to 4.6 in 1979. As a result, both current and full costs were covered in 1977 and 1978 but a subsidy of ₱21,773 was necessary in 1979.[1]

Based on an extrapolation of recent historical data, 1977 to 1979, the long-run financial profitability of Hiyas Cafetorium appears marginal. The numerical results suggest that its viability as a profit-making enterprise depends on its ability to operate at its past "peak" level, 1977, and even then it would appear to be a questionable investment. An enterprise or project becomes viable in the long-run when its net present value, given some predetermined rate of interest, is greater than zero. At 18 percent rate of interest, Hiyas Cafetorium, even on the basis of its best performance during the last three years, fails this test.

In other words, we have asked the following question. If the Cafetorium could be expected to replicate its 1977 performance (revenues covered all costs and produced a surplus of ₱84,416) indefinitely, would it be a good investment? The answer of course depends on the discount rate and the time horizon of the enterprise. At the lowest rate assumed, 14 percent, and 25 year project life, the Cafetorium would bring to the provincial treasury ₱114,330. Assuming the same low rate of interest but with a shorter project life (15 years), the Cafetorium would generate an additional revenue of ₱52,940.

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[1]Under the most conservative assumptions.

Perhaps a 14 percent return is not available to local governments, and we should attempt to discover that rate of return which the Cafetorium investment does yield. This internal rate of return ranges from 10.61 to 17.87 percent, depending on our assumptions. However, even under the best conditions--25-year project life and level of activity approximating previous "peak" level--an IRR of 17.87 is less than the prevailing commercial loan rates which are over 20 percent (Table VIII-8). One may argue that the relevant interest rate ought to be less than the commercial rates because of the public nature of the project. Moreover, there are reasons why provincial governments might not be able to take full advantage of the higher commercial rates available, i.e., some percent of surplus funds are earmarked for certain types of capital expenditure, investment of local governments' idle funds are restricted, etc. On the other hand, Hivas Cafetorium is a commercial venture, a fact that is indisputably supported by the lease contract arrangement. Hence, it seems appropriate that on the basis of its commercial orientation, its IRR must be compared with the prevailing commercial loan rates.

Even the above measures of profitability are likely to be overestimates of the social profitability of the project. Hivas Cafetorium essentially provides a private consumption good and would therefore tend to be substitutive (in the sense of siphoning off business from similar facilities within the Malolos area) rather than stimulative (in the sense of creating new jobs or inducing other economic productive activities). To the extent the Cafetorium does generate revenues for the local government, these gross amounts should be offset by the reductions due to lower business and property tax payments from competitor firms in the Province.

TABLE VIII-8

HIYAS CAFETORIUM: RESULTS OF FINANCIAL ANALYSIS
(in 1980 pesos)

Assumptions		Investment Criteria			
		Net Present Value		Internal Rate of Return	
Number of Years of Project	Discount Rate	'Best' Year	3-Year Average	'Best' Year	3-Year Average
n = 15	r = .14	52,940	-76,040	16.25	10.61
	r = .18	-35,310	-142,267		
n = 25	r = .14	114,330	-30,010	17.87	12.98
	r = .18	-3,780	-118,580		

SOURCE: Computed by authors from Case Study data.

Finally, there is the question of disposition of the profits, i.e., the current account surplus. Disturbing to the Commission on Audit, and probably to the other government officials, is that "profits derived from the operation were not remitted to the Office of the Provincial Treasurer for proper disposition."[1] There were references during our interviews in Bulacan to the fact that this enterprise was allowed to accumulate its surplus and that the provincial government draws on the accumulated surplus for its nutrition program.

Conclusions

Some important policy lessons can be learned from this enterprise. First, there seem to be no legal restrictions in establishing an independently run local government business venture. Under an operating contract arrangement, enterprise management may enjoy wide discretion in wage and employment decisions.

Second, an analysis of profitability may give different results depending on whether one considers the short- or long-run and on whether indirect effects are taken into account. Ostensibly, the Cafetorium is a viable proposition. It generated a positive cash flow by covering full costs in two of the past three years and we project the internal rate of return on this investment at between 10 and 17 percent. Even this performance, however, does not mean that the Cafetorium is a "good" investment for the provincial government. In the long-run, profitability requires establishing that a return greater than 10 percent is not available elsewhere for the

[1] Commission on Audit, "Report of the Financial Audit of the Province of Bulacan for the Calendar Year Ended December 31, 1979", February 27, 1980. (Typewritten.)

local government. In any case, even this relatively low rate of return may be *overstated* for two reasons. One is the failure to count indirect effects, i.e., the fact that competing restaurants now do less business and employ fewer resources than before (the Cafetorium) and hence they pay less property, occupation, and business tax than before. Surely these losses will offset some of the net revenues of the undertaking. The other is the very conservative way we have estimated depreciation, using historical book value. The much higher actual reproduction cost would raise the annual cost of capital and reduce profitability.

Hiyas Convention Center

The Hiyas Convention Center (HBCC) was established in July 1975 to provide facilities for conference, seminar and training for government and private agencies and organizations in Bulacan and other neighboring areas. As a matter of policy, the HBCC leases out its facilities at rates which allow it to cover current operating costs.

The Hiyas Convention Center is part of the Hiyas Complex which is situated in the twenty hectare Provincial Capitol grounds in Malolos. The other structures within the complex are the Hiyas ng Bulakan Cultural Center and Museum, the Hiyas Galeria, and the Hiyas Cafetorium. The nearest private enterprise of the HBCC-type within the Central Luzon area is Marisol Manor in Angeles, Pampanga which is approximately 48 kilometers away.

The Convention Center is run by the HBCC Manager who is hired on a contractual basis. The manager is directly responsible to the provincial governor and has overall supervision and control over the Center's three operating divisions: the Administrative Division, the Hostel and Facilities Division, and the Food Service Division.

Its facilities include 2 air-conditioned and carpeted suites, one with a 4 person capacity and another with a 2 person capacity; 15 dormitory rooms which can accommodate 20 persons per room; 2 secretariat or staff rooms, each with a 6 person capacity; 3 conference rooms, 2 with a 90 person capacity and the other with a 120 person capacity. In addition, it has an auditorium with a 400 person capacity, and recreational facilities including a swimming pool and tennis courts.

Revenue Performance and Policy

From ₱873 thousand in 1977, revenues more than doubled in 1978 (₱1.798 million), and then tapered off to ₱1.515 million in 1979. The drop in revenues in 1979 is more a reflection of collection problems than of the volume of business. If the accounts receivable were added to revenues, the adjusted figures would be ₱933.9 thousand for 1977, ₱1.944 million for 1978, and ₱2.273 million for 1979 (see Table VIII-9).

While open to all possible clientele and types of activities, the Convention Center operation has been catering primarily to government-sponsored conventions and training programs. As a result, the rates set prior to April 1979 were based on the amount of per diem given by the government to employees attending seminars and conferences at the

TABLE VIII-9

HIYAS CONVENTION CENTER: SHORT-RUN PERFORMANCE INDICES: 1977-79

	Basic Data			
	1977	1978	1979	Growth Rates, 1977-79 (Percent)
(1) Revenues[a]	873.1	1,797.5	1,515.0	73.5
(2) Current Expenditures	865.4	1,518.5	1,520.9	75.7
(3) Salaries and Wages	174.6	310.6	352.6	101.9
(4) Maintenance and Repair	690.8	1,207.9	1,168.4	69.8
(5) Capital Outlays[b]	2,822.6	171.0	245.2	
(6) Estimated Annual Cost of Capital[c]	883.0	883.0	883.0	
	Performance Indices (Excluding Accounts Receivable)			
(7) Current Account Surplus[d]	7.7	279.0	-5.9	
(8) Full Accounting Surplus (Deficit)[e]	-875.3	-604.0	-888.9	
	Performance Indices (Including Accounts Receivable)			
(9) Revenues Including Accounts Receivable	933.9	1,944.0	2,273.0	
(10) Current Account Surplus[f]	68.5	415.5	752.1	
(11) Full Accounting Surplus (Deficit)[g]	-814.5	-467.5	-398.7	

[a] Gross profit from sales.

[b] General Fund and Infrastructure Fund.

[c] See Table VIII-6.

[d] (1) - (2).

[e] (1) - [(2) + (6)].

[f] (9) - (2).

[g] (9) - [(2) + (6)].

SOURCE: Computed by authors from data furnished by the Provincial Treasurer's Office and Income Statement submitted by Hiyas Convention Center to the Commission on Audit.

Convention Center. However, recent rate increases have been necessitated by price increases, particularly for food and wages. The new daily rates of ₱39.50 for meals and ₱20.00 for lodging took effect in April 1979. Even at higher levels these rates seem competitive. An HBCC comparative study of hotel facilities in San Fernando, Pampanga (approximately 21 kilometers away) showed that food and accommodation costs were about ₱78 per individual per day.

The volume of convention activity depends largely on factors that are beyond the enterprise management's control--principally, Central Government policy. For example, while the occupancy rate in 1979 was above 80 percent, it fell to 45 percent during the first quarter of 1980 as a result of LOI 981 which prohibited the expenditure of government funds for attendance at conventions, seminars, workshops and other similar activities conducted by private groups. While the attendance of government officials and staff may be authorized, the payment of fees, per diem and transportation expenses may not. In addition, except for the Career Executive Service Course offered by the Development Academy of the Philippines and other programs approved by the Chairman of the Civil Service Commission and the Ministry of the Budget, all live-in training programs sponsored by government agencies were suspended. The Convention Center's vulnerability to such a limitation on government-sponsored training is, of course, exacerbated by its heavy reliance on one type of clientele (government employees). As a postscript, LOI 981 has recently been rescinded.

Operating and Capital Costs

Current expenditures have grown by 75.7 percent over the three year period, primarily because of rising non-labor costs. Maintenance and repair, the single most important expenditure item of this enterprise--representing nearly 80 percent of total expenditures in 1979--has increased by more than two-thirds during the period (Table VIII-9). The rising cost of food and beverages has been another major contributing factor to the dramatic growth of total expenditures. Salaries and wages increased by 77.9 percent from 1977 to 1978 but by only 13.5 percent from 1978 to 1979. As might be expected, the magnitude of these increases corresponded to the level of enterprise activity.

The management of the enterprise has been innovative in using casual employment to accommodate the irregular work loads which are characteristic of the hostel industry. During slack periods when there are no conferences, some workers are put on forced leave. If entitled, these workers may use their 15 days sick leave and 15 days vacation leave; otherwise, they must take off without pay.

Financial Profitability

The financial performance of the Hiyas ng Bulakan Convention Center is summarized in Table VIII-9. From 1977 to 1979, revenues, defined here as gross profit from sales, rose by 73.5 percent while current expenditures grew at a slightly faster rate of 75.7 percent. The financial performance of this enterprise during the last three years has been erratic. Its current account surplus rose from ₱7,000 in 1977 to ₱279,000 in 1978 and

then dropped dramatically to a deficit of ₱5,900 in 1979. The overall deficit has been substantial. HBCC has received a subsidy of no less than one-half million pesos during the last three years: ₱875.3 thousand in 1977, ₱604.0 thousand in 1978, and ₱888.9 thousand in 1979.

HBCC's financial performance, however, is not quite so dismal as the above figures would seem to indicate. One of its problems, as mentioned earlier, is an inability to collect unpaid accounts. Among the biggest nonpayers are the Ministry of Human Settlements (₱280,805), Ministry of Agrarian Reform (₱92,194), Human Settlements Regulatory Commission (₱98,059), and the Rural Roads Program (₱53,264). As of December 31, 1979, the accounts receivable of the Convention Center amounted to ₱965,247. If collected, the Convention Center would certainly cover its current operating costs. More importantly, at least for the last two years (1978 and 1979), it would have covered all current costs plus about one-half of the estimated annual amortization for the replacement of its fixed assets. While this would result in a positive cash flow, the enterprise would still not be breaking even.

To minimize nonpayment, a new policy has been instituted. Organizations who want to rent the facilities are now required to pay 30 percent of the estimated costs of the service in advance, with the balance due within 7 days after the convention. While this might go a long way toward reducing delinquent payments, the problem may not be fully solved unless there is a penalty for late payments. The legal restriction on the imposition of

interests and surcharges on the initial fees and charges due should be reconsidered. Yet, can a provincial enterprise reasonably expect to penalize a Central Government Ministry?

The possibilities for cost recovery, which seem real enough by these estimates, are based on a very conservative assumption about depreciation allowance. This important source of underestimation of costs arises from a computation procedure based on the historical or book value of fixed assets rather than on replacement cost. The costs of replacing the HBCC building alone has doubled; one local official estimated it at ₱10.8 million.

The implication of the NPV calculations is that, in the long-run, the net effect of Hiyas Convention Center on the provincial treasury will be negative. Even under the "best" possible set of assumptions--100 percent collection efficiency, 25-year project life, rate of interest of 14 percent, and a level of activity equivalent to recent "peak" performance--the enterprise stands to lose ₱1.75 million. That is, an alternative investment of equal amount, which yielded a 14 percent return, would earn ₱1.75 million more over the same 25 year period. Under the worst possible scenario--the present collection efficiency will continue; the discount rate is 18 percent; 15-year project life; and a level of activity equivalent to the average level of operation during the last three years--the loss will amount to ₱6.42 million (Table VIII-10). The reader should remember that "loss" in this case means the value today of the shortfall between the current surplus and the amount necessary to fully cover capital costs which will accumulate over the 15-year period. This "loss" may be perfectly consistent with the existence of positive cash flows on current account.

TABLE VIII-10

HIYAS CONVENTION CENTER: RESULTS OF FINANCIAL ANALYSIS
(In 1980 pesos)

Assumptions		Investment Criteria			
		Net Present Value		Internal Rate of Return	
Number of Years of Project	Discount Rate	'Best' Year	3 Year Average	'Best' Year	3 Year Average
		Assumption (a): 100 Percent Collection Efficiency			
n = 15	r = .14	-2,300,090	-4,388,430	6.84	-0.139
	r = .18	-3,090,130	-4,821,270		
n = 25	r = .14	-1,750,560	-4,087,350	9.84	3.34
	r = .18	-2,807,890	-4,666,630		
		Assumption (b): Present Collection Efficiency Will Continue			
n = 15	r = .14	-5,205,340	-6,320,140	-5.71	-15.15
	r = .18	-5,498,450	-6,422,570		
n = 25	r = .14	-5,001,450	-6,248,890	0.06	-6.81
	r = .18	-5,393,730	-6,385,980		

SOURCE: Computed by authors from Case Study data.

Based on varying assumptions, in four out of eight cases considered, the computed IRR is negative. More importantly, even under the best possible set of assumptions, the computed IRR is only 9.84, a rate of return on investments much lower than the prevailing government lending rates of 14 to 18 percent, and certainly considerably less than existing commercial loan rates.

The financial loss taken from a broader *national* viewpoint may be even greater. To the extent that the Hiyas Convention Center is, on balance, substitutive (in the sense that it has drawn away business from similar facilities in the adjoining provinces including Metropolitan Manila) then there may be some other indirect costs associated with it. First, it can be reasonably argued that the profitability of the hostel and convention center industry will then fall. The immediate effect is a decrease in tax revenues, either in the form of municipal business tax or income tax. Moreover, the ensuing excess capacity--i.e., lesser rooms rented out and dinners served--represents misallocation of resources and could rightfully be counted as indirect costs.

Some of these considerations may not be of concern to local governments. They highlight, however, the important issues that need to be addressed from the Central Government standpoint. Local public enterprises pose additional problems in that investment decisions for each local government are made by autonomous policymaking bodies. To the extent that the spill-over effects of an enterprise or project are ignored in the decisionmaking process, then it is possible that local governments may establish enterprises that are in direct competition with each other.

Conclusions

On the basis of the above discussion, several conclusions can be drawn. First, the problems and operation of this enterprise have demonstrated the susceptibility of local business undertakings to Central Government policies. For some of these policies, HBCC has an effective response. For example, its heavy reliance on casual employment was in response to stringent staffing and wage structure limitations faced by regular departments. There is no doubt but that the use of temporary employment has reduced the losses of this enterprise. The fact remains, however, that for some policies, HBCC had virtually no option. LOI 981 which limits training activities effectively reduced the level of operation of HBCC, and there did not seem to be an effective response.

This brings us to a related point: public enterprises that cater primarily to government agencies may face additional problems. The profitability--or, in this case, loss--of this enterprise was influenced heavily by the enterprise's inability to collect unpaid accounts from other Central Government agencies. As noted, if all the unpaid accounts were collected, the capital subsidy to HBCC would have been substantially reduced, or alternatively the surplus on current account would have been higher. Whether this collection problem will continue or not cannot be ascertained here. Its presence, however, is indicative of the difficulty that will likely be encountered by a public enterprise which has other government agencies as its major clientele.

Third, the long-run profitability of Hiyas Convention Center is not very promising. Past experience would suggest that it can be expected to break-even at a discount rate of about 10 percent, i.e., under the "best" possible set of conditions, it has an implied rate of return considerably lower than prevailing government lending rates. To the extent that the results of this financial analysis are valid, the implication is that the provincial government has overinvested in this enterprise.

Hiyas Agro-Commodities Center

The Hiyas Agro-Commodities Center (HACC) began operations in 1976. It was established mainly to stabilize the price to livestock producers and facilitate the flow, handling, and processing of livestock and meat producers of Bulacan; that is, it was initially set up as a price support program to serve the municipalities in Bulacan Province. The market prices of livestock and meat producers, however, have risen so much that there is no longer a need for a price support program. Its main activity at present is the slaughtering of livestock.

The plan for the slaughterhouse physical structure was prepared by the National Meat Inspection Commission and reviewed by the Ministry of Finance. The present building, valued at ₱1.435 million, and the equipment, valued at ₱727 thousand, were financed by the provincial government using internal funds.

Revenue Performance and Policy

Revenues from slaughterhouse fees, excluding post-mortem fees, rose by 137.5 percent over the 1977-1979 period (Table VIII-11). As will be shown below, this tremendous rise in revenues can be attributed to two major factors: (a) a pricing structure that is probably the highest and most comprehensive in the entire country, and (b) some locational advantages that enable HACC to maintain a high level of slaughterhouse activity.

The existing rate structure, based on Tax Ordinance No. 6, dated April 16, 1980 was patterned after that of the City of Manila. The penultimate schedule of fees and charges was set in 1976. A comparison of the slaughterhouse fees imposed by HACC vis-a-vis those set by some local units we surveyed suggest that Bulacan, along with most local governments, has imposed the maximum slaughter fees permitted. However, Bulacan appears to impose a wider array of slaughterhouse fees than most local governments (Table VIII-12).

Slaughterhouse fees include permit fee, slaughter fee, corral fee, ante-mortem fee, and post-mortem fee. The structure of slaughterhouse fees--base, fee rates and the local board or council's discretion in setting the fees--is summarized in Table VIII-13. The Local Tax Code (Presidential Decree 144, as amended) provides that before any animal is slaughtered for public consumption, a permit shall be secured from the health officer concerned or his duly authorized representative. The corresponding permit fee is then collected at a reasonable rate fixed by the council. No maximum is prescribed for the permit fee. Aside from slaughterhouse fees, permit fee and corral fee, two other fees are imposed by local governments: the ante-mortem and post-mortem fees.

TABLE VIII-11

HACC SLAUGHTERHOUSE: SHORT-RUN PERFORMANCE INDICES: 1977-79
(in pesos)

		Basic Data			
		1977	1978	1979	Growth Rates, 1977-79 (percent)
(1)	Revenues Excluding Post-Mortem Fee	403,946[a]	511,832	959,545	137.5
(2)	Revenue from Post-Mortem Fee[b]	247,401	365,133	763,656	208.7
(3)	70 Percent of Post-Mortem Fee	173,181	255,593	534,559	
(4)	Current Expenditures	353,066	414,483	568,679[c]	61.1
(5)	Salaries and Wages	277,061	308,899	362,124	30.7
(6)	Maintenance and Repair	76,004	105,584	206,555	171.8
(7)	Capital Outlays	234,224[a,d]	346,055[d]	---	
(8)	Estimated Annual Costs of Capital[e]	276,000	276,000	276,000	
		Assumption: Post-Mortem Fees Revert to the Central Government			
(9)	Current Account Surplus[f]	50,880	97,349	390,866	668.2
(10)	Full Accounting Surplus (Deficit)[g]	-225,120	-178,651	114,866	
		Assumption: 70 Percent of Post-Mortem Fees Retained at the Local Level; 30 Percent Reverts to the Central Government			
(11)	Current Account Surplus[h]	224,061	352,942	925,425	313.0
(12)	Full Accounting Surplus (Deficit)[i]	-51,939	76,942	649,425	

TABLE VIII-11 (CONT.)

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[a]Source: Ministry of Finance Budget Operation Statement.

[b]Data from Provincial Treasurer's Office, January 14, 1981

[c]For 1979, the annual budget is ₱675,296 disaggregated as follows: ₱432,296 for salaries and wages, and ₱243,000 for repair and maintenance.

[d]Financed from the Infrastructure Fund.

[e]See Table VIII-6.

[f](1) - (4).

[g](1) - [(4) + (8)].

[h][(1) + (3)] - (4).

[I][(1) + (3)] - [(4) + (8)].

SOURCE: Computed by authors from data supplied by the Provincial Treasurer's Office and the Ministry of Finance.

TABLE VIII-12

FEES AND CHARGES FOR SLAUGHTERHOUSE,
SELECTED JURISDICTIONS: 1980
(in pesos)

Type of Fees	Local Jurisdiction							
	Bulacan	Dumangas	Miagao	Tigbauan	Legaspi	Tabaco	Gubat	Sorsogon[e]
1. Slaughter[a] (Peso per head)	5.00/3.00[b]	2.00/1.00	5.00/3.00	5.00/3.00	5.00/3.00	5.00/3.00	5.00/3.00[c]	5.00/3.00[c]
2. Ante-mortem (Peso per head)	0.90/0.60[d]	2.00/1.00	0.90/0.60[d]	0.90/0.60[d]	---	---	0.90/0.60[d]	0.90/0.60[d]
3. Post-mortem (Peso per dress wt.)	0.05/0.05	0.05/0.05	---	---	---	0.90/0.60[f]	---	---
4. Permit fee (Peso per head)	2.00/1.00	2.00/1.00	---	---	2.00/1.00	---	---	---
5. Corral Fee	1.00/0.50	---	0.50/0.30	0.50/0.30	0.50/0.30	0.50/0.30	0.50/0.30	0.50/0.30

[a]Rate for public consumption.

[b]First figure is rate for large animals while the second figure is rate for small animals.

[c]Municipal market code provides that the fees collected should be in accordance with the schedule authorized under the Local Tax Code.

[d]₱0.30 for sheep and ₱0.20 for other small animals.

[e]In addition, Sorsogon imposes delivery service charge for the use of the meat delivery van service, operated by the Municipality of Sorsogon, from the abattoir to the public market at the following rates per head: large cattle (₱0.50), hogs (₱0.30), goats (₱0.20), sheeps and other small animals (₱0.20).

[f]Peso per head.

SOURCE: Case Study data.

TABLE VIII-13

STRUCTURE OF SLAUGHTERHOUSE FEES: 1980
(in pesos)

Type of Fees	Tax Base	Fee Structure: Large Cattle	Hogs	Other Small Animals	Maximum Prescribed In The Local Tax Code
1. Slaughter Fee	Per Head or Per Kilo	a. For public consumption:			Yes
		5.00	3.00	2.00	
		(0.05)[a]	(0.03)	(0.02)	
		b. For home consumption:			
		2.50	1.50	1.00	
		(0.025	(0.015)	(0.01)	
2. Permit Fee	Per Head	2.00	1.00	1.00	No
3. Corral Fee	Per Head	0.50	0.30	0.20	Yes

[a]The figure in parenthesis under the fee per head is the fee per kilo.

SOURCES: Local Tax Code (Presidential Decree 144, as amended); permit fee structure from Case Study data.

By law, the ante-mortem Health Inspection fees are to revert to the Central Government. The legal basis for this is well established. Section 461 of the Revised Manual of Instructions to Treasurers and Provinces, Cities and Municipalities, (1954 ed.) provides: "Ante-mortem fee collections accrue to the national government for credit to the Philippine Livestock Promotion Fund." The case of the post-mortem fees, however, is not so clear cut in terms of either the statutory basis for imposition or the conditions under which the collection should revert to the Central Government. The issue is important because the profitability of the enterprise may depend on the disposition of the post-mortem fees. Moreover, where the actual meat inspection is performed by health officers financed out of local funds, then there may be legitimate arguments for retaining the post-mortem fees at the local government level.

On at least two occasions, we were told that the revenue from the post-mortem fee reverts to the Central Government. But the Bulacan local officials argue that this is true only if the national government pays for the meat inspectors. Since Bulacan employs its own meat inspectors, its local officials feel justified in remitting only 30 percent of the amount due.[1]

The other contributing factor to the profitability of this enterprise is its high level of activity. HACC caters primarily to suppliers in three municipalities in Bulacan, namely: Marilao, Obando, and Malolos.

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[1]On the basis of this position, Bulacan has set aside the post-mortem fee collections in a trust account. Over a period of three years, a large sum had accumulated. On August 15, 1979, the Provincial Board of Bulacan passed Resolution No. 777, providing for the transfer of ₱735,000 to the Hiyas Agro-Commodities Center. The remainder was remitted to the Central Government.

The nearest slaughterhouse is located in Balagtas, approximately 5 to 6 kilometers away, and within a 20 kilometer radius, there are seven smaller slaughterhouses. In terms of slaughterhouse activity, HACC undoubtedly dominates within the Bulacan province. Yet, HACC's slaughterhouse activity goes beyond the confines of Bulacan. Because of its A-1 facilities, animals slaughtered at HACC can be transported anywhere in the country. In addition, a great deal of slaughterhouse activity was diverted to HACC after the closing of some 17 slaughterhouses in Greater Manila.[1]

The HACC officials perceive that the slaughterhouse is now operating at full capacity.[2] The information given indicates that the slaughterhouse is currently working at full capacity, defined in terms of time use. It is operated seven days a week, all year round, on a 24 hour basis.

Within a span of three years, 1977 to 1979, the volume of animals slaughtered has grown tremendously. Slaughtering of cattle has tripled from 1977 to 1978 and increased 17 times from 1978 to 1979. While the growth rates of carabaos and hogs slaughtered are not so dramatic, they are nonetheless significant. Hogs and carabaos account for the bulk of HACC's slaughterhouse activity (Table VIII-14).

Two considerations might dampen one's optimism about the slaughterhouse continuing to operate at this level. The first is a recent Presidential directive which prohibits the slaughter of carabaos on grounds of energy conservation (carabaos are used as substitutes for mechanized farm implements).

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[1] See National Tax Research Center, "Study of User Charges in Metropolitan Manila," 1977, p. 100. (Mimeographed).

[2] The concept of capacity utilization is not defined formally anywhere in this study. It may be defined in terms of some measured optimal level of plant use or alternatively, in terms of time utilization, i.e., number of hours open or operating per unit of time (day, week, year) as a percent of the number of operating hours possible.

TABLE VIII-14

LEVEL OF SLAUGHTERHOUSE ACTIVITY
HACC SLAUGHTERHOUSE, BULACAN PROVINCE: 1977-79

Type of Animals Slaughtered	Year			Growth Rates (Percent)	
	1977	1978	1979	1977-78	1978-79
Carabao	11,878	17,269	36,829	45.39	113.27
Cattle	82	331	6,079	303.66	1,736.56
Horse	---	---	32	---	---
Hogs	48,799	75,130	135,482	53.96	80.33

SOURCE: Data supplied by Hivas Agro-Commodities Center, Province of Bulacan.

This may have adverse effect on HACC's level of operation. However, it might be expected that as carabaos are not slaughtered, and therefore carabao meat is unavailable, consumers will substitute other animal meats (pork, beef, etc.). Thus, it is likely that some of the decline in slaughterhouse activity will be offset by an increased slaughter of hogs and cows. The ability of HACC to adapt to this substitution will be an important determinant of its future profitability. Considering its superior facilities and market power, it can be reasonably argued that the impact on Bulacan's slaughterhouse may be relatively slight.

The second problem is more formidable. HACC's considerable profits may provide enough incentives for local governments bordering Metropolitan Manila to open their own slaughterhouses, thereby cutting into HACC's operation. Short of a market study, we have no way of evaluating this prospect, though it is not a farfetched possibility. Should it materialize, the relatively higher transportation costs would make HACC less attractive for its Manila-based clientele.

Operating and Capital Costs

From 1977 to 1979, current expenditures grew by 61.1 percent, considerably less than the growth rate of revenues. Salaries and wages, which constitute about three-fourths of total current expenditures increased by 30.7 percent while repair and maintenance costs (including utilities) increased by 171.8 percent (Table VIII-11).

While there is a separate set of accounts for the enterprise, costs do not include any depreciation or allowance for replacement of the existing building and equipment. Also ignored is the imputed rent for the land on which the slaughterhouse building and facilities were constructed.[1]

A unique feature of the enterprise operation is the way it has shifted part of its costs to the slaughterhouse users--food manufacturers and meat dealers. The usual arrangement is that butchers are paid by the sponsoring local governments. Under the Bulacan set-up, however, butchers must register with HACC, but they are paid by the meat dealers and food manufacturers. Though we do not have a firm peso estimate, the amount saved by the provincial government is considerable. By one HACC official's estimate, some 300 to 400 small animals and 200 to 250 large animals are slaughtered daily. At the time of the interview, there were 57 registered dealers and about 300 registered butchers with HACC.

The arrangement is noteworthy for two reasons. For one, it provides a way of circumventing a nationally set price schedule which may be inappropriate for a given local unit and public enterprise facility. In this case, the effective slaughter fees have been increased over and above the national maximum. Second, by shifting part of the cost of slaughterhouse operation to the private sector, it increases the cash flow and the profitability of the undertaking. Looking at things strictly from the point of view of ease of administration, level of taxpayer resistance, and other benefit taxation arguments, the strategy of mobilizing public funds by shifting the costs to public enterprise users may be preferable to increased enterprise prices or taxation.

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[1] The value of the land, owned by the Province, has been estimated at about ₱1 million.

Financial Profitability

As noted above, the issue of the disposition of the post-mortem fees is important since it may affect the profitability measures. Table VIII-11, therefore, shows HACC's financial performance using two assumptions on the post-mortem fees: (1) the total amount reverts to the Central Government, and (2) 70 percent of post-mortem fees are retained at the local level while 30 percent reverts to the Central Government.

Over a three year period, the current account surplus rose enormously. On the assumption that the post-mortem fees revert to the Central Government, the current account surplus increased by 668.2 percent, to ₱390,866 in 1979. At this level of current account surplus, HACC slaughterhouse recovered full cost in 1979 with a surplus of ₱114,866. If we assume that 70 percent of post-mortem fees are retained at the local government level, we can estimate that full costs were recovered as early as 1978, two years after the beginning of operations, with a surplus that reached ₱649,425 in 1979. To give some perspective, the surplus, as a percentage of book value of fixed assets, was 3.56 in 1978 and 30.0 in 1979 (Table VIII-11).

The prospective performance of Hiyas Agro-Commodities Center, then, depends on the assumption about how post-mortem fees are handled. Under the "best" possible set of assumptions, the computed net present value of the enterprise is about ₱4.197 million. That is, over its 25-year life, the HACC investment will generate a revenue flow sufficient to cover all costs and provide a return of ₱4.2 million (valued in today's pesos). The set of "best" assumptions includes: retention by local governments of 70 percent of post-mortem

fees, 25-year project life, rate of interest of 14 percent, and a level of activity that approximates that of 1979, its peak year. If we assume, however, that all post-mortem fees revert to the national government, the project life is 15 years, the rate of interest is 18 percent, and that the level of enterprise activity will be the same as the average for the last three years, Hiyas Agro will be a huge drain to the provincial treasury. The financial loss will be ₱1.248 million (Table VIII-15).

The computed IRR under each of the eight sets of assumptions shows that in six of eight cases, this enterprise's IRR will exceed the prevailing government lending rates, and in some cases the current commercial loan rates as well. On the basis of computed NPVs and IRRs, this enterprise is undoubtedly the most profitable of the Bulacan enterprises.

Conclusions

On the basis of the foregoing analysis, the following observations might be made. First, this enterprise is clearly recovering its current costs, and has the potential of recovering its "full" costs, even on the assumption that post-mortem fees revert to the Central Government. This impressive financial performance can be partly attributed to two factors: first, its cost-reducing arrangement of shifting part of the costs to HACC users and second, its propitious market position (proximity to Metropolitan Manila where several slaughterhouses were shut down). The second reason strongly suggests the limited replicability of this enterprise.

TABLE VIII-15

HACC SLAUGHTERHOUSE: RESULTS OF FINANCIAL ANALYSIS
(in 1980 pesos)

Assumptions		Investment Criteria			
		Net Present Value		Internal Rate of Return	
Number of Years of Project	Discount Rate	'Best' Year	3-Year Average	'Best' Year	3-Year Average
		Assumption (a) Post-Mortem Fees Revert to the National Government			
n = 15	r = .14	₱232,450	₱-1,059,870	16.16	2.88
	r = .18	-177,260	-1,248,550		
n = 25	r = .14	523,630	- 949,240	17.77	6.64
	r = .18	- 25,990	-1,197,540		
		Assumption (b) Percent of Post-Mortem Fees is Retained at the Local Level, 30 Percent Reverts to the National Government			
n = 15	r = .14	₱3,520,960	₱913,000	42.6	21.99
	r = .18	2,548,750	386,860		
n = 25	r = .14	4,197,210	1,278,960	42.8	25.38
	r = .18	2,896,070	574,830		

SOURCE: Computed by authors from Case Study data.

Second, this enterprise has shown that while there are legal and administrative impediments to unconstrained public enterprise operation and pricing, they are not overly restrictive. That is, there exists a possibility for effective local response. For example, the hiring of the HACC manager is in response to the nationally set wages. The local response to the maximum rates to be charged (prescribed in PD 141) (a) is to use a wider array of changes and (b) to shift part of the costs of slaughtering animals to HACC users, thus making the actual user charges higher than the legal maximum.

Summary and Conclusions

The success of the Bulacan government with business enterprises has been uneven. In three of four cases there has not been a record of financial profitability, partly because of external factors, and it is not clear that the long-term performance will be markedly better. In this connection, it is noteworthy that financial feasibility studies were not carried out prior to establishing any of these enterprises. We have no way of making good forecasts of long-term revenue growth, but if our view is correct then one can conclude that these undertakings have not been successful in mobilizing additional resources for provincial government use.

On a more positive note, there have been management successes, particularly as regards the skill and flexibility of local officials in responding to potentially harmful Central Government policies.

Financial Profitability

The level of financial profitability of the Bulacan enterprises is not so high as many appear to believe. This misperception can be attributed to a system of government accounting that ignores the annual cost of capital and therefore substantially overreports net income. We have roughly (and conservatively) estimated annual capital costs for the 1977-1979 period and found that the Galeria was not even covering current costs, that neither the Cafetorium nor the Convention Center had covered full current and capital cost in every year, and that the slaughterhouse was covering all costs and generating a rather substantial surplus. Since the capital cost of all four projects was financed from accumulated surplus, both the Cafetorium and the Convention Center generate a positive annual cash flow to the provincial treasury, even though neither are truly "profitable" investments.

A long-run analysis requires us to ask what sort of return the government will get on its original investment in each case, taking into account the flow of net benefits in the future (as best as we could estimate this flow) and the opportunity cost of the government funds embodied in the facility. Of the four enterprises, three were analyzed in depth in terms of long-run impact on the local fisc: HACC slaughterhouse, the Cafetorium, and the Hiyas Convention Center. The results of the analysis show that only the HACC slaughterhouse can be expected to cover "full" costs, where full costs is defined to include allowance for the replacement of existing

fixed assets. There is little doubt but that in the long-run, it will be a major revenue contributor to the local fisc. The long-run prospect for the Hiyas Cafetorium to be a revenue contributor is marginal, while that of the Hiyas Convention Center is downright bleak.

The long-run fiscal impact of the three enterprises varies depending on the set of assumptions used. Under the "best" possible set of assumptions--a rate of discount of 14 percent, a 25-year project/facility life, a 100 percent collection efficiency for the Hiyas Convention Center, a 70 percent retention rate of the post-mortem fees collected by HACC slaughterhouse, and "peak" level operations for all enterprises--the net contribution of the three enterprises to the local fisc is approximately ₱2.561 million (Table VIII-16). On the other hand, under the "worst" possible set of assumptions, the three enterprises combined will cost the provincial treasury ₱7.813 million. The "worst" case assumptions include: rate of discount of 18 percent, 15-year project/facility life, status quo in the collection efficiency of the Convention Center, all post-mortem fees revert to the national government, and operating levels equal to the average of the last three years. Of course, one can construct a number of scenarios based on combinations of these assumptions. One likely scenario is to assume that all the assumptions in the "best" case above hold, except that the relevant rate of discount is the current government lending rate of 18 percent. Using this set of assumptions, the net impact on the provincial treasury is positive but only about ₱84 thousand. In general, the lower the discount rate, ceteris paribus, the more profitable the undertaking will appear.

TABLE VIII-16

BULACAN PUBLIC ENTERPRISES: SUMMARY RESULTS OF FINANCIAL ANALYSIS UNDER ALTERNATIVE ASSUMPTIONS

Enterprises	Net Present Value Under Alternative Scenarios		
	Best[a]	Most Likely[b]	Worst[c]
Hivas Cafetorium	₱ 114,330	₱ -3,780	₱ -142,267
Hivas Convention Center	-1,750,560	-2,807,890	-6,422,570
Hivas-Agro Commodities Center	4,197,210	2,896,070	-1,248,550
Net Result	2,560,980	84,400	-7,813,387

[a]Assumptions: (i) 25-year project life; (ii) rate of discount of 14 percent; (iii) 100 percent collection efficiency for the Convention Center; (iv) for the slaughterhouse only 30 percent of the post-mortem fees reverts to the Central Government.

[b]Assumptions are those in (a) above, except rate of discount is 18 percent.

[c]Assumptions: (i) 15-year project life; (ii) rate of discount of 18 percent; (iii) the present collection efficiency of the Convention Center would be maintained; and (iv) all post-mortem fees revert to the Central Government.

SOURCES: Tables VIII-8, VIII-10, and VIII-15.

It is important that we be clear on the meaning of these results. We want to know whether the flow of net revenues from these enterprises will be sufficient to cover capital depreciation and the opportunity cost of local funds. If only the former is covered, there is full cost recovery but nothing left over to contribute to the provincial treasury, i.e., the provincial government is earning no return on its original investment. Since both capital replacement cost and the opportunity cost depend on the interest rate, we derive a range of results. In the best case, the provincial government will cover all costs and add a total surplus of ₱2.561 million (1980 pesos) to its general fund over the life of the project. In the worst case, it will "cost" the province ₱7.813 million to fully cover depreciation and make up for the lost rate of return on the ₱10.240 million it originally invested. Except for the slaughterhouse, we cannot say that these ventures were an effective way to mobilize resources for general public sector operations.

Social Benefits and Economic Costs

These are mostly commercial projects but each carries some social purpose. To the extent these social benefits are important, the above measures of profitability are understated. On the other hand, these projects may also have imposed economic costs which make their profitability less than what is estimated above.

Consider first the economic costs. Because the goods and services provided by these enterprises are mainly private consumption goods, they tend to be substitutive (in the sense of drawing off business from the

private sector) rather than stimulative (in the sense of creating new jobs or inducing other productive activities). If we could measure it, we would reduce total profitability by the amount of this substitution effect.

The only possible exception is Hiyas Galeria. It is possible, though we cannot say how likely, that the program has resulted in increased production of cottage industry products within Bulacan--that is, that it has been stimulative. To the extent this is true, then the value of the induced economic activity can be counted as indirect benefits. Whether or not the monetary value of such indirect benefits is sufficient, to offset the substantial losses of Hiyas Galeria is a question that we cannot answer without more data and information.

External Environment

The financial performance of enterprises is invariably affected by factors that are external to the individual enterprise. Hence, evaluation of the financial profitability without looking into the external factors will almost certainly lead to erroneous policy conclusions. The variety of enterprise activities undertaken in Bulacan, their diversity in managerial arrangement, hiring and employment practices, pricing policy and disposition of surplus would seem to indicate that the external environment is not overly restrictive. Restraining laws do exist, but as demonstrated by the individual case analyses, so do the possibilities of avoiding some of these constraints. Indeed, some of the local responses (e.g., non-remittance of the post-mortem fees and the Hiyas Cafetorium's disposition of surplus on current accounts) are questionable.

Of course, some of the constraints are quite effective. One such constraint is the implicit policy to keep prices low relative to those charged in the private sector. This policy runs through all these enterprises with the exception of the slaughterhouse. Not surprisingly, it is the only financially viable enterprise, although its success is also due to some propitious market conditions.

Transferability

Following Bulacan's path of substantial involvement with commercial ventures may have disastrous results for other provinces. A first caution is that the profitability of the Bulacan enterprises may not be so high as is generally believed--the positive annual cash flows generated by the Cafetorium and Convention Center are deceiving. Moreover, following Bulacan's example may be totally inappropriate because of the province of Bulacan's somewhat unique features--high income, populous, growing, and proximity to Manila. On the other hand, some of the innovative cost-saving features which are documented in the individual case analyses are transferable. Among the most important are that less traditional public enterprises can be undertaken successfully, that in general there are a number of ways of going around externally imposed constraints, and that the operation and management of public enterprises can be undertaken in a number of ways (i.e., under varying degrees of public-private mix).

The Role of the Central Government

This work has led us toward a conclusion that there are good possibilities for local government business ventures, and that the management constraints may not be so great as one might expect. These undertakings should be

encouraged, but since risks are high, Central Government involvement and oversight will be necessary. Local governments need to be given latitude to identify business enterprise possibilities and freedom to operate them in an efficient manner. This would seem to call for little Central Government interference or regulation. But the issue is not so simple. As was pointed out above, local enterprises may also have regional or national implications. Moreover, in a system so centralized as the Philippines, the Central Government has a vested interest in all local government finance matters.

In this context, what are the lessons from the Bulacan experience? We have identified four areas of concern: public investment and financing practices, pricing policy, management behavior and organizational practices, and performance control and review.

Public Investment and Financing Practices

The Bulacan experience makes a good case for Central Government involvement in the planning stage for private ventures. Two issues arise here. The first is the need for external review of whether or not the proposed undertaking has reasonable prospects for financial success. The second 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.

Three of the four Bulacan enterprises are likely to be a drain on general revenues of the provincial government. It is not coincidental that a financial feasibility study was not made for any of these undertakings.

If Central Government policy is to encourage business enterprise activity, it must also encourage effective planning and design. If capital funding is obtained from loans, the feasibility study will be part of the loan application. If financing is from internal sources, a MOF or MLGCD sign-off on the feasibility study should also be required. We would recommend such a review procedure, and the establishing of standards for financial feasibility studies. Such standards could grow out of the procedures established by a new credit authority, as proposed in Chapters IX and X.[1] On the other hand, local government opportunities for business ventures are likely to vary, and all areas ought not be restricted to set types of undertakings. If the primary purpose of a business undertaking is to turn a profit, and if it can pass the test of a feasibility study, it is immaterial whether or not it meshes with government investment priorities. If, on the other hand, the project also has social goals and does not cover all costs, it should conform with national investment priorities. Business opportunities for local governments seem broad enough. For example, one can identify some feasible projects for local government undertakings: fish market, cold storage plant, farm implement manufacturing, fertilizer plant, resort facility, etc. But these projects should be undertaken only if (a) they are truly profitable, or (b) they conform to national economic development goals. In any case, a Central Government participation in the planning and design stage is essential.

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[1]This really is not a substantial departure from current procedures. It could be justified on grounds that part of the accumulated surplus is Allotment funds and that this activity is part of the capital budgeting process that requires Central Government monitoring.

We recommend that for purely business ventures, the Central Government give the local governments maximum discretion in project selection. Where the project must be justified partly on grounds of providing social benefits, normal Central Government review and sign-off should occur.

Pricing Policy

Considering that local preferences and economic conditions vary from one local community to another, it would seem reasonable to leave pricing decisions to the discretion of local governments. Nationally prescribed price schedules, e.g., slaughter fees, are infrequently changed and in any case may be improper for some local governments. For some enterprises, pricing autonomy may spell the difference between failure and success. We, therefore, recommend autonomy in pricing policy for all commercial-type ventures. Not to give this flexibility is to deny the basic idea of local governments operating as firms with respect to some of their activities.

The objective of commercial ventures is to raise funds for government, i.e., to make profits and the Central Government should give maximum incentive to local governments to achieve this goal. For commercial enterprises, we recommend no restrictions on the level of profits which may be earned or on the disposition of these profits.

Management Behavior and Organizational Practices

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 enterprise to function as a private firm. With the exception of the Hiyas Galeria, the enterprises have been run with some form of private sector participation--management contracting for HACC slaughterhouse and Hiyas

Convention Center and operating contract for Hiyas Cafetorium. In addition, and again with the exception of Hiyas Galeria which operates as a regular government department, the Bulacan enterprises have resorted to various labor-cost saving mechanisms which are largely unconventional by government standards. Hiyas Cafetorium, by operating as a private firm, employs workers as private sector employees and is therefore unencumbered by nationally imposed wage and benefit regulations. Hiyas Convention Center resorts heavily to casual or temporary employment, while the HACC slaughterhouse shifts part of the operating (labor) costs to the slaughterhouse users on "pay-as-you-go" basis.

Requiring the enterprises to operate as a regular department of the bureaucracy (like Hiyas Galeria) would ignore the fact that unlike a regular department where the demand for services is fairly constant throughout the year, the level of business activity of commercial enterprises may fluctuate considerably during the year. Public enterprises of the nature discussed here should be assured political and economic autonomy. Once the objectives and production targets have been explicitly specified, the day-to-day operation of the enterprise should be left to the enterprise manager.

We recommend that business type enterprises of local governments be given flexibility in terms of hiring and wage determination. While flexibility may not be a sufficient condition for the success of the operation, the likelihood of success is enhanced whenever the enterprise manager can employ workers in accordance with the level of enterprise activity and compensate them at the prevailing market wage rate rather than at nationally prescribed rates.

The organization type of these less traditional enterprises studied ranges from the most autonomously run--the case using operating contract (Hiyas Cafetorium)--to the polar case of departmentally-managed enterprise (Hiyas Galeria). One interesting implication derived from this wide diversity of organizational type is that the legal and administrative environment in the Philippines is not, or at least has not been, a major constraint in the managerial aspect of public enterprise activity.

An important question may be asked: Which one of these organizational types is "best" in terms of getting around the externally imposed constraints? As has been discussed before, if the nature of the constraint is one of wage and employment restrictions, then an operating contract arrangement is far superior to a departmentally-managed one. It should be obvious that the choice of organizational type is not limited to these two polar cases, for various mixed public-private organizational types can be designed. Private sector participation in the form of subcontracting can be considered for some aspects of public enterprise operation.

Performance Review and Control

On the basis of our case study analyses, one issue has become clear: proper measurement of profitability will be required if management is to be held accountable for its efficiency and if subsidies provided by the enterprise are to be detected.

Three of these enterprises--Hiyas Galeria, Hiyas Cafetorium, and Hiyas Convention Center--have been subsidized through the budgetary process. It is beyond the scope of this study to determine whether such subsidy corresponds

to the valuation of social objectives imposed on each enterprise. Estimates of the community's willingness to pay for such social objectives are simply not available, and in any case these objectives are not always explicitly stated. We would point out, however, that these are business enterprises whose primary function is to make a profit, i.e., to generate a surplus for general government use.

One can reasonably argue that under the present system of deficit financing and disposition of surplus, there appears to be no strong motivation for the enterprise management to minimize public subsidy. Expenditures are provided for through the annual budget process, while all revenues, and therefore, surpluses, revert to the General Fund. Additionally, to the extent that the sponsoring government looks at deficits on the basis of the difference between revenues and current operating costs, it may see profitability when it is not really there. As a result, there will be less pressure on the enterprise management to institute cost-saving devices to cover "full" costs and, therefore, to minimize budgetary subsidy.

To improve overall decisionmaking, generate a more cost-conscious managerial behavior, and facilitate performance monitoring of the enterprise, we recommend structural changes in the existing government accounting practices. Among other things, the following measures should be considered:

- Adopt a system of enterprise accounting that includes depreciation (or consumption of fixed capital) in the production accounts.

- Require the measurement and accounting of all forms of subsidy--either explicit (e.g., capital subsidy, statutory transfer, grants) or implicit (e.g., tax exemptions, preferential loan subsidy).[1]

- Call for the maintenance of a separate set of accounts for the enterprise. Transfers to and from any Government Funds (General, Infrastructure, Trust, Sinking, Fiduciary, etc.) should be recorded.

Finally, we recommend that the Central Government establish an integrated and well defined policy on local government involvement in less traditional public enterprises. The policy should specifically address the following issues: areas of national priority, sectoral targets for local public enterprise, conditions for financial profitability, pricing policy, the budgetary link between the enterprise and the local government, managerial and organizational autonomy, and a system of performance monitoring and control.

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[1] The concepts of explicit and implicit subsidies are more rigorously defined in Appendix VIII-A.

APPENDIX VIII-A

PROFITABILITY AND SOME CONCEPTS OF SUBSIDY

The profitability of public enterprises might be analyzed in the same framework as one would study the operation and profitability of a private firm. The accounting profit of the enterprise in period t[1]--profits or loss--is defined as

$$\pi_t = R_t - C_t^* \qquad (1)$$

where R_t and C_t^* are total revenues and total costs at period t, respectively. Total revenue, R_t, is defined as

$$R_t = p_t Q_t \qquad (2)$$

where p_t and Q_t are the price charged and the quantity provided by the enterprise and period t, respectively. Define total costs in period t as the sum of current expenditures, C_t^c, and annual capital cost, C_t^k. Current operating costs, C_t^c, is in turn disaggregated into two components, $w_t L_t$ and $S_t A_t$, such that

$$C_t^* = w_t L_t + S_t A_t + C_t^k \qquad (3)$$

where in period t, the annual compensation (including benefits) of employees is w_t, L_t is the number of employees, s_t is the per unit cost of other inputs

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[1]In its most general formulation, the net cash flow of the enterprise can be defined as:

$$\pi_t = (R_t - C_t^*) + R_t^t + R_t^p$$

where R_t^t is transfers from earmarked revenues and R_t^p is net property income (dividends, interest, rent), and π_t, R_t and C_t^* as defined above. These two additional sources of revenues are ignored in this Appendix.

taken collectively, (e.g., utilities, materials, supplies, etc.) and A_t is the volume of non-labor and non-capital inputs.

Combining (1), (2), and (3), the accounting profit of the enterprise in period t can then be written as

$$\pi_t = pQ_t - wL_t - sA_t - C_t^k \qquad (4)$$

To clarify the issues of subsidy, financing, and profitability, assume that the enterprise is wholly owned by the government with debt financing at an interest rate set by the government. C_t^k, annual cost of capital, can be assumed to depend on a number of factors, namely:

$$C_t^k = f(i, m, \delta, P, r_d) \qquad (5)$$

where

i = rate of interest

m = number of amortization periods

δ = rate of depreciation

P = present value of investment financed

r_d = rate of return on government deposits.

Combining equations (4) and (5), we can say that the accounting profit of the enterprise is equal to

$$\pi = p_tQ_t - w_tL_t - s_tA_t - f(i, m, \delta, P, r_d) \qquad (6)$$

The local government enterprise may enhance its profitability position, <u>ceteris paribus</u>, by increasing p or increasing Q, or both, and by lowering any component of costs--wage rates, level of employment, price of intermediate inputs, use of intermediate inputs, and capital costs. The

Central Government can influence profitability by, ceteris paribus, reducing i or increasing m. Errors in investment decisions--e.g., building of a plant (or facility) considerably more expensive than what is "appropriate" for the project--will be reflected in the annual cost of capital. Other things equal, the latter increases as P (the present value of investment financed) increases.

Of course, this framework oversimplifies. We have assumed away any scale economies and feedback effects. The latter are especially important, e.g., an improved (or better) capital facility may generate greater volume of sales. There also is no consideration of other short-term government actions that might increase sales, e.g., improved barangay roads which give better access to the facility and perhaps expand the market area. Despite these oversimplifications, this model identifies those factors which affect the financial viability of enterprise activities and those government policies that might improve things. As a short-term model, it would seem useful.

Operating and Capital Subsidy

One of the uses of the above model is to clarify the concepts of operating and capital subsidy. As mentioned in Chapter VI, a public enterprise can not be expected to recover "full" cost in all cases and in fact, for some public enterprises full cost recovery may be inappropriate. It is, however, important for performance evaluation and forward-looking policy decisions to be able to define exactly the amount of public subsidy involved.

Equation (6) can be rearranged to show the explicit subsidies, such that:

$$--_t = w_t L_t + s_t A_t - p_t Q_t + f(i, m, \text{[illegible]}, P, r_d) \qquad (7)$$

where the left-hand side shows explicit subsidies by means of provision,

while the right-hand side shows them in terms of the costs to be covered. Specifically, $-\pi_t$ is the amount of subsidy paid out of the public treasury. On the right-hand side, the terms--$(w_tL_t + s_tA_t - p_tQ_t)$--represent the operating subsidy, or the amount necessary to cover the difference between the market value of current output, p_tQ_t, and the value of variable labor and non-labor inputs. The annual cost of capital associated with the function $f(i, m, \delta, P, r_g)$ corresponds to the capital subsidy.

For "full" cost recovery requirement, i.e., that total revenues is enough to cover both capital and current cost, the total explicit subsidies, following directly from the right-hand side of Equation (7), is:

$$S_{fc} = w_tL_t + s_tA_t - p_tQ_t + f(i, m, \delta, P, r_g) \qquad (8)$$

For subsidies to be non-positive, we have the following requirement:

$$S_{fc} \leq 0 \rightarrow 1 \leq \frac{p_tQ_t}{w_tL_t + s_tA_t + f(i, m, \delta, P, r)} \qquad (9)$$

that is, that the ratio of total revenues to total costs be greater than one.

On the other hand, it is sometimes appropriate to simply require that the enterprise cover its current costs, i.e., not to be a drain on the local fisc on a year-to-year basis. Since operating subsidy is defined as $(w_tL_t + s_tA_t - p_tQ_t)$ then for operating subsidy to be non-positive we simply require that:

$$S_{oc} \leq 0 \rightarrow 1 \leq \frac{p_tQ_t}{w_tL_t + s_tA_t} \qquad (10)$$

that is, that the ratio of current revenues to current operating costs be greater than one.

It should be obvious that in addition to these explicit subsidies there are implicit subsidies. One is tax subsidy. Public enterprises, at least in the Philippine context and in most countries, are exempt from some type of taxes--business, sales, income, and even tariff and import taxes. There is therefore an implicit subsidy in terms of tax revenues foregone. The other implicit subsidy is the difference between the opportunity cost of capital and actual cost of capital faced by public enterprises. Local governments have access to low-interest loans through government financial institutions and in addition can, with minimal restrictions, make use of budgetary surpluses or "free" government funds. We call the former debt capital (K^d), the latter as equity or internally generated capital (K^e), where the sum of the two is total capital, i.e.,

$$K = K^e + K^d \tag{11}$$

Assume for simplicity that the tax subsidy is in the form of profits tax foregone. Formally, with τ as the profits tax rate, then the implicit subsidy is:

$$\tau r_t = \tau(p_t Q_t - w_t L_t - s_t A_t - f(i, m, \delta, P, r_g) \tag{12}$$

Let β be the opportunity cost of capital. Define the implicit subsidy in terms of concessionary loan, i.e., opportunity cost of capital minus actual or observed annual cost of capital:

$$\beta K_t^e - f(i, m, \delta, P, r_g) \tag{13}$$

Note that the annual cost of capital associated with $f(i, m, \delta, P, r_g)$ is its market value and is based on existing government policies. It is, in general, not equal to, and one can argue much lower than, the opportunity cost of capital. Define the implicit subsidy in terms of equity financed, or locally financed, capital as opportunity cost of government capital minus the accounting profit of the enterprise:

$$\beta K_t^e - \pi_t \tag{14}$$

Total explicit and implicit subsidies are then given by:

$$S_\Sigma = (1-\tau)(w_t L_t + s_t A_t) + \beta K_t - \tau f(i,m,\delta,P,r_g) - \pi_t - (1-\tau)p_t Q_t \tag{15}$$

and for total subsidies to be non-positive, a requirement that forces this enterprise to behave as a private firm, the following condition must hold:

$$S_\Sigma \leq 0 \rightarrow 1 \geq \frac{p_t Q_t}{(w_t L_t + s_t A_t) + (1/(1-\tau))\,[\beta K_t - \pi_t] - \{\tau/(1-\tau)\} f(i,m,\delta,P,r_g)} \tag{16}$$

Part Three

Expanding The Use of Credit Financing By Local Governments

CHAPTER IX

LOCAL GOVERNMENT CREDIT FINANCING IN THE PHILIPPINES: THE PRACTICE AND PROBLEMS

Introduction

In the Philippines, as in many developing countries, attention is being given to ways of enlarging local government responsibilities for the planning, financing and administration of basic infrastructure facilities. The thrust in the Philippines is in the direction of promoting "income generating" projects, such as water supply and sewerage disposal, markets, streets, utility services, and recreation facilities. There are substantial advantages to this approach to strengthening local government. More local revenues can be mobilized for development projects, governmental response to public demands can be improved, and the administrative and financial burdens of Central agencies might be lessened.

The problem is how to bring about more local government involvement in the financing and operation of capital intensive facilities when local resources are limited, technical capabilities to plan capital projects are limited and the ability to manage commercial-type ventures is limited. One approach--which might deal with a least the first two of these problems--is the increased use of credit financing, possibly enhanced by the creation of a specialized credit authority. The question on the table is whether such a reform, by lowering annual capital costs, might get some local governments past the cost recovery bottleneck. The answer to this question ought to be affirmative. As was pointed out above, local governments do have opportunities to pursue income generating projects, adjustments in interest rates and

maturity schedules can significantly lower annual capital costs, and local governments may have substantial idle balances which might be leveled with an effective credit financing scheme. In evaluating this possibility, four concerns need to be addressed:

i. A description and critique of the policies, procedures and practices instituted under Presidential Decree (PD) 752.

ii. A review of the lending programs of institutions presently granting loans to local governments, and a consideration of some of the practical difficulties and shortcomings of the present system.

iii. A review of the state of the practice on the structure, organization, management and capitalization of local government lending authorities in other countries.

iv. An analysis of alternative policy guidelines for restructuring local government credit financing in the Philippines--including consideration of a specialized credit authority.

The first two of these issues are addressed here and the other two in Chapter X.

Local Government Credit Financing: The Present System

National economic development policy in recent years has persistently emphasized regional development planning as a means to achieve economic growth, social justice and an equitable distribution of income within and among regions of the country. The framework for regional planning and its relationship to the national planning process has been outlined in a series of Presidential Decrees (PD 1 and 1200) and Letters of Instructions (LOI 542 and 542-A). The issuance of Executive Order (EO)

589 in April 1980 represents still another step toward the goal of regional development. Specifically, it attempts to link the planning and budgeting processes at the regional level by requiring the formation of a Regional Development Investment Program (RDIP) in each of the 14 regions. Responsibility for preparation of the RDIP rests primarily with the Regional Development Council which is charged with the task of identifying, consolidating and reconciling programs and projects that are to be undertaken by national line agencies, local governments, government-owned and controlled corporations and other government development authorities and, to the extent possible, by the private sector.

Executive Order 589 has important implications for local governments within a region and for their residents. First, the development procedures adopted under the order should foster greater local participation in the identification and selection of national projects. Second, it should provide for a more efficient allocation of financial resources within a region. Third, projects financed by local governments from sources should be more effectively integrated with nationally budgeted projects. Knowing what type of projects the line agencies of a region plan to pursue over the next five or ten years should enable local units in the region to more intelligently plan their own projects, both in terms of compatibility with the national projects and in terms of meeting local needs. Last, although locally-financed government projects are normally independent of the capital expenditure activities of the line agency and should remain

so under the new order, Central Government Ministries exercise considerable control over the capital budgets of local governments. As discussed in more detail elsewhere, this is because local governments often must secure the endorsement of national bureaus or Ministries before proceeding with a capital investment project. For example, the Ministry of Local Government and Community Development reviews all investment projects financed by local units from their Infrastructure Fund; and, in the case of large projects--those in excess of ₱2 million--the National Economic and Development Authority's approval must be obtained.[1]

Authority for Local Government Credit Financing

As detailed in PD 752, the Decree on Credit Financing for Local Governments, provinces, cities and municipalities may borrow to cover expenditures in advance of revenues, and to finance the construction, installation, improvement, expansion, operation or maintenance of local infrastructure and other socioeconomic development projects. The implementing instructions issued by the Ministry of Finance, on August 12, 1975, less than a month after the Decree was signed, outline the specific provisions, conditions and limitations for borrowing and the proper procedures to be followed by local government loan applicants. The Philippine National Bank (PNB), the Development Bank of the Philippines (DBP), and the Government Service Insurance System (GSIS) are authorized to grant loans and credits to local governments. However, as a matter of policy, the PNB

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[1] Letters of Instruction 646 and 794 outline the procedures to be followed.

makes no long-term loans to local governments. Their credit experience with local governments has been restricted to short-term advances against tax receipts.

Section 4(a) of PD 752 lists the types of projects which are eligible for long-term financing by the three lending institutions. Loans are authorized for construction, improvement and operation of the following:

1. Electric light and power plants;
2. Public markets and slaughterhouses;
3. Waterworks and irrigation systems;
4. Telephone and radio communication systems;
5. Government housing projects;
6. Purchase of rural and urban estates; and
7. Other capital investment projects.

Further, in Section 4(b), provincial, city and municipal governments are granted the authority to obtain medium- and long-term loans from the Land Bank of the Philippines (LBP). These loans may be secured by real estate and/or other acceptable assets, and may be used for the establishment, development or expansion of agricultural, industrial, home building and other enterprises.

Procedures and Conditions

To secure a loan for one or more of the above types of projects, as well as for such other items as heavy equipment or farm machinery which are not specifically mentioned, a number of documents and/or approvals are required. The most recent checklist of items to be submitted by local governments to the MOF is dated June 1, 1978. Depending on the type of project to be financed, between nine and twelve different documents and/or approvals must be filed before the MOF will process the application. MOF's approval is a necessary condition for the submission of the projects

to one of the lending institutions for funding, but is not a sufficient condition for approval by that institution. The sufficient condition is that the project meet the institution's standards for financial viability.

Returning to the approval process itself, the following sequential steps must be taken and the appropriate documents and/or approvals obtained:

i. A resolution duly signed by a majority of the members of the local board or council and endorsed by the chief executive specifying the amount desired, the project to be financed and the name of the lending institution.

ii. A resolution from the local legislative body authorizing the local chief executive to negotiate and enter into a contract with the lending institution.

iii. In the case of municipalities, a resolution of the provincial legislature favorably recommending the council resolution.

iv. Certification of the Commission on Audit (Quezon City) as to the legal borrowing and paying capacity of the local government, based on its operation for the last three years.[1]

v. The project plans and specifications together with the feasibility study prepared by the local engineer and/or development staff officer. In the absence of a municipal engineer, the municipal mayor may request participation of the provincial engineer or provincial development staff.

vi. For projects partly funded from the 20 percent development fund (PD 144), the approval of the Secretary of MLGCD. In practice, his review is requested on all projects.

vii. In the case of projects concerned with agrarian reform (Land Bank loans), certification of the Ministry of Agrarian Reform as to the number of farmer beneficiaries residing in the particular local government area.

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[1]Currently, the COA has defined legal borrowing capacity as 7 percent of assessed values of taxable real property minus any outstanding loans. This measure of financial strength comes from Sec. 11, Jones Law, Act 2896, as amended by Acts 2950 & 3051, and is thus not based on any current Presidential Decree or legislation. Paying capacity is defined as the average yearly excess of gross revenues over total budget charges, excluding repayment, divided by an approximation of yearly amortization charges for the loan.

viii. The favorable recommendation of the provincial treasurer in the case of province and municipalities and of the city treasurer in the case of cities.

ix. Endorsement of the project by the MOF, with a commitment of the MOF that in the case of default of the local government, the Ministry will release the defaulted amount[1] to the lending institution out of the BIR Allotment due the local government.

x. For slaughterhouses and homebuilding it is required that cost estimates, plans and specifications, bills for materials and programs of work for the project be endorsed by the governor or mayor. There must also be endorsement of the project by the Ministry of Human Settlements.

xi. For financing agricultural equipment and heavy equipment, it is required to furnish (a) a list of machinery and equipment to be purchased and their costs; (b) a guarantee by equipment dealers of the availability of spare parts; and (c) in the case of road equipment, certification of the Ministry of Public Highways to the effect that the local government would be able to utilize 50 percent of the Highway Special Fund for repayment, and that the heavy equipment cannot be rented elsewhere.

Bonds and Other Forms of Long-Term Indebtedness

In addition to borrowing from designated government institutions, provinces and cities under PD 752 are also authorized to issue bonds, debentures, securities, collaterals, notes and other obligations to finance self-liquidating and/or income producing development projects. The issuances of the bonds and other long-term securities are, however, subject to several conditions: 1) "They shall be in registered form and transferable at the Central Bank of the Philippines." 2) "They shall not be sold at less than face value." 3) "They shall be redeemable ten years or more from the date of issue..., but may be redeemable earlier by the local government upon approval by the majority of all the members of the local

[1] This is a lending requirement.

Council." 4) Before the issuance of the bonds, the Secretary of Finance determines the annual rate of interest payable, as well as the mode of payment. 5) Finally, and perhaps most importantly, the self-liquidating or income-producing project must be certified by NEDA, and the aggregate amount of outstanding bonds or securities at any one time may not exceed 5 percent of the total assessed value of taxable real property within the territorial jurisdiction of the local government unit.[1] Perhaps because of these restrictions, no local governments have made use of this provision of PD 752. Except for very large infrastructure projects, the cost of issuing bonds and complying with the other conditions of this section would seem to be prohibitive.

To enable cities and municipalities to finance capital investment projects within areas larger than the legal boundaries of a single jurisdiction, jointly executed projects are also provided for in PD 752. This provision has great potential since there are a number of such locally-oriented projects as slaughterhouses and public markets with market areas much larger than the geographical boundaries of the unit in which it is physically located. We know of no local governments making use of this aspect of the Decree.

While we can only speculate as to why local governments have availed themselves of neither of these provisions, one possible reason may be that local officials feel that local facilities such as public markets are essential to preserve the community's identity and therefore should not be located outside the jurisdictional boundaries.

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[1]Presidential Decree 1195 (March 20, 1978) amended Sec. 6(a) of PD 752 and raised the aggregate amount from one-half of 1 percent to 5 percent.

Lending Programs of the Authorized Institutions

While PD 752 gave explicit instructions about procedures to be followed by local governments seeking loans, much discretion over loan conditions was given to the three designated lending institutions. An analysis of the effectiveness of these lending programs must begin with a discussion of their legal authority, current policies concerning eligibility, and conditions and terms for repayment.

Development Bank of the Philippines

Pursuant to Republic Act 2081, approved June 14, 1958, the Development Bank of the Philippines succeeded the Rehabilitation Finance Corporation (RFC), an agency established under Republic Act 85 of October 19, 1946. The DBP is owned wholly by the government. It was established "to provide credit facilities for the rehabilitation and development and expansion of agriculture, industry, and reconstruction of property damaged by war and (for) the broadening and the diversification of the national economy, and to promote the establishment of private development banks in the province and cities."[1] With reference to local governments, the charter provides for the financing of provincial, city and municipal self-liquidating or income-producing projects. It specifically forbids the financing of non-self-liquidating projects. Local governments are eligible to borrow for the construction, installation, improvement, operation or maintenance of electric plants and systems, public markets and slaughterhouses, waterworks systems, telephone communication, agricultural equipment, heavy equipment and machinery, cadastral survey, and other income-generating projects.

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[1] Development Bank of Philippines, 1979 Annual Report, p. 32; parentheses added.

Under Republic Act 85, the initial authorized capitalization of DBP was set at ₱300 million. Over the years the government's capital contribution has been steadily raised in a series of amendments to the original Act. The most recent change occurred on June 11, 1978 under PD 1461, when the Bank's authorized capitalization was increased to ₱5 billion. As of December 31, 1979, however, the actual level of capitalization stood at a little over ₱3 billion. In round numbers, based on data furnished by DBP, the other major sources of investment funds at the end of 1979 were: bonds, notes and loans ₱7.6 billion; demand, time and savings deposits, ₱1 billion; other sources ₱400 million.

Terms and Conditions. The standard repayment period of DBP loans is 10 years with a two to three year grace period. Currently (1980) the interest rate on government loans is 18 percent per annum with a 1 percent rebate if the annual payment is received on time. A nominal application fee is collected from each applicant based on the value of the loan. For loans of a million pesos, for example, the fee is only ₱5,000 or one-half of 1 percent of the value of the loan.

Bank policy states that the amount advanced for a project be based on two factors: (1) the financial needs of the project, and (2) its repayment capacity. Providing that the principal amount does not exceed the borrower's legal borrowing capacity and that the MOF favorably endorses the project, the policy permits 100 percent financing of projects that are totally self-liquidating. In practice, DBP determines the "financial needs" and the total cost of a project from details furnished by the applicant.

Normally, DBP's appraised or estimated project value differs from the loan amount requested, usually falling below that estimated by the applicant. Using their own total cost (loan) figure, DBP projects the net income from operations of the facility after all operating expenses and debt amortization. If the projected cash flow is sufficient to accommodate the requested loan, 100 percent financing is extended; if it is not, the shortfall in net income becomes the equity or counterpart funds required of the applicant. In fact, if DBP identifies the project amount as some percentage of the true project amount, an implicit "down payment" is being required. It is altogether possible that DBP is lending only that percentage of project costs that are recoverable from project revenues.

Heavy equipment loans, due to the nature of the capital investment, must qualify under another set of policy rules and are subject to different terms and conditions. As previously mentioned, the procedures and steps for financing equipment are spelled-out in a Joint-Memorandum (MLGCD & MOF) Circular 78-1 dated June 1, 1978. Assuming all the proper endorsements are obtained, heavy equipment loans currently are made at 14 percent interest per annum plus a 2 percent service charge, and are repayable over seven years. The equipment is secured by a chattel mortgage,[1] and like the long-term capital projects, 100 percent financing is possible, depending on the projected rental income from the equipment.

Finally, a statement or guarantee is required from the MOF to the effect that should loan default occur they will withhold a portion of the local government's BIR Allotment. According to PD 231 as amended, in the

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[1]Title to the equipment remains with the lending institution until the equipment loan is paid off.

event a jurisdiction is unable to meet its annual amortization payments when they fall due, upon notification by DBP, the MOF is to withhold a sufficient amount from the monthly internal revenue (BIR) Allotment of the local government to repay the amortization, penalties and any accrued interest charges on the loan.[1] If recipient local governments have BIR Allotments equal to or greater than the annual amortized value of their loans to DBP, one would expect that the Bank's risk of total default is virtually nil. In practice this is not quite the way it works. According to the DBP, when a local government defaults on its loan, the conditions of the loan guarantee are seldom completely honored. In the Bank's experience, the MOF normally only remits between 20 and 30 percent of the annual amortized amount owed. The reported response of the DBP's management to this practice is to discount the importance of the guarantee and in general to follow a more conservative lending program than they would otherwise. In defense of the MOF's actions, however, the scaled-down payments may be called for in many cases because withholding the full amount could jeopardize the local government's financial stability. Hence, what at first blush seems to be an iron-clad financial guarantee for the lending institution in reality is a much more limited form of loss protection.

Land Bank of the Philippines

Creation of a special banking facility to serve the needs of the rural population can be traced back to Republic Act 3844 or the Agrarian Reforms Code (ARC) approved on September 10, 1971. The legislation called

[1] Land Bank and Government Service Insurance System are also covered by this provision of PD 231.

for the establishment of a Land Bank to finance owner-cultivated family farms, and cooperatives involved in the production, processing, marketing, distribution and financing of agricultural goods. However, owing to organizational difficulties and inadequate capitalization, the Bank was ill-equipped to implement the programs of the original charter or the later policies outlined in Presidential Decrees 27 and 85 on agrarian reform.

In recognition of these limitations, a number of important revisions were made in the Charter in May of 1973 under PD 251. In this Decree the Bank was given power to prescribe, repeal and alter its own by-laws with respect to Bank operation (Sec. 2), to expand its capitalization through the issuance of bonds and preferred shares (Sec. 3 and 4) and purchase of three billion pesos of its capital stock by the Philippine Government, and to accept demand, savings and time deposits (Sec. 6).

Issuance of PD 717 in 1975 boosted the financial resources of the Bank still further. The most significant aspect of this Decree was the requirement that all banking institutions, whether government or private, set aside at least 25 percent of their loanable funds for agricultural credit in general, of which at least 10 percent was to be made available for agrarian reform credit to beneficiaries. The latter are defined as individuals or local governments located in areas which are designated as agrarian reform regions under the ARC as amended. One way banks can comply with the financing requirements of PD 717 is to purchase designated securities or other financial instruments of the Land Bank. This provision further augmented the financial resources of the Bank.

Collectively, these revisions and Charter amendments have greatly enhanced the Bank's ability to support agrarian reform. They have also increased the institution's scope of operation. At present, it can and does engage in such commercial banking operations as extending commercial loans, accepting deposits, engaging in import-export financing, international banking, and trust operations. From the 1980 Annual Report, the primary financial resources of the Bank are shown to be capital contributions from the National Government (₱1.4 billion), demand, time and savings deposits (₱2.2 billion), Bank bonds (₱0.7 billion) and retained earnings of (₱1.7 billion).

Terms and Conditions. The applicant follows virtually the same step-by-step process for loan approval at the Land Bank as at DBP. The procedures are identical by design: to avoid reinventing the wheel, the LBP drew upon the loan experience of DBP when establishing its own lending practices and procedures in 1975. Thus, the chief difference between the two institutions is one of emphasis. As already noted, the Land Bank must limit its lending to areas where land reform has taken place, and concentrates on projects which benefit the agricultural sector.[1]

Repayment terms vary with the type of project to be financed. The normal length of amortization is ten years for slaughterhouses and markets, seven years for heavy equipment, and four years for hand equipment.[2] The current (January 1981) interest rate is 18 percent on the longer term (10 years or more) loans. (Prior to January 1, 1980, the rate was 14 percent.)

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[1] Based on criteria set forth in Republic Act 38[illegible] as amended, the MAR has specified certain areas as "agricultural reform areas."

[2] Small farm implements such as plows.

Medium-term loans (7 years or less) are 16 to 18 percent (up from 15 to 16 percent). Loans are repaid on an annual basis for markets and slaughterhouses, and on a semi-annual basis for agricultural and heavy equipment.

Most loans have an equity-debt ratio of 15-85, but for some the ratio has been as high as 50-50. The Bank has rather wide discretion in determining what it will accept as equity. Land Bank bonds, real estate, buildings and plant and equipment are the most common equities. Like DBP, all equipment loans are secured by a chattel mortgage and are subject to the special rules and regulations mentioned above.

Government Service Insurance System

Commonwealth Act 86, passed on November 14, 1936, established a permanent pension plan system for eligible government employees. The original appropriation for the Government Service Insurance System (GSIS) created by this Act came from the teachers' pension fund. Although the coverage and operating policies have been amended on several occasions since passage, the basic intent of the Act remains unaltered, that is, the development of an actuarially sound life and retirement insurance plan for the benefit of government employees. Like all insurance based programs, the premium payments of members are invested in interest-bearing financial instruments.

Section 22 of the Act details the general conditions for the investment of funds by the Board of GSIS. According to this section, portions of the monies not required to meet the current payments in the form of

life annuities, death claims, and expenses incidental to carrying out the purpose of the Act are to be invested in interest-bearing deposits, bonds, or securities, or in loans to local governments or to the Government of the Philippines for the construction of self-liquidating projects.

Terms and Conditions. Standardization of the loan application process by the MOF means in essence that GSIS's documentation requirements and approval process are identical to that of the DBP and LBP. To the extent that a difference does exist between GSIS and one or both of the other institutions, it is with respect to the terms and conditions of loans. In contrast to DBP and Land Bank, GSIS is much more flexible on the terms of repayment. While the stated policy is to amortize loans over a maximum of 10 years, in practice, the repayment period may be twice the stated length. Ordinarily, however, the loan period does not exceed 15 years.

Prior to 1980, GSIS charged an interest rate of 5 percent per annum. In 1970 it was raised to 9 percent, and since June of 1980 the interest rate has been 14 percent. The current rate for local governments is a full 4 percentage points less than the Land Bank and DBP interest charge. According to GSIS officials the more favorable rate stems from the unique source of funding, i.e., insurance premiums and the requirement that all local governments purchase insurance from GSIS.

With regard to debt-equity ratios, GSIS generally attempts to keep the ratio at 5 to 1. However, if the project is judged to be totally self-supporting from current operations, 100 percent financing is possible and at least on one occasion has been granted. Finally, GSIS tends to

interpret the debt-carrying capacity rule rather liberally: they have given loans beyond the paying capacity limit if the outside collateral or self-financing looks particularly strong. This suggests, then, that the two lending requirements are not legally binding, and the institution feels free to extend loans in excess of a local government's paying capacity if in the lender's judgment the project is an acceptable credit risk.

Level of Credit Financing

An overview of the magnitude of local government borrowing or, conversely, of institutional lending is presented in Table IX-1. These data leave little doubt but that credit financing is not a widely practiced method of financing local projects in the Philippines.[1] Over the five year period from 1976 to 1980, the three authorities combined underwrote only 180 projects totalling ₱573.5 million. Relating these figures to the total number of local jurisdictions in the country and to their gross revenues demonstrates just how limited the practice actually is. During the five year period, approximately one out of every ten local jurisdictions had a project loan approved, and the cumulated borrowings in 1980 amounted to slightly more than 14 percent of the gross revenues of local governments in that year. Further, the 1980 figure for total outstanding balances plus partially funded projects of ₱415.1 million is some ₱158.4 million less than the total for the five year period, which suggests that the rate of loan repayments is outpacing the growth of new loans.

[1]The summary data contained in Table IX-1 were pieced together from the records of the individual lending institutions.

TABLE IX-1

CONSOLIDATED STATEMENT OF APPROVED LOANS TO LOCAL GOVERNMENTS BY THE DEVELOPMENT BANK OF THE PHILIPPINES, THE LAND BANK AND GSIS, 1976-80
(in thousands of pesos)

Type of Project	1976		1977		1978		1979	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Markets and Slaughterhouses	10	16,313	17	47,968	4	22,081	6	32,540
Commercial Bldg.					1	3,000	2	33,593
Water Works	1	12,000	2	200				
Electrical Systems								
Heavy Equipment	9	20,237	16	57,728	9	45,577	26	107,062
Farm Equipment			8	5,927	16	9,088	14	7,529
Fire Fighting Equipment					1	43,500		
Cadastral Surveys					1	1,350		
All Other	—	—	1	2,881	—	—	1	7,425
Totals[a]	20	48,550	44	114,764	35	124,596	49	188,149

TABLE IX-1 (CONT.)

Type of Project	1980 Number	1980 Amount	Total 1976-80 Number	Total 1976-80 Amount	Total Outstanding December 31, 1980 Number	Total Outstanding December 31, 1980 Amount
Markets and Slaughterhouses	9	37,169	49	156,071	167	101,620
Commercial Bldg.			3	36,593	6	25,498
Water Works			3	12,260	25	12,309
Electrical Systems					12	4,287
Heavy Equipment	15	52,723	75	283,327	50	112,132
Farm Equipment	7	2,539	45	25,083	36	14,295
Fire Fighting Equipment			1	43,500	1	27,580
Cadastral Surveys			1	1,350	7	1,498
All Other	1	5,000	3	15,306	4	6,532
Totals[a]	32	97,431	180	573,490	308	305,751[b]

[a]The annual totals reflect the number and amount of loans approved by the various lending institutions. All the funds were not dispersed during that year.

[b]An amount of ₱109.3 million should be added to the ₱305.7 million figure for partially funded projects.

SOURCE: Unpublished data, Development Bank of the Philippines, The Land Bank and GSIS.

Of the institutions identified, DBP was the largest lender during the period 1976 through 1980. It accounted for nearly 53 percent of all the funds borrowed and 50 percent of loans made to local governments. The Land Bank was the second most important source of financing, contributing a little over 40 percent of the total funds over the five year period. With just two loans, representing slightly less than 7 percent of the total, GSIS was the least active of the three institutions.

Development Bank of the Philippines

In Table IX-2 the amount and type of loans financed by DBP from 1976 to 1980 are shown. Heavy machinery loans dominate the list of projects financed both in terms of number of loans and total value. During the period, 46 projects were financed at a value of ₱135.7 million. This represents 44.9 percent of all DBP loans to local governments during the five years. Loans for public markets and slaughterhouses accounted for nearly 40 percent of the total. Loan amounts for projects which one assumes would dominate the institution's portfolio, i.e., waterworks, electrical systems and telephone systems, are, in contrast, presently performed largely by special national authorities. For water projects, the Local Water Utilities Administration (LWUA) has become the dominant institution; in the case of electricity, the National Electrification Administration (NEA) now handles most of the financing.[1]

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[1] LWUA was established on September 21, 1972 under PD 198 (as amended by PDs 768 and 1479). NEA in its present form came into existence in 1973. Telecommunication also is now under a national regulatory board.

TABLE IX-2

APPROVED LOANS TO LOCAL GOVERNMENTS BY THE DEVELOPMENT BANK OF THE PHILIPPINES: 1976-80
(in thousands of pesos)

Type of Project	1976		1977		1978		1979	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Markets and Slaughterhouses	10	16,313	15	40,868	6	17,381	2	21,050
Heavy Equipment	9	20,237	12	38,515	5	9,824	13	39,582
Fire Fighting Equipment[a]					1	43,500		
Water Works[b]	1	12,000	2	260				
Electrical Systems[c]								
Cadastral Surveys					1	1,350		
Others	—	—	—	—	—	—	—	—
Totals[c]	20	48,550	29	79,643	13	72,055	15	60,632

TABLE IX-2 (CONT.)

Type of Project	1980 Number	1980 Amount	Total 1976-80 Number	Total 1976-80 Amount	Total Outstanding December 31, 1980 Number	Total Outstanding December 31, 1980 Amount
Markets and Slaughterhouses	5	13,831	38	109,443	146	
Heavy Equipment	7	27,583	46	135,741	50	
Fire Fighting Equipment[a]			1	43,500	1	
Water Works[b]			3	12,260	26	
Electrical Systems[c]					3	
Cadastral Surveys			1	1,350	4	
Others	—	—	—	—	6	—
Totals[c]	12	41,414[d]	89	302,294[e]	236	176,751[f]

[a] A loan to Metropolitan Manila for purchase of equipment.

[b] With the formation of Local Water Utility Administration (LWUA) and National Electrification Administration (NEA) few loans are now being made for utilities.

[c] Annual totals include projects which have been approved but not necessarily totally funded.

[d] Only ₱12,099 of the total amount approved was released in 1980.

[e] Of the 1976-80 total, ₱139,194 or 44 percent was for local governments in Region IV.

[f] To the outstanding total of ₱176.7 million, an amount of ₱101.5 million should be added for approved but as of yet only partially funded projects. This would bring the aggregate total to ₱278.2 million.

SOURCE: Unpublished data, Development Bank of the Philippines, January 1981.

Land Bank

Lending to local governments is a relatively new activity of the Land Bank, beginning with the passage of PD 752. The first loan requests were received during 1976 and funds for fifteen projects were committed in 1977. Over the four year period ending December 31, 1980, a total of 89 loans were extended to qualified local governments. As shown in Table IX-3, approved borrowings during that period amounted to nearly ₱233 million, most of which went to finance the purchase of heavy equipment.

Compared to DBP, the Land Bank is a more specialized lending institution. This is clear from the types of loans which they make and is primarily a result of their commitment to agricultural reform and development. An examination of the breakdown of projects by type reveals that heavy equipment loans made up 63 percent of the total, and that most of this amount went to provinces for the purchase of road construction equipment to extend and upgrade farm to market roads. The other two major categories of loans, public markets and slaughterhouses, and farm equipment represent 20 percent and 11 percent respectively of the total. These purposes are justified because markets are seen as a method of improving the agricultural distribution system, and the provision of the farm equipment as a technique for increasing agricultural production through the renting of custom farm machinery to farmers. Although cities can and do borrow from the Bank, the Bank's agricultural orientation favors the financing of projects of provinces and municipalities.

TABLE IX-3

APPROVED LOANS TO LOCAL GOVERNMENTS BY LAND BANK: 1977-80[a]
(in thousands of pesos)

Type of Project	1977		1978		1979	
	Number	Amount	Number	Amount	Number	Amount
Public Markets and Slaughterhouses	2	7,100	1	4,700	4	11,490
Heavy Equipment	4	19,213	4	35,753	13	67,480
Farm Equipment	8	5,927	16	9,088	14	7,529
Commercial Building			1	3,000	1	2,493
Road Construction	1	2,881	—	—	—	—
Totals[b]	15	35,121	22	52,541	32	88,992

TABLE IX-3 (CONT.)

Type of Project	1980 Number	1980 Amount	Total 1977-80 Number	Total 1977-80 Amount	Total Outstanding December 31, 1980 Number	Total Outstanding December 31, 1980 Amount
Public Markets and Slaughterhouses	4	23,338	11	46,628		15,591
Heavy Equipment	8	25,140	29	147,586		89,519
Farm Equipment	7	2,539	45	25,083		17,564
Commercial Building			2	5,493		4,252
Road Construction	1	5,000	2	7,881		2,080
Totals[b]	20	56,017[c]	89	232,671		129,000[d]

[a]Land Bank's loans to local governments started in 1977.

[b]The term "approved loans" refers to the annual number and amount of loans approved by the Board. All the funds were not necessarily disbursed during the year the loans were approved.

[c]In 1980, the total amount actually disbursed to local governments was ₱7.8 million or 14 percent of the amount approved.

[d]To the outstanding total of ₱129 million, an amount of ₱7.8 million should be added for four approved but as of yet only partially funded projects.

SOURCE: Unpublished data, Land Bank of the Philippines, January 1981.

Government Services Insurance System

Of the three lending institutions, GSIS has been least involved in local government credit financing. With the sole exception of a commercial building loan in 1979, no self-financing loans have been made to local governments since 1972.[1] In the 24 year period (1956 to 1979) that GSIS has been making loans to local governments, they have underwritten an average of less than one project per year (see Table IX-4). To the extent that they have financed projects in the past, approximately three-fourths of the funds have gone for markets and slaughterhouses, and commercial buildings.

As the record shows, GSIS has not been active in the area of local government credit financing. Moreover, from discussions with GSIS officials there seems little likelihood that the situation will change in the near future. In recent years the agency has elected to limit its loan activity to large national projects and national enterprises such as Philippines Airlines.

Delinquencies

There is a relatively high rate of delinquency among borrowers. Data gathered from the three lending institutions shows that nearly a third of the 295 current loans are past due (Table IX-5). The incidence of delinquencies, however, varies considerably among lenders. Primarily as a result of poor administrative practices in the past, GSIS has an astonishing 87 percent of their loans classified as past due. These account for approximately one-half of the ₱44.8 million in delinquent loans.

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[1] As noted in Table IX-4, a loan was made to the City of Manila for a beautification project in 1979. This loan does not fit the accepted definition of an income generating project or a self-financing project, i.e., a project which generates revenues sufficient to cover some portion of costs.

TABLE IX-4

LOANS TO LOCAL GOVERNMENTS BY THE GOVERNMENT SERVICE INSURANCE SYSTEM: 1979
(in thousands of pesos)

Type of Project	1979		Total Outstanding March 31, 1979[a]	
	Number	Amount	Number	Amount
Markets and Slaughterhouses	---	---	15	14,290
Commercial Building	1	31,100	5	34,332
Electrical Systems	---	---	7	6,482
Water Works	---	---	1	564
Cemeteries	---	---	1	40
Bridges	---	---	1	73
Beautification Projects Manila	1	7,425	1	7,425
Totals	2	38,525	31	63,206

[a]The period covered is from 1956 to March 1979. Excluding the two loans in 1979, GSIS made no loans to local governments between 1974 and 1979.

SOURCE: Government Service Insurance System, May 1980.

In contrast to the GSIS record, the Land Bank lists just four of their 71 loans (6 percent) as past due. In part, the very low figure for Land Bank is attributable to the newness of their lending program and the fact that annual loans are not considered in the arrears until a local government has missed two annual payments.

The oldest and largest of the lenders, DBP, reports one-third of their loans are past due. Many of the loans go back several years and are for rather small amounts--the 63 delinquent accounts represent not quite 14 percent of the Bank's total outstanding loans to local governments. It is quite interesting to note that both DBP and GSIS have made little use of the BIR Allotment guarantee in collecting past due accounts. From the data available, it would appear that only 20 of the 94 delinquent loans are being repaid in this manner.

Obstacles to Credit Financing

The unmistakable conclusion to be drawn from the discussion thus far is that local governments have borrowed very little to finance capital projects. A first reaction is to think of constraints in terms of availability of funds or availability of suitable projects. The former would not seem to be a binding constraint at present. According to DBP officials, there has been no constraint or limit placed on the amount of funds available for financing local government projects by that institution. The current policy is to budget an amount for the local government sector based on projected loan demands. Available funds are reported to have exceeded project loan applications by local governments.

TABLE IX-5

PAST DUE LOCAL GOVERNMENT LOANS WITH THE DEVELOPMENT BANK OF THE PHILIPPINES, THE LAND BANK AND GSIS: 1980
(in thousands of pesos)

Lending Institution	Total Accounts	Number of Past Due Accounts	Percent Past Due	Amount Past Due	Total Loans	Percent Past Due	Subject to BIR Allotment
DBP	193	63	33	₱19,440	₱143,172	14	8
Land Bank	71	4	6	3,390	129,000	3	4
GSIS	31	27	87	22,000	63,206	35	8
Totals	295	94	32	44,830	335,378	13	20

Note: The Central Bank of the Philippines defines the term "past due" as follows: for monthly accounts, a loan which is 10 months in the arrears; for quarterly accounts 4 quarters behind; for semi-annual 3 payments in the arrears; and for annual accounts, 2 payments behind.

SOURCE: Unpublished data, DBP, the Land Bank and GSIS.

Neither would a binding constraint appear to be on the project side. From our analysis in Chapters VI-VIII, it appears that viable income generating projects--with some degree of cost recovery--are available to local governments. It also seems clear that such projects can meet important public service deficiencies. Why, then, is more borrowing not occurring at the present time?

Administration and Management Difficulties

Administratively, the credit financing system operates under the rules and regulations established by the Ministry of Finance. Project financing falls outside the sphere of MOF responsibility and is controlled by the lending institutions. This arrangement introduces a number of operational and managerial problems. With at least three and sometimes four or five agencies involved in the approval process, significant delays in the processing of a loan can occur. Some indirect evidence of the effects of these multi-agency clearances is provided in Table IX-6. Of the total of 396 loan applications received over the six year period, 1974 to 1980, it is reported that nearly 40 percent (155 projects) are still pending further action. The lack of proper endorsements or incomplete documentation, according to the lending officials, are the two chief reasons for such a backlog of pending applications.[1]

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[1] However, both DBP and Land Bank reported during interviews that fully documented applications are processed in 60 to 90 days.

TABLE IX-6

LOANS PROCESSED BY THE DEVELOPMENT BANK OF THE PHILIPPINES, THE LAND BANK AND GSIS: 1975-1980

Institution	Received	Approved	Pending[b]	Rejected
Land Bank	162	73	52	37
DBP[a]	229	111	102	16
GSIS	5	2	1	2
	396	186	155	55

[a]DBP does a pre-submission evaluation of projects for local governments prior to official submission. This prescreening process is designed to save local governments filing fees and to discourage them from submitting applications on economically unfeasible projects.

[b]Many applications in this category are actually dormant or inactive awaiting further documentation or information from local governments.

SOURCE: Assembled from data provided by the Land Bank, Development Bank of the Philippines, and Government Service Insurance System.

While it is hazardous to generalize from a small sample and anecdotal evidence, a review of several recently-approved loans indicated that it does take an inordinate length of time to approve and fund projects. To illustrate a point, the municipality of Magsingal, Ilocos Sur received a commitment letter on May 2, 1979 for an agricultural equipment loan--nearly three years after the process was initiated. Similar lengthy waits, two to three years, were also noticed for such other projects as public markets and slaughterhouses.[1] In Cadiz City, the local resolution authorizing the Mayor to seek financing of a public market was passed in September of 1978. Final loan approval for that project, however, was not received until August of 1980. In the case of Tagbilaran City, a ₱4 million loan for a market took 22 months for final approval from October 1977 to August 1979.

Regardless of the merits of a checks and balances system, the cumulative effect of these delays may be to significantly dampen a local government's enthusiasm for borrowing. This certainly might be the case of local officials believe such delays might cause their "pet" project not to be completed during their administration. This is surely one reason for the paucity of local government use of credit financing.

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[1] A cursory review of the records of the two major lenders , Land Bank and DBP, showed no significant difference in the length of time required to fully process loan applications or the length of administrative delays in processing loans.

A second problem relates to the preparation of a financial feasibility study--an integral part of the application. Local governments lack the professional staff to accomplish this important preliminary step and the lenders, a logical source for such assistance, find it difficult to justify organizing a professional staff for this purpose because of the low volume of loan activity.[1] A cursory examination of the professional staffs of the three institutions lends support to this observation. The Land Bank, for example, has a very small professional staff. At present all loan applications are handled by the division chief and four analysts. In addition to scrutinizing project proposals, the staff is responsible for following-up existing loans to insure that prescribed accounting procedures are observed. By comparison, very little staff time is spent assisting local governments in the preparation of proposals.

GSIS recently reorganized the Business and Investment Department which administered all loans prior to October 1978. The new Government Investment and Loans Department is headed by a director and supported by 14 professionals, a technical assistant, three lawyers, four accounts and/or finance analysts, and three engineers. Nearly all of the positions have been filled, but at the time of our visit (May 1980) the department was still grappling with a number of internal management problems and spending the bulk of their time on revising existing loans.

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[1] According to the 1979 Annual Reports of the Land Bank and DBP, local government loans accounted for less than 1 percent of each institution's total domestic loans in 1978 and 1979.

DBP funnels all local government loan inquiries through the Community Development Department. Depending on the type of project, the loan application is routed to one of two divisions--heavy equipment or construction. Each unit has seven professionals--a division chief and an assistant, two technical analysts and three financial analysts. Similar to GSIS, the department was reorganized in 1978, but unlike GSIS, the changes were less apparent. The major focus was improved managerial procedures for evaluating projects.[1] Specifically, since 1978 all feasibility studies submitted by local governments have been validated by the staff, i.e., reestimated,[2] and upon approval and release of funds, on-site progress inspections are conducted. Once completed, the project is monitored for three to six months to see if the projected revenue targets are being met. If they are, no further monitoring takes place unless the loan becomes delinquent.

In general, one may conclude that Land Bank and DBP would not appear to be staffed at a level sufficient to provide specialized assistance to local governments. Further, with the exception of department directors and some of the division chiefs, the professional staffs, in general, would appear to be rather inexperienced in local government affairs--both operations and finance.

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[1] It is not possible to compare the work-loads of the personnel of the institutions since the personnel handling local government loans have responsibilities in addition to local government loans.

[2] The Ministry of Finance reviews each case, but due to a shortage of analysts with technical expertise in this area, makes no judgment as to the accuracy of the feasibility studies submitted.

A third obstacle--actually more a frustration--to local officials applying for loans is the highly centralized nature of the process. Each national government agency (Ministry of Finance, MLGCD and COA) and each lending institution requires that local jurisdictions deal directly with their Manila office. Field offices may not process loan requests. While this centralization may be defensible on important grounds, such a policy makes the local government official's job much more difficult. Jurisdictions located some distance from the Metro Manila area find communication with the lenders and other agencies to be a major stumbling block. One municipal mayor reported that in order to keep the application process moving, frequent trips to Manila were necessary, at times as often as once each week.

Inadequate Information and Attitudes of Local Officials

In order to better understand why local governments do not borrow more, the mayors and treasurers of 13 jurisdictions were interviewed. The following observations came largely from this fieldwork.[1] Naturally, the small size and non-random nature of the sample suggests that the findings should be interpreted with care. Of the jurisdictions contacted, approximately half had existing or pending loans. Thus local governments who had not, were covered in the case studies. When appropriate, the views and attitudes of the two groups have been separated.

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[1] Thirteen jurisdictions were surveyed, one city, one province, and 11 municipalities (see Table IX-7 for the specific list).

Ignorance about borrowing powers would not appear to be a major problem. Although local officials varied in their understanding of the details of PD 752, all those interviewed were aware of the credit financing provisions of the decree. Provincial and city officials were the best informed, most having either been granted or recently applied for a loan. Municipal officials, by comparison, were less well-versed on the provisions of PD 752, but certainly well enough so to initiate the loan process.

General agreement existed among the mayors and local treasurers on three basic points. First, for large self-financing projects such as public markets and slaughterhouses, local units often must turn to outside consultants for technical assistance. This applies both to the preparation of the feasibility study and to required architectural plans. According to one mayor, the fees charged by consultants for these services range from 3 to 7 percent of the value of the project. In his city's case, preparation of a proposal and preliminary drawings for a new market will cost between ₱500,000 and ₱600,000. As with most projects, this is "up front" money that must be paid by the jurisdiction whether the project is funded or not. The problem is magnified for municipalities, since few of them possess the technical capability to perform these tasks and must purchase the services from even more limited financial resources.

Without exception, those not borrowing pointed to high interest rates as a major impediment. When presssed on the subject, most of the mayors were of the opinion that the Central Government should subsidize local projects with below market interest rates of 6 to 8 percent.

Elected officials of jurisdictions with recently-approved projects also expressed some concern over the current high level of interest rates (18 percent), indicating that if rates were to rise above the current level they would in all probability postpone any new projects.

The third view shared by local officials and treasurers was their generally conservative fiscal attitude. This is an important psychological barrier inhibiting the wider use of credit financing, and one which may prove to be intractable. By and large the mayors and treasurers in our survey had a "pay-as-you-go" philosophy of local government: revenues are accumulated until such time as a project can be fully paid for. To leave office with the municipality in debt is often viewed as the mark of an irresponsible public official and, in general, as bad management. The Bulacan experience described in Chapter VIII is an extreme example of this philosophy. In fairness, the cautious attitude is not always irrational. Many mayors feel that the revenue sources of the municipality are so limited that large reserves must be maintained to meet such unforeseen calamities as typhoons and collapses in the market price paid for their agricultural products. Municipalities located in Albay and Sorsogon provinces have evidently experienced those problems first hand.

The attitude of public officials in the two cities visited was much less conservative: both cities had sought loans and were looking forward to their funding. One explanation for this observed difference in attitude is the dissimilar financial resources of the two types of governmental unit. Cities have a broader and more diversified revenue

base and are much more financially secure. Many treasurers have adopted a conservative attitude toward investment projects because they believe Section 10 of PD 752, which deals with remedies, sanctions and penalties for nonpayment of loans, holds them personally and officially liable for such defaults. While we know of no local government treasurer who has been held personally accountable for a loan default, the language of the Decree apparently has created some apprehension on the part of treasurers. Their attitude toward development projects can best be described as "extremely cautious". The importance of this cautious attitude is underlined when it is remembered that local government treasurers, particularly the provincial treasurers, have considerable influence when it comes to credit financing matters. As noted above, a loan application must have the favorable recommendation of the provincial treasurer in the province and municipalities and the city treasurer in the case of cities.

The "conservative attitude" obstacle raises some interesting questions about needed reforms to increase the use of credit financing. In an inflationary environment, such a view is normally treated as being more a psychological than a substantive reason for not borrowing. As a matter of fact, in an inflationary environment, other things being equal, local governments should initiate rather than postpone self-financing projects. There are two basic arguments to support this statement. First, in an inflationary period, debtors benefit from the fact that fixed-term obligations are repaid in depreciated pesos, and second, any postponement of construction only serves to increase the project's total cost.

Regardless of the validity of these arguments, if a psychological barrier does exist, steps must be taken to break it down. While there are major exceptions to the rule, local governments must be made more aware of the fact that inflation affects both sides of the equation--revenues and expenditures--and therefore high interest rates *per se* should not discourage them from borrowing.

Unrealistic Loan Standards

Apart from the procedures, endorsements, and policy rules connected with the loan application process, two financial requirements must be satisfied for institutional approval. First, as certified by COA, the loan must be within the legal borrowing capacity of the government--7 percent of assessed value. Currently, this particular requirement does not appear to be a major stumbling block for city governments. As shown in Appendix Table IX -1, of the 58 cities for which data could be obtained, only two have exceeded the ceiling, and another three might be considered close to their limit. For municipalities, a similar situation is believed to exist, but the small number of units surveyed does not permit a definitive statement. None of the 11 municipalities shown in Table IX-7 exceeded its legal borrowing capacity in 1979. This financial requirement would not seem a constraint on local government credit financing.

A more binding constraint is the paying capacity requirement. This requirement is imposed to exclude governments that do not have the financial ability to cover the amortization requirements of a new obligation. The formula used first determines the average yearly excess of gross revenues over total budget charges--excluding sinking fund installments and repay-

TABLE IX-7

LEGAL BORROWING CAPACITY AND NET PAYING CAPACITY DATA
FOR THIRTEEN LOCAL JURISDICTIONS: 1979
(in thousands of pesos)

Local Jurisdiction	Type[b]	Assessed Value of Taxable Property	Seven Percent Rule	Outstanding Loans	Legal Borrowing Capacity
Passi	M	82,151	5,750	---	5,750
Sorsogon	M	51,861	3,630	2,628	1,002
Gubat	M	39,224	2,746	731	2,014
Barotac Viejo	M	34,211	2,437	244	2,193
Tigbauan	M	20,060	1,404	169	1,235
Tabaco	M	28,126	1,969	---	1,969
Malinao	M	12,458	872	---	872
Albay	P	313,805	21,966	---	21,966
Miagao	M	21,318[a]	1,492[a]	18	1,474
Legaspi City	C	151,157[a]	10,577[a]	1,760	8,817
Dumangas	M	31,000	2,170	---	2,170
Barotac Nuevo	M	34,500	2,415	---	2,415
Oton	M	44,602	3,122	---	3,122

	Average Yearly Excess 1976-79	Gross Paying Capacity (based on .24)	Adjusted for Slippage (40%)	Less Loans Outstanding	Net Paying Capacity
Passi	204	849	509	---	509
Sorsogon	83	348	209	2,628	(2,419)
Gubat	271	1,130	678	731	(53)
Barotac Viejo	40	166	97	244	(147)
Tigbauan	35	145	87	169	(82)
Tabaco	261	1,089	653	---	653
Malinao	19	80	48	---	48
Albay	---	---	---	---	---
Miagao	103	428	257	18	239
Legaspi City	8,894	3,706	2,224	1,760	464
Dumangas	143	595	357	---	357
Barotac Nuevo	118	492	297	---	297
Oton	19	80	48	---	48

[a]Assessed value as of December 31, 1980.

[b]Legend: P-province; M-municipality; C-city.

SOURCES: Furnished by Local Treasurers.

ments of loans and capital outlays--for the past three years. A jurisdiction's gross paying capacity is found by dividing the calculated average yearly excess figure by a yearly amortization factor. To illustrate, for a 10 year loan at 14 percent interest per year, an amortization factor of .269 would be used. To allow for possible slippages or a sudden fall in revenues, the gross paying capacity figure is adjusted downward even further. In the case of revenue-producing projects, 60 percent of the paying capacity figure is allowed, while for non-revenue producing projects, the gross paying capacity figure is cut in half. From the remaining discounted figure, outstanding loan balances are deducted to finally determine the local unit's net loan absorption capacity. In words, the formula outlined essentially assumes that the calculated current surplus will be indefinitely extended into the future and that the present value of that income will be available for debt repayment. Deducting for possible revenue slippage and previous debt repayment commitments, the jurisdiction's paying capacity is determined.

Working through an example in Table IX-7 might help to clarify more fully this second test of financial capability. Starting with an average yearly excess of ₱271,000 over the period 1976-79, the gross paying capacity for Gubat is calculated to be ₱1,007,435. The latter figure results from dividing the former amount by .269 which is the yearly amortization factor for a 10 year loan at 14 percent interest. Assuming the project is revenue-producing, the gross paying capacity estimate of ₱1,007,435 is reduced by 40 percent to build in a margin for revenue slippage or shortfall. This adjustment cuts Gubat's gross paying capacity estimate from ₱1,007,435 to

₱604,461. From the latter amount, outstanding loans of ₱731,000 are subtracted to determine the jurisdiction's net paying capacity. In the case of Gubat, the resulting figure is a negative ₱126,539. Not only is there no capacity to absorb new debt, they have already exceeded their legal borrowing capacity.

This method of measuring the creditworthiness of a local government is quite conservative. The 40 percent "slippage" is a large and arbitrarily assumed amount and no room is allowed for discretionary revenue increases. If local treasurers have taken their cue from such requirements, their conservatism is not hard to understand. At any rate, this requirement would appear to be a limiting factor on local government credit financing. Only about half of the sample governments in Table IX-7 show any capacity to absorb new borrowings.

A review of some recently granted loans shows that the lending institutions sometimes ignore the financial viability or paying capacity requirement, believing it to be too restrictive. In essence, lenders seem to believe the measure is overly conservative since it ignores the self-liquidating aspects of projects. Reducing the revenue slippage adjustment ratio from 60 to 40 percent, in their mind, gives far too little credit for the revenue generation aspect of such projects.[1] Therefore, loans which fail to qualify under the narrow net paying capacity standard have not been automatically rejected by the lenders if the project merits

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[1] The point here is that revenues generated by the project are not accounted for in the formula, yet only revenue generating projects can be financed under PD 752. Reducing the slippage factor from 60 to 40 percent gives insufficient weight to the income producing aspect of the project.

consideration from a self-financing standpoint. The fact that many local governments do not meet the specific standard and lenders often choose to overlook it raises some question as to the usefulness and appropriateness of the net paying capacity measure.

Recommendations: An Alternative Loan Standard

The two currently applied loan requirements are ill-conceived. The limitation of total debt outstanding is arbitrary but not binding hence it does not seriously affect the use of credit financing. The paying capacity requirement is equally arbitrary but (legally) disqualifies many potential local government borrowers. While there will always be some element of subjectivity in establishing debt ceilings, it ought to be possible to improve on these two alternatives.

Adhering to the simple principle that a local government's borrowing capacity should be tied to its ability to repay the indebtedness, we suggest the legal borrowing capacity be determined as follows:

Step (1): Calculate the average yearly excess of gross revenues over total budget charges--excluding repayment of loans--for the past three years.[1]

Step (2): To the average yearly excess amount (1) add 75 percent of the projected net annual income (receipts, less variable costs) of the project in constant pesos.[2] This yields a measure of Gross Annual Revenue (GAR) for the local government.

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[1] With the possibility of substantial increases in the Specific Tax and BIR Allotments, and with some improvement in own source revenues, the average yearly excess figure calculated is a conservative estimate of the local government's ability to repay long-term indebtedness.

[2] If the project is self-liquidating, the annual revenues from user charges, rents or fees are sufficient to cover all costs of operation, maintenance and amortization of the loan. Any increase in the variable costs (operation and maintenance) should be met through increased fees or rents. Thus, the constant peso value of the net annual revenues should not change over the life of the project. Adding a discounted value of the project's net annual income to the local governments revenues, while conservative, is warranted given the income generating aspect of the pro[illegible]

Step (3): Capitalize the Gross Annual Revenue (2) amount as follows: Divide GAR by a yearly amortization factor estimated as the sum of i and 1/n, where i = the annual rate of interest of the loan, and n = the number of years repayable.[1] This yields a measure of the local government's legal borrowing capacity.

Step (4): Subtract from the legal borrowing capacity (3) the value of all outstanding loans. This final step yields the jurisdiction's net borrowing capacity.

Using a formula of this type to evaluate borrowing capacity would seem to overcome the major objections and shortcomings of the present standards while at the same time not exaggerating a jurisdiction's ability to repay its obligations. Extending the repayment period from the current 10 to 12 years to 20 to 25 years would also increase the borrowing capacity of local governments.

Applying this alternative standard to the earlier example of Gubat yields the following results for a proposed market loan of ₱1,196,000 repayable over 20 years at 14 percent interest:

Step (1): Average yearly excess (Table IX-7): ₱271,000.

Step (2): Average yearly excess of ₱271,000 plus 75 percent of projected net annual income of the market:[2] ₱1,658,053.

Step (3): Capitalized at .19:[3] ₱8,726,595.

Step (4): ₱8,726,595 - ₱731,000 (Table IX-6), yields a net legal borrowing capacity of: ₱8,653,495.

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[1] Clearly, the amortization factor calculated is not mathematically elegant. In fact, it is only a crude approximation of the present discounted value expression $1/(1 + i)^n$. For larger values of n it yields a more conservative or smaller amortization value than does the expression $1/(1 + i)^n$.

[2] The actual figures for a market loan made by DBP are as follows: estimated annual revenue (₱2,700,150) less estimated operating expenses (₱850,746) equals net annual income (₱1,849,404). Multiplying ₱1,849,404 times .75 yields ₱1,387,053.

[3] The capitalization factor of .19 comes from the sum of the interest rate (.14) and 1/20 or .05.

Conclusions

Credit financing is not a widely practiced method of funding local government projects in the ROP. From 1976 to 1980 just 180 projects were financed, or about one out of ten of the local jurisdictions in the country secured a loan. Further, while the value of these loans totalled ₱573.5 million, in comparison to the gross revenues of the local government sector the amount of total financing was quite small, representing slightly more than 14 percent of total revenues in 1980.

A breakdown of the projects by type shows that the bulk of the funds have gone for two basic categories of investments--heavy and farm equipment, and public markets and slaughterhouses. Together they account for over 81 percent of all loans granted from 1976 to 1980. In addition, with the required authorization period for these loans falling between seven and ten years, local government borrowing essentially has been limited to short-term and medium-term financing.

Focusing on the reasons for the low level of borrowing, several weaknesses in the present system of credit financing are identified. Among the most significant factors are the following:

i. Administrative and management difficulties which stem mainly from the complexities of the present application process.

ii. The limited emphasis given local government loans by the individual lending institutions. For each institution, local government loans represent an extremely small percentage of their overall portfolios.

iii. The lack of technical expertise at the local government level in the preparation of feasibility studies and other technical documents required for the loan application.

iv. Apprehension on the part of local officials over the rate of interest charged by the lending institutions.

v. A generally conservative attitude on the part of elected local officials and treasurers with respect to debt financing, i.e., a preference for a "pay as you go" approach to local government investments.

vi. Financial limitations on borrowing as established in the net paying capacity provision, i.e., the short repayment schedules (7-10 years) coupled with the conservative application of the principle makes it difficult for many local governments to qualify.

In the context of the present system, it is difficult to know how one might go about improving things. Certainly the net paying capacity measure is too stringent, and we have recommended alternative formulas (see pp. 40-41 above).

The barrier of a conservative attitude of local officials can be removed in time, but only with the guidance of MOF. Local Treasurers must be made to realize that there are conditions under which it is prudent, even necessary, for a local government to assume debt. Surely the MOF, which controls the reward and penalty system for local treasurers, could manage such a reorientation. It would, however, also likely prove useful if the MOF would inform local treasurers about the loan application process, including assisting them in preparing the necessary technical documents required.

However, the remaining barriers have to do with local governments being small borrowers relative to others, and with the major lenders not being willing or able to adjust to their special needs. It is this factor that has lead us to the need for a specialized local government credit authority--a proposition to which we now turn.

APPENDIX IX-A

TABLE IX-A-1

DEBT LIMITATION OF CITIES, 1977

City	Total Population 1975	Assessed Value of Taxable Prop. Dec.31, 1977 (P million)	Value per Capita (P)	Debt Limitation (7% of Value) (P million)	Present Debt (Dec.31, 1977) (P million)	Remaining Legal Borrowing Capacity (P million)
Manila	1,479,116	5,087.9	3,440	356.2	7.4	348.8
Quezon City	956,864	2,866.8	2,996	200.7	-	200.7
Caloocan City	397,201	654.0	1,647	45.8	-	45.8
Pasay City	254,999	445.2	1,746	31.2	12.1	19.1
Metropolitan Manila	4,970,006	15,891.9	3,198	1,112.4	26.3	1,086.1
Cebu	413,125	1,103.3	2,671	77.2	13.2	64.0
Iloilo	227,027	404.0	1,780	28.3	3.6	24.7
Bacolod	223,392	780.5	3,494	54.6	0.4	54.2
Davao	484,678	844.5	1,742	59.1	15.3	43.8
Angeles	151,164	250.7	1,658	17.5	1.1	16.4
Olongapo	147,109	213.7	1,453	15.0	6.4	8.6
Baguio	97,449	351.4	3,606	24.6	0.02	24.6
Lucena	92,336	143.0	1,549	10.0	0.0	10.0
Dagupan	90,092	83.5	927	5.8	0.0	5.8
Naga	83,337	116.0	1,392	8.1	3.6	4.5
Cavite	82,456	90.6	1,099	6.3	0.1	6.3
Lapu-Lapu	79,484	81.3	1,023	5.7	0.9	4.8
Mandaue	75,904	129.9	1,711	9.1	3.1	6.0
Tacloban	80,707	105.8	1,311	7.4	0.0	7.4
Marawi	63,332	25.1	396	1.8	0.0	1.8
General Santos	91,154	169.7	1,862	11.9	1.2	10.7

City	Total Population 1975	Assessed Value of Taxable Prop. Dec.31, 1977 (P million)	Value per Capita (P)	Debt Limitation (7% of Value) (P million)	Present Debt (Dec.31, 1977) (P million)	Remaining Legal Borrowing Capacity (P million)
Butuan	132,682	135.1	1,018	9.5	1.6	7.9
Cotabato	67,097	169.7	1,862	11.9	0.0	11.9
Zamboanga	261,978	200.8	766	14.1	1.8	12.4
San Pablo	116,607	126.7	1,087	8.9	0.0	8.9
Legaspi	88,378	83.6	946	5.8	0.0	5.8
Tagbilaran	37,335	47.7	1,278	3.3	0.2	3.1
Cagayan de Oro	165,220	265.8	1,609	18.6	6.8	11.8
Cabanatuan	113,814	109.1	959	7.6	2.0	5.6
Laoag	66,259	113.2	1,708	9.1	2.2	6.9
Silay	104,887	137.5	1,311	9.6	0.9	8.7
Pagadian	67,499	45.4	673	3.2	0.1	3.1
Cadiz	127,653	108.4	849	7.6	0.0	7.6
Surigao	56,027	46.3	701	3.2	0.0	3.2
San Carlos,N.O.	90,982	86.3	949	6.0	0.0	6.0
Dumaguete	52,765	67.1	1,272	4.7	0.2	4.7
Dipolog	48,493	42.9	886	3.0	0.0	3.0
La Carlota	40,984	128.8	3,143	9.0	0.1	8.9
Batangas	125,363	287.8	2,296	20.1	7.4	12.7
Iligan	118,778	484.9	4,108	34.2	0.01	34.2
Lipa	106,094	104.8	988	7.3	0.7	6.6
Calbayog	102,619	46.4	452	3.2	0.2	3.0
San Carlos, Pang.	90,882	53.5	589	3.7	0.0	3.7
Ormoc	89,466	155.6	1,739	1.1	2.6	(1.5)

City	Total Population 1975	Assessed Value of Taxable Prop. Dec.31, 1977 (P million)	Value per Capita (P)	Debt Limitation (7% of Value) (P million)	Present Debt (Dec.31, 1977) (P million)	Remaining Legal Borrowing Capacity (P million)
Bago	89,213	121.9	1,366	8.5	0.1	8.4
Ozamis	71,559	75.1	1,049	5.3	0.2	5.1
Iriga	75,885	45.2	596	3.2	0.0	3.2
Roxas	71,305	66.0	926	4.6	2.2	2.4
Toledo	76,521	176.7	2,309	12.4	0.4	12.0
Gingoog	66,577	65.4	982	4.6	0.0	4.6
Tagaytay	58,274	104.9	1,800	7.6	0.0	7.6
Davao	50,260	91.2	1,815	6.4	15.3	(8.9)
Oroquieta	42,497	30.3	713	2.1	0.03	2.0
Tangub	40,461	15.0	371	1.1	0.02	1.0
Puerto Princesa	45,709	55.0	1,203	3.8	0.0	3.8
Bais	45,672	126.7	2,774	8.9	0.04	8.8
Canlaon	29,152	15.8	542	1.1	0.2	0.9
Dapitan	46,261	22.6	489	1.6	0.0	1.6

SOURCE: Computed from basic data provided in the Commission on Audit, Report on Local Governments, 1977.

CHAPTER X

THE FEASIBILITY AND FORM OF A SPECIALIZED LOCAL GOVERNMENT CREDIT AUTHORITY

The weaknesses in the current system of credit financing might be restated in terms of three basic problems. First, there is a lack of technical expertise at the local government level to properly evaluate the economic feasibility of local projects. Second, the fragmented system of loan financing mitigates against the establishment of technical support staffs to assist local jurisdiction in this recognized area of weakness. Third, a complex set of compliance procedures both frustrates local officials in their pursuit of loan financing, and seriously delays the lenders' approval of acceptable projects. Assuming that this accurately characterizes the major impediments, rather substantive changes are called for if local governments are to be encouraged to undertake credit-financed projects. Essentially, the options are (a) to appropriately modify the present system by changing current policies, procedures and practices, or (b) to propose a bolder solution and recommend the creation of a new, specialized entity. Although neither approach is without its problems, we think that the weight of the evidence tips in favor of the establishment of a new credit facility for local governments.

The major reason for recommending option (b) over (a) is the commonly shared belief of many local government credit experts that project planning, appraisal, and management assistance are so critical to the credit financing process that technical staffs, skilled in the different fields

of public sector investments and in local government finance, must be maintained. It is doubtful, in our opinion, that this could happen without the establishment of a specialized institution. There is precedent in the Philippines to cause one to expect success with such a venture. The general success of two central authorities, NEA and LWUA in the public utility field, demonstrates how specialized institutions can effectively mobilize local support and resources for the provision of local services. Working closely with local officials and residents, they have introduced service in new jurisdictions, rescued some fledgling local utilities, and by switching to a user charge type of pricing scheme have raised the overall level of local funding.

If one accepts the general idea of a specialized institution, the question arises as to what forms it should take in the Philippines. It is to this question that we now turn, by examining the practice in other developing countries and considering these alternatives in a Philippine context.

Typology of Specialized Credit Authorities

According to information compiled by the Internal Centre for Local Credit, (ICLC), a wide variety of organizations and practices are followed throughout the world.[1] Some specialized authorities, for example, have developed as public agencies, completely controlled by the Central Governments, while others have been organized by local governments or by

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[1] A comparative study of 34 local credit authorities in 29 countries was carried out by the United Nations with the collaboration of the International Centre for Local Credit in 1970. United Nations, Credit Institutions for Local Authorities, (New York, New York: 1972). Much of the discussion in this and the following section of the paper is based on the results of that survey. A summary of some of the salient features of the 34 authorities studied is given in Appendix IX-B.

associations of local governments. In some cases the credit authority is wholly funded by the National Treasury, and in others, the authority is expected to finance projects from its own funding sources. Finally, some are controlled by mixed boards composed of representatives from the private sector. This variety underscores the marked differences in circumstances and conditions of the countries, and in particular, the degree of local government autonomy, the maturity of the country's capital markets, and the emphasis of the Central Government with respect to social and economic development.

Generally speaking, credit institutions for local governments may be classified into three categories according to their legal status and administrative structure:

i. centrally controlled authorities

ii. locally controlled authorities

iii. authorities with shared managerial responsibilities, i.e., mixed participation.

Central Government Authorities

About half the credit institutions surveyed by the ICLC were created and are controlled by the Central Government, usually through a special law. Commonly, the Central Government through the treasury or some other Ministry (local government, or housing, for example) controls the management and basic policies of the institution. Quite often, the institution is a corporate body with a distinct legal identity. For example, the National Water and Sewerage Service and the National Institute of Housing and Urbanization in Costa Rica, are credit authorities

which have a pronounced Central Government character and rely entirely upon the National Government for capital funds. Other countries following this model are Kenya, Tanzania, and the United Kingdom. In some cases, the centrally-controlled institutions have been set up to receive deposits of public funds and/or private savings accounts. In still other cases, such as Japan, the government authority is permitted to raise a major part of its capital from non-treasury resources by issuing its own debentures or by agreements with other institutions, both public and private. Regardless of the method of capitalization, however, the chief characteristic of centrally-controlled facilities is the government's dominance of the institution's loan programs and policies.

Locally Controlled Authorities

Of the countries surveyed, only Austria, Belgium, Denmark and Norway had local authorities that could be classified as locally controlled. Local control is in most cases assured by the share-contribution of the local governments. To illustrate, the Municipal Credit Bank of Belgium is share-owned by the provinces and municipalities of the country. Its capital shares are distributed among the local governments in such a way that no single unit is able to exercise control. In such other countries as Denmark and Norway the loan capital of the authority is derived from the funds deposited by the municipal governments. In these countries, municipal pension fund contributions provide the bulk of the new capital. Given the origin of their support, these institutions operate with a much greater degree of autonomy than do those which are more firmly tied to the central authority.

Mixed Authorities

Of the eleven mixed institutions surveyed, most enjoy a considerable degree of autonomy from the Central Government. The autonomy in some cases can be traced to the enabling legislation which created the institution, and in other instances, the autonomy stems from the method of capitalization. In the latter case, by allowing the institutions to offer shares in the capital markets, non-governmental interests either directly or indirectly become involved in policymaking. Two examples of "mixed" authorities are the Autonomous Municipal Bank of Honduras and the Foundation for Community and Municipal Development in Venezuela. Both authorities were established by their Central Governments as distinct legal entities, but with Central Government representation in management, provision for a municipal voice in management and a municipal capital contribution.

The above classification provides some guidance as to the design and organizational features of credit authorities for local governments. But clearly, no set blueprint fits all situations, and the type of local credit institution created depends on a number of environmental factors. Broadly speaking, such factors as the financial strength of local governments, the ability of local governments to act collectively, and the system of intergovernmental relations weigh heavily in the decision.

With respect to the Philippines, the nature of Central and local Government relations rules out the establishment of a locally-controlled authority. A necessary condition for a locally-controlled authority is financial

independence. While it is possible to structure or identify capitalization sources within the country which would meet this criteria, e.g., local government cash reserves and/or local government pension funds, macro-economic objectives dictate a continued need to coordinate public saving and investment decisions at the national level. Moreover, an autonomous, locally-controlled institution is simply incongruous with the centralized character of intergovernmental fiscal relations in the Philippines. The formation of a centrally-controlled institution--no significant local government input or representation--while possible, seems to be inconsistent with the Government's policy of decentralization. Moreover, it seems reasonable to assume that failure to involve the local governments in the formal decision-making process would almost certainly undermine any serious attempt to encourage local, self-financed enterprises. Thus the realistic alternative for the Philippines would appear to be a "mixed" credit authority of some type, but inevitably one in which the balance of power tilts toward the Central Government.

Structure and Organization of Credit Authorities

The structure and management of a local government authority is influenced by a number of factors. These include the division of supervisory control between the Central Government and the local governments, the division of managerial responsibility within the institution, and the degree of influence of the other national agencies with which the credit authority is either formally or informally linked. Clearly, considerable latitude exists in defining the division of responsibilities between the Board of Directors and the management of the authority.

Structure

Almost without exception among the credit institutions surveyed by the ICLC, policy-making powers are vested in a group of high-level officials that constitute the Board of Directors. As the top-management body they must formulate policy, represent the authority in its official business, evaluate the authority's operations, and render the final decision on policy matters. Members of governing boards, according to the study, are usually selected by (1) appointment by higher authorities; (2) selection by local units; or (3) combinations of (1) and (2).

With respect to the Philippines, it is recommended that the credit authority be established by law and governed by a Board of Directors. It is further recommended that the Board be comprised of representatives of Ministries presently involved in local government development projects, and of local government officials. A reasonable composition of this Board would include the Ministers of Finance, Local Government and Community Development, Economic Development (NEDA), the Governor of the Central Bank and representatives of the Budget Ministry and the Ministry of Human Settlements. If it is to be a balanced body, an equal number of local government representatives should be appointed to the Board. Care should be taken, however, to include representation from provincial, municipal and city governments. One way to ensure this is to have the respective local government national organizations elect members to the Board. From among the permanent members of the Board, the President would appoint a chairman.

Apart from the practical considerations, there are some fundamental economic reasons for placing the three previously-mentioned ministries on the Board. First, from a fiscal management standpoint, their presence helps ensure that the credit authority's lending activities conform to the broader economic, fiscal and monetary policies of the country. This may prove to be an extremely important consideration in the long-run if the institution becomes large enough to have an impact upon monetary stability, foreign exchange transactions, and domestic cyclical and counter-cyclical policies. In addition, the format accommodates the national effort to coordinate all public sector expenditures within the country.

Second, to the extent that the credit authority wished to raise investment capital by the issuance of debt, it can do so at a lower cost as a national government entity. The economies of scale associated with large scale capital financing are well known and need not be repeated here.[1]

Internal Management

Arrangements must be made for capable and experienced management. With competent management a credit facility may be successful, even if there are inadequacies in the original concept of the institution or shortcomings in its charter. But no institution, however well conceived, can overcome the handicap of poor management.

The Chief Executive Officer (who may carry the title of President, Chairman or Managing Director) is the most important member of the manage-

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[1] Joseph A. Kane, Development Banking (Lexington, Mass.: D.C. Heath and Co., 1975).

ment team. This is particularly true during the early stages of the institution's organization and development, because he will bear the brunt of the responsibility for the recruitment of staff, formulation and implementation of policy, and representation of the institution in its official business with other governmental agencies.

In general, managing directors are chosen in one of two ways: (1) appointed by the Central Government, or (2) selected directly by the Board of Directors. Both methods are widely employed. As an illustration of the former approach, in the United Kingdom, the Secretary to the Commissioners of the Public Works Loan Board is the permanent head of the Board's office. He is appointed by the Prime Minister or the recommendation of the Commissioners and with the approval of the treasury. In Guatemala, the Manager of the Guatemala Institute of Municipal Development is appointed by the President of the Republic for an indefinite term. He is responsible for the execution of the Institute's policies and for all internal management matters.

In those cases where the Board makes the appointment, the managers are hired primarily for their professional and technical skills, and are directly responsible to the credit authority's Director. Most managers are allowed to attend Board meetings but they do not have the power to vote. Through established policy guidelines, however, the Boards often delegate substantive functions to the managers. Credit authorities in Greece, Colombia and Zambia follow this general format.

While no preferred method of appointment emerges from this discussion, an approach similar to that used in the United Kingdom and Norway would seem appropriate for the Philippines. That is to say, the Director should be appointed by the President based on the recommendation of the Board.

Capitalization and Functions of a New Credit Authority[1]

The establishing of a credit authority for local governments sounds good in principle and the organizational issues seem manageable, but the feasibility of this proposal turns on how the authority can be capitalized. The conclusion that we keep coming back to is that there are feasible options for funding such an authority.

We begin by reviewing the options followed in other countries and then turn to the possibilities in the Philippines. No attempt will be made here to detail all the capitalization methods utilized by credit institutions. Instead, a brief summary of the usual sources of capital for credit institutions in developing countries is offered. As reported in Appendix X-2, in developing countries, local government credit authorities rely on:

i. Central Government grants in the form of initial capital grants, and/or other grants which are either recurrent or non-recurrent,

ii. Central Government loans,

iii. revenues from specified taxes, national or local, earmarked for the credit authority,

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[1] See also United Nations Commission on Human Settlements, Meetings of the Ad Hoc Group of Experts on Ways and Means of Establishing or Strengthening Financial Institutions for Human Settlements Financing and Investment, Nairobi, January 28, 1981.

iv. contributions of local governments, often a fixed percentage of local tax revenues,

v. required deposits from reserve accounts, cash balance and pension funds.

Central Government Grants

In one form or another, Central Government capital grants provided the initial capitalization for three-fourths of the surveyed credit authorities in less developed countries (LDCs). In a number of countries, notably Kenya, Honduras and Venezuela, Central Government grants have accounted for a major share of capital funds. Several institutions, mainly in Latin America, also have been aided by large capital grants from external lenders, e.g., the Inter-American Development Bank and USAID. Among credit institution executives, there is general agreement that generous capital grants are very important during the early stages of the facility's development. Besides ensuring some minimum level of operation, they are necessary if the local authority plans to extend concessionary loans to local jurisdictions with inadequate financial resources.

Central Government Loans

Surprisingly, only two countries among the LDCs surveyed, Kenya and Guatemala, use this method to augment the capital of local credit authorities. From their actions, it appears that Central Governments find this method of capital replenishment inferior to the other cited possibilities.

Earmarked Taxes

Earmarking the proceeds of a specified local or national tax has great potential but is not widely used as a method of capitalization. In Guatemala, the Institute of Municipal Development is partially funded from

revenues from a specific tax on liquor consumed within municipal boundaries. Another country making use of a liquor tax is Colombia, where, in addition to government grants, the National Institute for Municipal Development obtains revenues from a special national tax on distilled spirits.

Contributions from Local Government Revenue

Among LDCs, contributions from local governments are an important source of capital in Niger, Tanzania, Thailand, and Honduras. While the percentage of contributions required varies, the pattern remains the same. That is to say, in each country the local governments pay a fixed percentage of their annual revenues to the local credit authority. In Tanzania, for example, the local governments are required to deposit a percentage of their "annual recurrent revenue." Similarly, in Niger, local governments must contribute 3 percent of the amount included in their recurrent budget.

Loan Requirements and Possible Sources of Capitalization for a Philippine Local Credit Authority

It isn't reasonable to expect that a new credit authority will be funded solely from a new Central Government appropriation. Such a recommendation would ignore the resource constraint and it would not be in keeping with the objective of mobilizing more resources through the local public sector. On the other hand, it would be unrealistic for the Central Government to believe that any scheme for increasing the local government use of credit financing would be costless. Indeed, it is the lure of more Central Government revenues (including interest subsidies and technical assistance) that will induce local governments to increase their own efforts to finance development outlays.

Before considering specific alternatives for initial and continuing funding, the important relationship between method of capitalization and the functions and operations of the credit institution must be considered. The consequences of ignoring this relationship may be disastrous and quite far-reaching, since it is virtually impossible to divorce the institution's lending policies and practices from its capital structure, or vice versa. Thus, at an early stage, decisions must be rendered on the type and duration of loans, and the kinds of financial activities other than credit financing in which the institution will engage. An important example is that the credit institution's decision to extend long-term loans (20 to 30 years) must be related to its ability to command funds for the same period. In essence, this means a matching of loan maturities with the maturities held by their own creditors and with the long-term dependability and stability of continuing government subsidies. The need for local government loans with a longer maturity suggests that a Central Government grant, recurring and dependable, should provide the bulk of the capitalization of the authority.

Capitalization Requirements

What will be the demand for loans in the event a specialized authority is established? History is little help here, there simply isn't a consistent trend. In fact, there was a sharp drop (nearly 50 percent) in the amount borrowed between 1979 to 1980. We might, however, make some reasonable guesses about what sorts of loan demands might emerge if the new authority is able to remove some of the important barriers to increased local government use of credit financing.

If the establishment of the authority is successful in reversing the sudden decline in government loan demand, a reasonable estimate of first year loan demand might be ₱200 million. For the sake of developing an optimistic target, let us suppose that the increase would be 40 percent in each of the next two years--25 percent because of new borrowing and 15 percent because of inflation. This would place an annual requirement of ₱392 million on the fund by 1983 (see Table X-1).[1]

The projections are optimistic, but not unrealistic if a specialized authority were properly staffed and managed. The average loan during 1978-1980 was ₱3.5 million and allowing for inflation we might assume that it could rise to 4 million by 1983. Hence, our projections would imply an approval of 98 loans by 1983, up from 32, 49, and 35 in 1978, 1979, and 1980, respectively. A specialized authority ought to be able to generate at least this increase in volume by shortening the application process, assisting in project preparation, and in adjusting loan terms to make the issuance of debt a more viable proposition.

Sources of Capitalization

These projections, even though illustrative, lead us to the central question: where might the government find enough seed capital or continuing contribution to support nearly ₱900 million in long-term loans

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[1]Obviously, a serious intent to go ahead with a credit authority will require a careful, detailed projection of loan demand. These computations, using 1981 as the initial year, are obviously for purposes of illustration.

TABLE X-1

NECESSARY CAPITALIZATION OF LOCAL GOVERNMENT CREDIT AUTHORITY: OPTIMISTIC ASSUMPTIONS
(in millions of pesos)

Actual Borrowing		Potential Growth in Borrowing		
1979	1980	1981[a]	1982[b]	1983
₱189.2	₱97.4	₱200	₱280	₱392

[a]It is assumed that in 1981, with the establishment of a binding authority, the level of borrowing would rebound from the 1980 low.

[b]After the initial year, 1981, it is anticipated that borrowing will increase at an annual rate of 40 percent in 1982 and 1983. This represents a real growth in borrowing of approximately .25 percent per year, based on an expected inflation rate of 15 percent per year.

to local governments over this three year period, and commensurate annual amounts beyond? The answer is that there would seem to be several promising possibilities: annual shares of the BIR, Specific Tax, or National Tax Allotments, partial capitalization from local government cash balances, and capitalization from an external donor. We consider the feasibility of these possibilities below, and then turn to recommendation of what seems the most feasible course.

Specific Tax Allotment. An attractive option for an annual contribution to the authority is a share of the Specific Tax Allotment.[1] This is a particularly appealing alternative for several reasons. Local government revenue entitlements from this source have increased rather dramatically in the last two years. From 1979 to 1980, the amount due jumped an astonishing 665 percent, rising from ₱115.3 million to ₱766.9 million. In the 1981 budget year the amount is scheduled to rise an additional 15 percent to ₱881.7 million. As little as a 20 percent annual share of the Specific Allotment would provide a substantial proportion of the necessary capital for a credit authority. Furthermore, as discussed in Chapter V, revenues from the Specific Tax Allotment are earmarked for infrastructure projects, so using a portion of this growing revenue source to fund all or a part of the credit authority would not subvert the original intent of the Tax Allotment.

Channeling a share of the increased revenue to a Local Credit Authority could also provide an efficient mechanism for converting these additional monies into capital projects as the present ability of local units to plan

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[1] See pp. V-36 to V-42.

and initiate projects is apparently quite limited. As discussed above, in recent years some local governments, in aggregate, have tended to maintain rather large cash balances. If this practice is indeed widespread, there is a strong possibility that the increased revenues from the Specific Tax Allotment may simply be accumulated rather than serve to stimulate additional capital investment by local governments. This would certainly be the case if a major stumbling block to local capital investment is, as we expect, the inability of local governments to plan and execute relatively large projects.

There are problems with using the Specific Tax Allotment for this purpose. First, the credit authority will require a "certain" revenue source, and actual disbursements from the Specific Tax Allotment have been sporadic (see Table V-7). Second, the funding of local government capital projects with a share of specific taxes on petroleum products raises enough problems to make one wonder if the practice will continue much longer. This would imply that an important revenue source to the authority might be abolished or markedly revised, thereby compromising the flow of funds to the authority. Third, the Specific Tax Allotment is quite income inelastic and grows only because of increases in the tax rate on petroleum products. The demand for loans may be responsive to income, population and urbanization--which are rising--but natural growth in this funding source would be in proportion to the volume of petroleum consumption--which is flat or declining. Finally, the Specific Tax Allotment is an important revenue source for some local governments and sharing it with the authority will delete local government's ability to make capital expenditures.

BIR Allotment. A second possible source of continuing funding is an annual share of the BIR Allotment. In 1980, ₱1.9 billion in annual BIR Allotment was due, but as in the two previous years, only ₱659 million was distributed. Present practice requires that 20 percent of this amount be earmarked for development expenditures, but analysis above (Chapter V) did not provide good evidence that the BIR was stimulative of local government economic development expenditures. Hence, one might want to argue that the allocation of this share to the credit authority would be a better course. A 20 percent share would amount to ₱131 million annually at the present level of distribution, and ₱165 million at a possible 1981 BIR Allotment distribution of ₱823.6 million.[1]

There are drawbacks to such a proposal. First, the disbursements, though more certain than those from the Specific Tax Allotment, have been subject to frequent government alterations.[2] As a result, there have been real declines in the amounts distributed in recent years. Second, some local governments have come to depend quite heavily on the BIR Allotment (see Table II-IX) and its withdrawal could cause a major hardship.

National Tax Allotment and Barangay Shares. Two other grant programs which might be legitimately redirected toward the capitalization of a credit authority are the National Tax Allotment and the barangay shares of the Specific Tax and BIR Allotments.[3] Both programs have the purpose

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[1] As suggested in an interview at the MOB.

[2] See pp. V-2 to V-7.

[3] For a discussion of these programs, see pp. V-42 to V-49.

of supporting community development type projects, hence, using the funds for local government loans would not distort the basic program intent. At 1979 levels, the total annual amount due barangays and local governments from this program was ₱703 million.[1] Obviously, only a small share of this amount, as an annual contribution, would go a long way towards meeting the annual lending requirements of a credit authority.

Again, there are important problems with such a proposal. First, these programs exist much more in law than in practice--only 11 percent of the 1979 amount was actually distributed (7 percent in 1980). Second, the use of the barangay shares would be conditional on the government's backing away from its commitment to strengthen the financial participation of the barangay unit. Such a change in policy, so far as we know, is not being discussed.

Local Government Cash Balances. An alternative source of initial funding of a credit authority is use of the cash surpluses or reserves of local governments. Most of these are kept in current accounts and time deposits. As shown in Table X-2 the aggregate amount of these funds is very large and relatively stable. Starting in the first quarter of 1978, demand deposits were ₱796.6 million. They were steadily drawn down over the year, falling to ₱660.2 million in the fourth quarter. From that low point, fourth quarter balances have continuously climbed, reaching 860.0 million in 1980. Savings and time deposits have shown somewhat more fluctuation,

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[1] See Table V-9.

TABLE X-2

SUMMARY SCHEDULE OF LOCAL GOVERNMENT DEPOSITS
FIRST QUARTER, 1978 TO FOURTH QUARTER, 1980
(in thousands of pesos)

Year	Quarter	Demand Deposit	Savings Deposit	Time Deposit	Total Deposits
1978	1st	796,641	9,754	691,774	1,498,169
	2nd	731,821	7,445	733,299	1,472,565
	3rd	710,418	32,653	730,147	1,473,218
	4th	660,252	12,990	683,433	1,356,675
1979	1st	792,478	13,615	693,252	1,499,345
	2nd	843,220	9,238	699,553	1,552,001
	3rd	946,242	9,951	766,128	1,722,321
	4th	840,808	15,340	751,207	1,607,355
1980	1st	1,070,583	17,236	826,509	1,914,328
	2nd	941,177	22,210	553,198	1,516,585
	3rd	877,822	49,000	565,495	1,492,319
	4th	859,955	41,300	585,497	1,484,752

SOURCES: Data supplied by Development Bank of the Philippines, Land Bank of the Philippines, Philippine National Bank, and Philippine Veterans Bank.

but also have remained large over the period.[1] Combined, the savings and time deposits decreased from ₱696.4 million in the fourth quarter of 1978 to ₱626.7 million in the last quarter of 1980.

Clearly, from the recorded data, local government deposits offer an attractive alternative for initial funding. The balances are both large and stable enough to underwrite a significant portion of the institution's initial capital. For example, ₱200 million might be obtained from surplus cash reserves, i.e., exchange of local government cash balances for capital stock in the credit authority.[2]

Capitalizing the credit institution from local government balances, however, is not so straightforward as is suggested by this simple illustration. One issue to be addressed is the impact that the shift in funds will have upon the portfolios of the depository banks--PNB, Land Bank and Veterans Bank. Unless the depository banks have excess reserves equal to the capitalization amount, they will be unable to adjust without liquidating some of their own assets, trimming their lending programs, or both. Thus, from a macroeconomic standpoint, if all public savings are fully invested, capitalization of the credit facility will come at the expense of some other investment opportunities.

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[1] As of January 1981, three-year time deposits bear an interest rate of 15 percent and one-year deposits pay 12 percent.

[2] Given that local government cash reserves in the aggregate are large and have remained so for several years, and are primarily held at the PNB, the Central Bank could require that a portion of these reserves held by PNB be earmarked for purchase of capital stock in the new authority. As long as the cash reserves held at the PNB in the aggregate did not fall below the capitalization amount (₱200 million), the financial obligations of the local governments could be met from their own cash reserve balances. In essence, PNB would alter its portfolio by reducing excess reserves or exchanging other assets for the capital stock in the authority.

In defense of the suggested alternative, it should be pointed out that since PNB makes no long-term loans to local governments, these cash balances are currently being used to finance investment projects in other sectors of the economy. Thus, requiring that part of these balances flow into local projects through the purchase of capital stock in the authority simply ensures that part of the savings of the local government sector is invested in that sector.

There are drawbacks to this option. First, we are not certain how much of these balances is restricted and hence whether some expenditure earmarking requirements will have to be relaxed. Second, we do not know how concentrated these holdings are among local governments, e.g., is it possible that a relatively few large governments have saved substantial amounts in anticipation of making a major capital outlay? Tying these funds up in the share capital of a lending authority, probably at subsidized rates of return, would initially cause postponement of the capital expenditure and could discourage local government savings. If holdings are more widespread and if the percentage allocated to the credit authority is not large, this problem may not occur. Finally, one needs to be concerned about the consequences of various combinations of these capitalization alternatives. For example, will the allocation of a share of the BIR and Specific Tax Allotment substantially dry up the local government cash balances?

External Donor. The fifth possible source of capital funding is an international donor. In late 1978, after considerable consultation with the Ministry of Finance and other government offices, USAID proposed to

make a concessionary loan of $10 million to help capitalize a credit authority for "poor" local governments. Proceeds of the loan, plus counterpart funds from the Philippine government, were to be used to finance projects at low interest rates--6 percent plus a 1 percent DBP service fee. The proposal was shelved, but recently there has been renewed interest in the Ministry of Finance. In its original form, the proposal might be viewed as a method of augmenting the capital base of the new credit authority and as a way of widening the institution's scope of operation. As discussed below, such funding, if obtained, would permit the credit authority to establish two different credit windows, one for bankable projects, the other for projects requiring concessionary terms.

The major danger in such an arrangement is that the government may get committed to a program designed *primarily* to benefit poorer jurisdictions. Social benefits aside, this would run contrary to the goal of strengthening local government finances, promoting local autonomy, and mobilizing more local government revenues. Some low income jurisdiction assistance is possible under a credit authority, but it must be a secondary rather than a guiding objective.

Sources of Capitalization: Recommendations

The discussion above would seem to make it clear that with some reallocation of resources already earmarked for the local government sector, it will be possible to capitalize a specialized local government credit authority. Moreover, this authority can be capitalized at a

reasonable level, at least for the first few years. However, as noted above, each funding source brings certain costs and benefits with it. Sound public policy requires identifying those possibilities that bring us closest to the ultimate objectives of the reform:

- stimulate the undertaking of capital projects,
- encourage the initiation of income generating projects,
- stimulate local government tax effort.

In a nutshell, the objective is to design a credit authority which promotes these three objectives and to finance the authority primarily from funds diverted from other local government activities. The diversions, however, should not come at the expense of capital project or tax effort stimulation. For example, if idle cash balances are converted to loans through a credit authority, there will be a net stimulative effect. If, on the other hand, the credit authority is capitalized from local revenues that would have been spent for capital purposes, the credit authority will exert only a transfer effect within the local government sector.

The proper choice of a financing scheme, then, turns out to be the key matter. Based on these considerations and a review of the options and the projected levels of funding over the three-year period 1981 through 1983, we would recommend capitalizing the new authority from a combination of sources rather than from a single source.[1] This approach provides the authority with a broader financial base, permits greater flexibility in meeting future capital demands, and in all probability would be received

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[1] This approach differs from the B.M. Villanueva proposal which recommended that the credit authority be funded from the undistributed portion of the BIR Allotment and other unencumbered balances in the National Treasury.

more favorably by local and Central Government officials than would a plan for funding from a single source. The philosophy to this strategy is that there is enough slack in each of the programs considered here to allow for some reductions without great harm, but as the cuts are deeper, unwanted local finance adjustments might be induced.

We recommend that the major source of continued funding be from a share of regular Allotments. It was recommended in Chapter V that the grant system be consolidated and suggested that the Allotment share be set at about 30 percent of collections.[1] We would further recommend that a share of this Consolidated Allotment be directed, annually, to the credit authority.

Any specifics that we offer beyond this general proposal--about the growth in Allotment or the necessary share--will be much more guesswork than reasonable projections. Based on data supplied by MOB, we can estimate that the Consolidated Allotment if fully distributed, would yield ₱3.9 billion in 1981 (₱882 million in Specific Tax Allotment, ₱2.5 billion in BIR Allotment, and ₱618 million in National Tax Allotment). For the sake of illustration, we will hold this amount constant after 1981, and refer to it as "Alternative A". For comparative purposes, we will define an "Alternative B" as a more stringent distribution of ₱1.5 billion (₱882 million in Specific Tax Allotment and ₱659 million in BIR Allotment), but will assume that the amount distributed increases by 25 percent per year after 1981.[2] These would appear to be two rather extreme scenarios for the future distribution of Central grants to local governments.

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[1] Since we were unable to determine the exact Specific Tax Allotment entitlement under the present system, we can but roughly estimate the "equal yield" share of BIR collections under the proposed consolidated Allotment.

[2] Such growth would not be inconsistent with the announced government plan to increase substantially the Allotments to local jurisdictions. According to the MOB, the BIR Allotment will increase from ₱650.9 million in 1980 to ₱823.6 million in 1981, or by ₱172.7 million. The incremental increase in 1981-82 is estimated to be some ₱205.9 million, and in 1982-83, an additional ₱257.4 million.

In order to get some feel for the potential for capitalizing a credit authority, assume that 10 percent of the Consolidated Allotment flows to the credit authority. Under the more conservative distribution assumed in Alternative B, funds sufficient to cover loan requirements are generated (Table X-3). Under Alternative A, there are more resources available to the authority but no growth in the annual contribution. In the long-run, a scheme will have to be developed to guarantee both an adequate amount and a regular flow of resources to the authority.

In addition to the Consolidated Allotment share, we would propose making use of the cash balances which local governments hold in banks. For the three year period, we recommend at total of ₱218 million. As noted in Table X-3, the contributed amount is to rise gradually from ₱50 million in the initial year to ₱98 million in the third year.[1] Structuring the paid-in capital in this way should allow the bank or banks to comply without any serious short-term adjustments in their portfolios.

Under either assumption about the distribution and growth of the Consolidated Allotment, this plan generates resources adequate to cover loan requirements for our illustrative three year period (Table X-3). Beyond this period, without further recourse to local government cash balances, a shortfall could arise if the Allotment distribution is not allowed to increase with BIR collections. This problem will be especially important in the early years of the authority, when the volume of loan repayments will be low and the default rate relatively high. There are a number of ways that such shortfalls might be covered. One possibility is to allocate a portion of the

[1] Instead of setting aside or designating a specific amount of funds, an alternative is to allocate a fixed percentage of the bank cash balances directly to the authority. For example, the Banks could be required to place ₱218 million or no less than 25 percent of local government cash balances with the authority.

TABLE X-3

CAPITALIZATION OF A CREDIT AUTHORITY: 1981-1983
(in millions of current pesos)

	1981	1982	1983
Alternative A: Consolidated Allotment Held Constant at ₱1540	150	150	150
Alternative B: Consolidated Allotment Growth of 25 Percent Per Year	150	210	292
Local Government Cash Balances	50	70	98
Total Loan Requirements	200	280	390
Shortfall under Alternative A	---	60	142

Barangay Allotment shares to the authority. Another is to increase the Allotment share allocated to the authority, but this may bite too deeply into general revenues of the local governments. An only slightly different approach would be to require an annual contribution (or share capital purchase) from each local government. Other, more traditional sources, e.g., local government employee pension funds, would not appear to be available for this purpose. Finally, loans could be curtailed, but this would be self-defeating, i.e., why go to the trouble to create a credit authority and then not use it? A consideration of these alternatives, and their drawbacks, leads us back to the original funding proposal--a share of a more fully funded Allotment system and local government cash balances.

The Problem of Reallocation

As noted above, capitalizing the authority primarily from a share of the Consolidated Allotment reduces the amount that would otherwise have been directly distributed to local governments. More importantly, however, since these funds are presently distributed on a formula basis, some jurisdictions will suffer a greater revenue loss than others. In particular, jurisdictions with greater land areas and larger populations, and those which have a better capacity to absorb funding for capital projects will be the biggest losers. Loans to local governments obviously will result in some redistribution, since we cannot believe that the present or proposed Allotment formula is a reasonable way to establish eligibility to borrow and since the loan amount will be concentrated on a relatively small number of jurisdictions.[1]

[1] We estimated above that by 1983, about 100 loans could be made, up from a total of about 100 in 1981 and 1982. There are more than 1600 local government jurisdictions.

The credit authority, then, will effect some redistribution of resources among local governments--and the redistribution of resources will be larger to the extent the credit authority's annual share of the consolidated Allotment is larger. This raises the need for the authority to establish clear rules for the distribution of loans. Two possibilities are, (1) to use a formula approach, perhaps based on need, to target loans on lower income jurisdictions; and (2) to allocate on a basis of repayment potential, merit of the project, and local matching shares. We would recommend the second alternative, though we would caution against a totally ad hoc approach.

To focus on lower income jurisdictions, with such a limited capitalization of the authority, is to invite a greater risk of default and to stimulate less additional local spending and taxing than might otherwise be the case. With respect to the latter, more populous and higher income jurisdictions appear to have more discretionary resources which might be directed to capital projects (Chapter II), a greater potential for tax revenue increase (Chapters III, IV), and a greater potential for project implementation and financial success (Chapter VII). One should not enter the process of developing a credit authority with the idea that it may primarily serve the poorest jurisdictions, unless he places the short-run equalization goal above that of strengthening the financial participation of local governments in the development process. At least for the present, the two goals are not fully compatible. It is on this very point that a problem with the USAID capitalization proposal should have created difficulties.

This is not to say that all funds should be allocated to cities, large municipalities, or to the wealthiest jurisdictions, or that constraints should not be placed on the distribution of loans. Since the 10 percent share of the Consolidated Allotment would be taken from provinces, cities, and municipalities in the ratio of 28 percent, 44 percent and 28 percent,[1] loan ceilings of like percentage could be established. A similar rule might be established for the 12 economic development regions. To address the possible redistribution of funds among regions of the country, the authority might want to establish a simple rule that local governments in each region would have an opportunity to borrow an amount up to that which would have been allocated to the region under the Consolidated Allotment, or according to some other government criteria for the regional distribution of funds. Within the region, however, loans would be allocated on a merit basis.

New Lending Policies

The terms of lending to local governments might be adjusted for two purposes. The first is to lower the "price" of borrowing. The sharp decline in the level of local government borrowing, from ₱189.2 million in 1979 to ₱97.4 million in 1980, suggests that the current terms of repayment (7-10 years) and interest rates (16-18 percent) may be unmanageable for any local governments. The second is to use the availability of loan funds to stimulate increments in local government spending for capital projects. We would suggest the following program as a method of achieving both objectives.

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[1] Since cities receive 25 percent of the total Allotment share, and since barangays receive 10 percent, cities receive 28 percent of the amount distributed to cities, provinces, and municipalities. The provincial and municipal shares are calculated in a similar fashion.

We recommend that the loan rate be set to vary inversely with the amount of cash equity a local government has in the project. Moreover, we recommend lending rates that, at least in the initial years of the authority, are set below the market rate of interest. While a specific structure needs to be worked out in much greater detail, the general approach could be as described in Table X-4.

The rationale for such a recommendation is quite straightforward. First, and most important, the variable interest rate program provides an incentive for local governments to mobilize more resources for an equity contribution. That is, the greater the equity contribution, the lower the interest rate and the lower the loan service fee. Second, if the Authority is capitalized by funds originally earmarked for local governments (e.g., the Allotment and local government cash balances), offering a below-market interest rate is justified since local governments are in essence borrowing from themselves. Third, since the amount of loan coverage rises with the percentage of equity, the risk of default decreases and a lower rate of interest is justified. Fourth, if local governments are permitted to borrow for non-revenue producing type projects (and we would argue that this can be good public policy), loans for this purpose should bear a higher interest rate because of the greater risk of default.

The variable interest rate proposal is not without problems. The most obvious disadvantage, as pointed out above, is that some redistribution of funds may take place among local government units. Those with large cash balances and rather buoyant economies will take advantage of the

TABLE X-4

ILLUSTRATIVE LENDING TERMS FOR A SPECIALIZED LOCAL GOVERNMENT CREDIT AUTHORITY
(in percent)

Cash Equity Required	Annual Interest Rate	Loan Service Fee	Total Annual Interest Charge
Self-Liquidating Projects			
15	10	2	12
20	9	2	11
25	8	2	10
30	7	2	9
35	6	2	8
40	5	2	7
Non-Revenue Producing Projects			
20	16	2	18
25	15	1	16
30	14	1	15
35	13	1	14
40	12	1	13

incentives, while the poorer and less economically prosperous local governments will be unable to do so. Thus, the interest subsidy may come at the expense of some of these local governments. An undesirable result such as this can be avoided to some extent, however, by allocating a share of the credit institution's resources to the poorer jurisdictions. We address this possibility below.

In addition to the variable interest rate structure, we propose lengthening loan maturities for local government projects. A major weakness in the current credit financing arrangement is the relatively short period of repayment for a number of projects which are normally considered to be long-term investments--that is, projects which have an expected life much greater than the duration of the loan.[1] To remedy this situation the authority should structure its loan repayment schedules to be more in line with the economically useful life of the projects which it finances. This would probably mean extending the period of amortization for projects like public markets and slaughterhouses to 20 years. This practice should stimulate local government borrowing since the annual debt repayments are reduced, and because stretching out the amortization period increases the local government's calculated net borrowing capacity, i.e., its eligibility to borrow.

A third recommendation is that apart from the type of self-liquidating projects detailed in PD 752, the government should consider using the credit authority to broaden the list of eligible investments to include

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[1]As noted in Chapter VII, the useful economic life of public markets and slaughterhouses is from 20 to 30 years. Loan maturities for local government projects are of much shorter duration.

certain non-revenue generating projects, i.e., to permit local governments to assume general obligation debt. During the field interviews undertaken in connection with this study, local officials emphasized on numerous occasions the importance of allowing for the financing of such projects. Those most often mentioned were public office buildings, recreational facilities, and road improvement projects. Assuming that the local jurisdiction can meet some objective standards of creditworthiness (paying and borrowing capacity), there seems little reason to exclude such projects from credit financing.

Standards for Project Analysis

In a capital scarce country like the Philippines, a major responsibility of the credit institution is to develop its capacity to analyze the technical, economic, and financial viability of proposed projects. Technical assistance provided by the authority should also enhance the ability of local governments to prepare and implement projects. To meet these objectives, the credit authority should:

i. develop strict, but reasonable rules for approving loan applications,

ii. develop a staff with the technical skills to analyze, implement and monitor the success of investment projects,

iii. develop the capacity to train and assist local government officials in the preparation and development of projects.

In developing these capacities the authority will overcome some of the problems that have discouraged more local government borrowing.

The major task will be evaluating loan applications, i.e., determining whether proposed borrowings are somehow viable. Credit authorities usually require that certain conditions are met before granting loans to local governments. Among the more common ones are: (1) the legal authority to borrow; (2) proof of the economic soundness of the proposed project; (3) proof of the capacity of the borrower to repay; (4) liens of various kinds; (5) proof that the project will benefit the community; (6) a matching financial contribution by the borrowing government. The question at hand is whether a staff, of necessary size and competence, can be assembled to (a) establish borrowing criteria, (b) carry out the necessary financial and project analysis, and (c) provide the appropriate technical assistance.

We believe that in the Philippines, a critical mass of talent does exist, and if the new authority carries the same civil service status as DBP and the Land Bank it should have no difficulty in attracting qualified personnel. Hence, the authority could have a much better view of local government financial problems than now exists, and because of this expertise should be able to drastically reduce the time necessary to gain loan approval.

Some further comment should be made about the relationship between the objective of providing assistance in the preparation of proposals and feasibility studies and the needs for coordination with MOF and MLGCD. Though the authority will be autonomous in its management and operations.

close cooperation with the Ministries will be essential, since MOF and MLGCD will continue to have sign-off powers. It would make little sense to develop an independent credit authority to hasten the borrowing process only to have it slowed down by misunderstandings and bureaucratic entanglements. MLGCD and MOF membership on the Board of Directors is one step toward avoiding such problems. Another is to clarify and simplify procedures at the outset. In conjunction with the MOF and MLGCD, the authority could establish a manual for project preparation and loan application, and perhaps could decentralize its activities enough to permit local officials to avoid the numerous trips to Manila that they cite as so burdensome.

Administrative Cost

A credit authority will not run on its capitalization alone. A target of nearly ₱900 million in loans in three years and perhaps as many as 200 new loans implies a staff of substantial size and quality. Moreover, the newness of the effort implies a substantial set-up cost, including an important training component.

The operation of the authority might be funded from four sources. First, a 1 or 2 percent add-on to the interest rate could fund a substantial portion of costs to the authority.[1] As noted in Table X-4, we propose a lower service charge for a larger equity contribution as another inducement for larger local government allocations to revenue producing projects. The service charge does raise the cost of borrowing, but it must be remembered that under the present system there is a 1 percent service charge and an

[1]This is the service charge amount used by DBP.

additional cost of preparing the feasibility study. In any case, the resulting price of the loan, including the service charge, will be below the market interest rate under this proposal (see Table X-4). Second, a charge could be made for "extra" assistance in project preparation. Third, a Central Government operating subsidy could be granted. Finally, if external assistance were solicited, it could provide a substantial share of the initial set-up and training costs.

Soft Loans for Poor Jurisdictions

The primary purpose of the credit authority is to generate local government spending on capital projects and to encourage the mobilization of additional local resources. There should be no backing away from these primary objectives. Yet, there may be a way to provide some funds for poorer jurisdictions which can neither propose economically viable projects nor satisfy even minimal equity participation or financial soundness criteria.

Suppose an external donor, such as USAID, contributed to the capitalization as had earlier been proposed. Some of these funds could be earmarked for a "soft-loan" window where poorer, smaller local units would be eligible for low interest/low equity loans. This program would serve broader social purposes rather than the objectives of the credit authority. Indeed, it is unlikely that increases in tax effort or new income generating projects would emerge.

There are advantages to a second window approach. It does provide some measure of equalization and channels some resources to very poor jurisdictions. It inevitably will strengthen the capacity of participating

local governments to administer and manage their fiscal affairs. It permits lending for socially desirable projects that cannot meet cost recovery tests. Finally, another advantage is that some portion of the external funding, and probably the majority, could be used to capitalize the bankable loans window of the credit authority and to underwrite some of the initial training effort.

In one sense this discussion of equalization objectives is misleading. Nearly all of the jurisdictions we have been discussing are poor, most have heavy rural components and few can easily justify heavy debt obligations. Equalization objectives may have much more to do with the kinds of projects being financed by the authority Certainly for non-revenue generating projects--those which may be most pro-poor--there may be dim prospects for justification in some communities. It is here that a second window approach may have important distributional effects.

APPENDIX X-A

SURVEY OF LOCAL GOVERNMENT DEVELOPMENT FINANCE INSTITUTIONS: 1972

TABLE A-1

I. Controlled Primarily by Central Governments

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Brazil	Federal and State Institutions for Local Authorities	Multiple credit institutions, rather than a single multi-purpose credit institution or bank. Each is organized separately—National, State and municipal entities. Funding differs from institution to institution. National Housing Bank—grant from government payroll tax. Federal Services for Housing and Urbanism--joint financing of local projects. (Federal, state, and local) Development Projects Fund—established by Ministry of Finance; funded by that Ministry State Savings Bank--loan directly to municipalities.	Depends on institution; payroll tax, grants, savings deposits of state banks.	Construction of housing units and sewage systems. Comunity planning, technical assistance.
Colombia	National Institute of Municipal Development (1957)—a decentralized public service.	Board of Directors approves budget and has power to authorize all operations greater than $5,000. Manager responsible for management of Institution subject to control by Controllorship of Finance.	Own resources; Loans from Inter-American Development Bank. Special tax on distilled spirits grants from Central Government. Set up with resources from predecessor organizations.	Construction and on completion management of water and sewage systems. Capital disbursements.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Costa Rica	National Water and Sewage Service; National Institute of Housing and Urbanization, Costa Rican Institute of Electricity—autonomous agencies created by Central government. Institute of Municipal Assistance and Development (1970) (IFAM)	Directing Council—overall supervision of Institute (IFAM). Executive Director—day-to-day management. Under National Council of Government.	Initial capital through grant from National government; loan from USAID; liquor taxes, interest from loans and investment; fees for non-credit services; deposits; grants; donations from National government.	Finance agents of municipalities; Central purchasing agency; technical assistance to municipalities; Administers municipal public works.
France	Deposit and Consignment Bank (1816) Sinking Fund (1816)	Autonomous and public. Under direct supervision of Parliament. Run by Managing Director and 3 directors under government. Supervisory Commission.	Own capital formed by reserves built up from operating surpluses. Outside capital—funds from National Savings Bank; role as bank for workers' social institutions; Also bank for deposits and consignments.	Loans for Housing, Local public works, Credit to industry, Agriculture and transport. Two groups of subsidiary corporations: Societe central immobiliere de la Caisse des depots (SCIC); Societe centrale pour l'equipment du territoire (SCET). Also Societe d'etudes pour le developpement economique et Social (SEDES); Caisse d' aide a l'equipement des collectivites locales (CAECL)
Greece	Loan and Consignment Fund of Greece.	Enjoys administrative and financial autonomy. Subject to state policy control and supervision exercised by Minister of Finance and Currency Committee. Currency Committee—rate of compound interest. Administrative Board—decides borrowing policy, quality, quantity of investment allotments.	Own capital—solely consisting of reserves. Outside capital—Deposits by public bodies, from private consignments, interest charges.	Housing and building loans. Finance public works and tourist development.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Indonesia	Local Development Banks—1962, established by law 25 LDBs—one for each province.	Managed by a Board of managing directors and supervised by a Supervisory Council subject to control by Central bank.	From local governments and/or local government enterprises, deposits of private business and individuals.	Loans to Production sector, Export sector and other areas.
Italy	Deposit and Credit Bank of Italy (1863) Post Office Savings Bank (1875) Autonomous Municipal and Provincial Credit Section (1899)	Organs of Bank fall within competence of Treasury Ministry—its employees and Treasury Ministry employees. Autonomy of Deposit and Credit Bank relatively formal.	Capital resources—built up reserves. Outside capital—obligatory deposits; Funds deposited by public institutions; postal savings.	Loans for public works, to bodies engaged in drainage, land improvement, reclamation, irrigation, water supplies for industry and hydraulic engineering projects.
Japan	Japanese Finance Corporation of Local Public Enterprise (1957)	Corporation is legal entity substantially established by government. Main official of Corporation is Governor, appointed by Competent minister. Also three directors.	Own capital all provided by Central government. Outside capital—securities issues—public subscription and closed subscription.	Provide support to local authorities in fields of their finances and bond issues. Promotion and supply of funds to local public enterprises. Loans—long term; advance loans preceding issue of bonds; short term.
Kenya	Local Government Loans Authority (1953)—Credit institutions for local authorities. National Housing Corporation. Development and Reconstruction Authority (DARA). African Land Development (ALDEV).	A Statutory board set up by Kenya government. Management in hands of civil servants of Ministry of Local Government.	Commenced operations with grant from DARA. Local authority surplus funds on short-term deposit.	Loan money for sewage and water supplies, road works, administrative offices, health centers, road making plant and equipment, staff housing, markets, street lighting. Long-term, medium-term loans; temporary loans.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Niger	Niger Local Authorities' Loans Board (CPCL), (1962)—by law of government.	Public financial establishment possessed own legal status and financial autonomy. Run by a Board. Chairman of Board empowered to do everything for management and execution of resolutions of Board.	Starting with state grant. Annual contribution from territorial units. Loans from bank and credit organizations, foreign aid funds.	Grant loans to corporate public-law bodies. Assistance in form of Direct Credit and Guarantees. Loans for: water supply, sanitation, transport, education, health, electricity.
Norway	Municipal Bank of Norway (1926)—a state bank.	Supervised by Ministry of Finance. Board of Directors—Parliament selects Chairman. Daily management—Managing Director.	Own resources—Foundation Fund provided by State; Reserve Fund—Bank's surpluses; Contingency Fund—percentage deduction from each individual loan. State finance—provided to Bank. Two Guarantee Funid—a general and a special one.	Send money to municipalities, port authorities. For electricity and water supplies, Education, hospitals.
Portugal	General Deposit, Credit and Provident Bank—law of 1876. Portugese Savings Bank (1880). National Credit Fund (1929) (NCF)	Bank (CCD&P) has administrative and financial autonomy. Under supervision of Minister of Finance. Includes Central and Ancillary departments. Ancillary—consists of National Credit Fund and National Provident Fund.	Very large reserves. Accepts sight and time deposits. Deposits of public bodies; centralized funds of private sector social security system.	Subscriptions to public debt securities, Treasury Bonds and National Development promissory notes. Majority of loans to private sector for Agriculture and Industry through NCF. Mortgage credits and advances against securities provided. Loans for water, housing electricity, transport, town planning.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Spain	Local Credit Bank of Spain (1925). Nationalized in 1962. Now a public law body with juridical personality and full competence under Ministry of Finance. Medium-Term and Long-Term Credit Institute (M&LTCI).	Responsibility for Bank investments in Ministry of Finance through (M&LTCI). Organs—President, Managing Director, Board of Directors, Executive Committee. Appropriation of profits—determined by Ministry of Finance.	All stock owned by State. Issue bonds initially. Now necessary funds obtained from Public Treasury through (M&LTCI). Funds via: issue of fixed-interest securities; Treasury advances, loans from foreign organizations and from Bank of Spain, international credit institutions.	Stimulate development and progress of public-law entities, provide financial and technical assistance. Forms of assistance: Opening of credits, Conversion of debts, advise local authorities on urban planning and improvement. Loans for water, transport, education, building, fire services, tourist development.
Thailand	Development Fund of Thailand (1955).	Co-operative savings society of local government units, comprising Municipal Development Fund (MDF), Sanitary Districts Development Fund (SDF) and Provincial Administrative Development Fund (PDF). Under jurisdiction of Department of Local Administration.	Deposits from member municipalities. Difference between borrowing and lending rates. 5% of annual revenue of local authorities to be reserved in Fund.	Loans for public utilities For fresh-food markets, office buildings, electricity, water supply.
Turkey	The Provinces Bank of Turkey.	A state institution. General meeting of shareholders approves balance sheet. Bank's activities, rate of interest and Bank charges determined by Board of Directors.	Authorized capital obtained from provinces, villages and municipalities. Percentage of annual revenues of municipalities and *ad hoc* provincial administrations; percentage of net revenues. Proceeds from real estate tax; percentage of bank's net revenues; funds from sale of property, grants, loans from special fund of Ministry. Collections from a number of taxes and duties—Tax on Automotive Transport. State subsidies.	Chief function is to act as a financial institution Extending of loans to regional authorities, municipalities, villages for investment programs. Prepare plans and projects for works. Technical assistance. Loans—drinking water, electrification, public utility services.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
United Kingdom of Great Britain and Northern Ireland	Public Works Loan Board	Board of Directors appointed by Sovereign. Secretary to Commissioners appointed by Prime Minister allowed to transact business on Commissioners' behalf.	Board draws money from Exchequer via Local Loans Fund. No equity capital or debt capital.	Loans to local authorities generally under some restrictions. Loans to housing associations and fishery harbours—rarely given. Also to school building.
United Republic of Tanzania	Local Government Loans Board of Tanzania (1965)	Board appointed by Minister responsible for local government affairs.	Finance from Loans Fund & Cess Fund consists of 30% of produce; cess levied on four crops. Also from Local Government Units Fund.	Receive, administer and invest funds of Board. Lend funds for provision of development works and services. Provide financial assistance to local authorities. Loans—education, health, fire services, markets, roads.
Zambia	Zambia Housing Board (1926). Local Authorities Loan Board up to 1962—now operated by Ministry.	Members of Board appointed by Local Government and Housing Minister. Board empowered to determine conditions of service. Advisory to Minister	Establish grant from government. Grant funds as annual appropriations from Central Government.	High- and medium-density housing loans, loans for aerial surveys, electrical wiring, improvement for old housing. Direct Building Organization—Construction work. Proposals for construction of dwelling and housing schemes.

APPENDIX TABLE X-A-1 (CONT.)

II. Credit Institutions Controlled Primarily by Local Governments

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Austria	Central Savings Bank of the Municipality of Vienna—resolution to set up—1905.	Bank is a juridical person sui generis and to be regarded as belonging to private sector—self-contained institution independent in management and activities. Administrative Board—six members.	Own capital—allocations to reserve from annual profit. Outside funds—savings deposits; "Other deposits"—credit institutions deposits, fixed-date deposits; "Borrowed funds."	Communal-benefit activities: school and youth savings, education in savings, social tasks, promotion occupational training, promotion of trade, science, arts. Accumulation of deposits: Savings business Commercial credit business: for small and medium sized traders, private individuals. Long-term credit business: housing and local-authority finance. Services: wide range—securities commission business, buying and selling of foreign exchange.
Belgium	Municipal Credit Bank of Belgium (1860)—supplier of capital to local authorities.	State takes no part in running of Bank nor in appointment of any members. General meeting of shareholders approves balance sheet and profit and loss account. Board fixes interest. Supervisory Board supervision over all transactions.	Municiaplities and provinces subscribed to Bank's share Capital to set up Bank. Outside capital—cash vouchers or certificates running for medium terms: small and medium size savings; interest on sight and time accounts offered to local authorities.	Long and medium term loans for sewage, drinking water supplies, hygiene, public health, provincial and municipal buildings. Also, all other services expected from a Bank.
Denmark	Danish Municipal Pension Fund (1929)—arrange municipal pension liabilities on insurance basis.	Intermunicipal fund (pension) entirely owned and run by municipalities. Institution is autonomous.	Own Capital—Share capital Outside Capital—premiums paid by municipalities and employees.	A pension institution for municipalities; a credit institution also.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Norway	Norwegian Municipal Pension Fund (KLP)—(1949)—founded with approval of Central Government.	Legal entity in its own right—intermunicipal mutual pension fund. Board of Directors has five members. Ministry of Municipal Affairs and Labor approve KLP's accounts. Close collaboration with Municipal Bank of Norway.	From municipal employers and part also from employees.	Loans granted to municipalities, counties and municipal institutions which are members of KLP. Loans for: School buildings, residences, electricity, hospitals, water supply, industry, construction of roads, bridges and quays.

III. Credit Institutions with Mixed Control (Central Government, local authorities, and other institutions)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Austria	Austrian Municipal Credit Company for Development of Industrial sites (1959).	General meeting of shareholders—decides on use to which net profit is to be put. Supervisory Board—supervises business activities of company.	Shares of company entirely in hands of financial institutions. Loans from ERP Fund (counter-part funds under former Marshall Plan). Receives capital funds from share holders on normal market terms.	Provision of long term loans for financing of site development work for industry and of construction of factory buildings.
Canada	Alberta Municipal Financing Corporation (1956) (AMFC)	Shareholders of Corporation meet. Approval of shareholders not required for any borrowings of corporation. Board of Directors—seven members.	Share capital represented by 5000 registered shares. AMFC has recourse to public bond issues. Alberta's share of fund established under Canada Pension Plan. AMFC may issue securities.	Loans to municipalities for any capital project. Funds for school boards and hospital boards provided by corporation.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Denmark	Municipal Credit Association of Denmark	Supreme authority is Board of Directors. Amendment of by-laws decided by Board must be approved by Minister of Home Affairs.	Every borrower pays 1% of principal of loan to reserve fund and also contribution of 1 per mille of principal every six months. Outside Capital—issue of debenture bonds "on top." Borrower pay ½ of 1% of principal to reserve fund. Possible for association to levy extraordinary taxes.	Long-term and medium-term loans to local authorities and to public utilities. Principal objects of current loans—education, sewerage and cleaning systems, district heating, acquisition of sites, waterworks. Co-operation with Central Government's counter-cyclical policy. Facility for bond holders to register local credit institution bonds with association.
Federal Republic of Germany	German Central Giro Institution—German Municipal Bank (1918). Free Savings Banks (1932) form part of German Savings Bank and Clearing Association.	General Meeting—approval of annual account, balance, sheet with profit and loss account, utilization of assets, distribution of net profit and coverage of losses. Board of Directors—supervises entire conduct of business and basic regulation of transactions of Bank.	From funds of German Savings Bank and Clearing Association. Outside Capital—surplus liquid funds of regional credit institutions centres.	Government loans to corporations and other law bodies, administrations of surplus liquid funds, co-operation in issue of foreign loans, performs all banking functions.
Guatemala	Guatemalan Institute of Municipal Development (1957).	Central government and municipalities have considerable say in institutes and affairs. Board of Directors—three members.	Revenue from special duty on liquor. Central government bonds issued to raise Capital of Institute. Tax on alcoholic beverages. Proportion of annual Central government expense budget for construction of public works; operating surplus provides funds; temporary use of proceeds from taxes.	Make loans to finance municipalities, public works and services; discount bills or notes of municipalities. Loans mainly for--markets, paving, sewers, power distribution. It is a Construction agency; also a promotional and organizational agency. Functions dealing with personal administration.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Honduras	Autonomous Municipalities Bank of Honduras (1961).	President—appointed by President of Republic Board of Directors—guides and directs policy of Bank as to its functions. Manager responsible for execution of budget, direction of operations. Bank has legal personality.	Original capital—grant from Central government. Bonds have been issued. Deposits of Municipalities. Issue preferred and Common stock.	Depository for funds, bonds, securities of all classes belonging to Municipalities; financing organization for public works; promote investment spirit; co-ordinate economic and financial activities of municipalities with economic policy of state; purchasing agent for equipment needed by municipalities. Loans—airports, markets, electricity, street paving.
Israel	Bank of Israeli Local Authorities (1954).	General meeting approves balance sheet and profit and loss account and announces distribution of dividends for the year. General manager appointed by Board of Directors.	Authorized capital consisting of ordinary shares. Deposits by governments and banks.	Grant long term loans to Municipalities, local and regional authorities and other public institutions in local authority sector. Loans for—education, public works, clinics and public institutions. Main criteria—develop and establish new urban centres.
Netherlands	Bank for Netherlands Municipalities (1914)—provision of credit for municipalities.	Supreme authority vested in general meeting of shareholders. Board of Directors—supervises management.	Own capital—share capital and reserves not of major significance. Bond and savings bond issues for Long-term Capital. Concluding loans with pension funds, insurance companies, savings banks, etc. Time and sight deposits of local authorities.	Long and Medium term loans for public works, land for housing, streets, industry, etc. Bank is cashier of local authorities. Assist governments Counter-cyclical policy.

APPENDIX TABLE X-A-1 (CONT.)

Country	Institution	Structure/Approach	Source of Finance	Type of Activities
Sweden	Municipal Credit Company of Sweden	An association of local savings banks in form of a limited liability company. Powers and responsibilities of management established by Board of Company.	Share capital not of any great significance. Outside capital—bond issues quoted and dealt in on stock exchange.	To meet local authorities' credit requirements. Co-operation in structural and counter cyclical policy of government.
Venezuela	Foundation for Community and Municipal Development (1962)—provide credit to Municipal governments.	Council of Directors—drafts regulations, approves loan applications, discusses and approves annual budget. President—prepare proposed budget, annual report.	Equity Capital—Contributions from Central Government. Loan Capital—from USAID; grants from Central Government.	Assist in raising financial administrative and legal competence of local governments; provide lendable funds to communities. Special Fund for contributions to Community Development—created to stimulate incipient activity of community action.

Source: United Nations, Credit Institutions for Local Authorities. New York, New York: United Nations Publication, 1972.

in terms of what they can or must budget for certain, specified functions. While this practice, in theory, enhances the direction which the Central Government can give, it markedly reduces the discretion which local governments have in determining the size and makeup of their budgets. It would seem to follow, then, that local governments may not be held completely accountable for failing to respond to fiscal crises.

A useful concept for evaluating the ability of a government to respond to fiscal difficulties is that of "controllability." If the bulk of expenditures in a budget cannot be controlled by the public body but instead are essentially "determined" by outside forces, a number of problems arise: (a) the flexibility of the local government to respond to particular circumstances is limited, and (b) the local government feels much less accountable for its fiscal actions. If revenue bases are narrowly prescribed and tax rate ceilings and the base coverage are fixed, the options for fiscal response are further narrowed.

In fact, the budgets of local governments in the Philippines are quite substantially affected by Central Government mandates. The restrictions include:

> Statutory Reserve: Two percent of estimated revenues from regular sources must be held in reserve to cover unforeseen circumstances.
>
> Election Reserve: Under the Election Code, contributions to election expenses are on the basis of one-third from the National Government, one-third from provincial governments and one-third from the city or municipal government. To insure that these monies are available for elections, an election reserve based on 1/4 of the local election costs from the previous election must be set aside.
>
> Infrastructure Fund Transfer: Between 8 and 12 percent of annual net income in the General Fund must be transferred to the Infrastructure Fund.

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

Integrated National Police (INP): Since the issuance of PD 632, local police and fire protection has been supported by a uniform contribution of 18 percent of total General Fund income from regular sources. The INP is centrally administered; however, at least some localities find that it is necessary to supplement this 18 percent contribution rate periodically as local needs arise.

Barangay Development Fund: In conjunction with the strengthening of the barangay as an additional layer of government, each municipality, city and province makes an allocation from the General Fund. The amount transferred is not to exceed ₱500 per year per barangay and, while there is not a statutory minimum, our investigation into the accounts of localities suggest that nearly all local governments are making some contribution.

Twenty Percent Development Fund: As mentioned above, 20 percent of the BIR Allotment to the General Fund is to be set aside for "development projects". While the previously listed types of projects qualify for inclusion, the final two items in that list--training programs for government employees and "other projects based on local priorities"--allow for considerable flexibility within this requirement. By the same token, more flexibility is given to the approving agency, the MLGCD in this case. Numerous local jurisdictions have utilized significant proportions of their 20 percent Development Fund to support the Barangay Brigade Program, even though such expenditures are not strictly capital investments.

Personnel Expenditures: There are several restrictions placed on personnel expenditures of local governments. One overriding restriction is that total annual appropriations on wages and salaries of all local government employees are not to exceed 45 percent of total annual income from regular sources in first and second class jurisdictions (55 percent in jurisdictions lower than second class).[1]

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[1] Jurisdictions are classified according to the amount of revenue collected.

> This limitation does not include salaries and wages of public school officials and employees, employees of hospitals, health and agricultural services, public utilities, markets and slaughterhouses, or other economic enterprises operated by the jurisdiction. Emergency cost-of-living allowances are also excluded. The Secretary of Finance can authorize appropriations which exceed these limits in exceptional cases. Another constraining provision concerns salaries. Salary ranges for different job titles are set by the Central Government although individual jurisdictions can pay the lower bounds in cases of extenuating circumstances. Likewise, some local governments with available resources have paid a bonus, e.g., some local governments in Iloilo (in 1979) paid "thirteenth month" salaries, thus effectively providing an 8.3 percent increase in pay. Nevertheless, the imposition of salary scales from the national level obviously decreases the budgetary flexibility of a locality, since it makes it difficult to respond to labor market conditions that might be particular to the local area.

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

Local government autonomy in the Philippines, it would appear, is quite limited.

The Fiscal Performance of Philippine Local Governments

The measurement of fiscal performance calls for developing an objective index of how well local governments are doing their job. Even in countries where data are readily available, however, this turns out to be a very subjective matter.[1] On the expenditure side, there is the problem of not being able to measure public sector output which in turn prohibits direct measurement of the efficiency of government operations, the productivity of government workers or the quality of public services provided. We can do little more than speculate about these important issues. On the revenue side, good measures of the potential taxable base (e.g., the amount of income above subsistence, the full market value of property, etc.) cannot be made, hence, evaluation of revenue effort and collection efficiency is more qualified than we would like. In sum, we cannot say, in any normative sense, how well a government is spending its budget or taxing its base. Where this leads most analysts, us included, is to try and infer fiscal performance from measurement of actual fiscal outcomes, for example, deviations from "normal" revenue and expenditure patterns, fiscal surpluses and deficits, and tax effort.

Before turning to these analyses, we should caution once more about the limitations in the data and in the approach taken. The measurement of fiscal outcomes is complicated in the Philippines by the absence of comparable,

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[1] At a time when many U.S. cities are facing serious financial shortfalls, and some have actually defaulted on their debt obligations, the U.S. government is unable to decide what constitutes a "distressed" city. For discussions of this, see James W. Fossett and Richard P. Nathan, "The Prospects for Urban Revival," and Roy Bahl, "The Next Decade in State and Local Government Finance: A Period of Adjustment," both in Urban Government Finance, Emerging Trends, edited by Roy Bahl (Beverly Hills: Sage Publications, 1981).

current data. The local government financial statistics used here were taken from audited financial reports from the Commission on Audit (COA). Unfortunately, the latest available information is for FY 1977, hence, recent important trends and developments are not observable. This is an unfortunate data limitation, but one that we had no way of getting around. Another limitation is the breadth of the data used. Ideally, we would have a 100 percent sample of local governments but time and resource constraints would not permit. Instead, the COA data have been compiled for selected municipalities--those in the Provinces of Albay, Bulacan, Iloilo and Sorsogon--and for all chartered cities outside Metropolitan Manila.[1] While these data provide considerable insight into the composition of revenues and expenditures, they do not constitute a random sample and thus conclusions must be limited to the domain of this "sample".[2] In the section below, we examine the variability within this sample and the comparability between this sample and the rest of the Philippines.

A supplementary, and more detailed analysis of some aspects of financial performance--particularly the measurement of budgetary surplus and deficit--required considerable field work. Time and resource constraints limited this sample to only 15 municipalities in Iloilo, Albay and Bulacan plus the Cities of Legaspi and Iloilo. In these cases, data for the more recent 1978-1979 period were available.

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[1]The municipalities of Jordan, New Valencia and San Miguel, in Iloilo Province, and Casiguran and Sorsogon in Sorsogon Province were excluded from the sample since the data were not available from COA. Appendix II-A contains a listing of the jurisdictions included in our sample.

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

Variations in Socio-Economic Structure

Fiscal performance and potential is in some measure related to the socio-economic and demographic makeup of a jurisdiction. The proper place to begin this analysis is with a description of the variations among jurisdictions in the sample under study here, and with a discussion about the representativeness of this sample relative to the rest of the nation. We have focused on personal income level and distribution, population size and growth rate, and urbanization. As always, there are data problems, but they are not so severe that a reasonable profile of community characteristics cannot be obtained. Detailed demographic and economic characteristics are not available annually for municipalities, hence, we have relied heavily upon the findings from the 1975 Integrated Census of the Population and its Economic Activities which, among other things, provides estimates of the level and source distribution of income within municipalities. Summary background data on these four provinces and selected comparisons with the rest of the Philippines are presented in Table II-3.

The upper panel shows the province-wide levels for four different indicators of the social and economic setting in the municipalities.[1] Albay stands out as being considerably poorer and less urbanized than the other provinces studied here and by comparison with the rest of the nation. At the other extreme, Bulacan is more heavily urbanized and has a relatively high per capita income. Another measure of the industrial development of

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[1]Note that these data refer only to the municipalities that we have included in our sample. See Appendix II-A for a listing.

TABLE II-3

MEANS AND COEFFICIENTS OF VARIATIONS OF SELECTED SOCIO-ECONOMIC CHARACTERISTICS, SAMPLE JURISDICTIONS, METRO MANILA, AND THE NATION

Jurisdiction	Per Capita 1975 Income	1975 Urban Population[a]	Percent of Non-Agricultural Income, 1975[b]	1977 Assessed Value Per Capita	1975 Population[c]
Albay	₱ 797	8.1%	49.5%	₱ 403	657,855
Bulacan	1035	36.0	70.8	1407	890,133
Iloilo	935	12.2	43.7	674	998,504
Sorsogon	985	16.6	32.8	460	426,570
Four Provinces[f]	941	19.0	52.1	803	2,973,062
Chartered Cities[d]	1258	54.9	63.9	2244	3,902,508
Metro Manila[g]	2125	100.0	NA	NA	4,970,000
Philippines[g]	1111	31.6	NA	NA	42,071,000
			Unweighted Mean Values		
Albay (17)[e]	₱ 734	8.3%	48.4%	₱ 379	38,697
Bulacan (23)	1046	29.4	69.5	1501	38,701
Iloilo (43)	904	12.3	43.7	678	23,221
Sorsogon (15)	935	14.7	36.4	425	28,438
Four Provinces (98)	912	16.0	49.5	781	30,337
Cities (42)	1174	46.2	59.7	1453	80,756
			Coefficients of Variation		
Albay	32.5	97.9	44.8	33.9	46.8
Bulacan	22.2	117.8	20.9	68.8	47.3
Iloilo	31.5	67.6	37.7	98.1	45.1
Sorsogon	27.6	81.0	55.7	33.0	49.7
Four Provinces	30.3	123.9	42.4	100.4	53.0
Cities	25.8	80.5	28.5	86.1	78.0

[a]Percent 1975 population living in urbanized areas. Based on the 1975 definition of urban by the NCSO.

[b]Income from retail sales, manufacturing and wages as percent of total 1975 income.

[c]In top panel, entries are totals; in lower panels entries are means and coefficients of variation across municipalities/cities in sample.

[d]Includes only the 42 cities for which complete data were available from 1975 Census. See Appendix II-A.

[e]Number of observations.

[f]Weighted mean.

[g]These are preliminary estimates based on National Economic Development Authority, Regional Development: Issues and Strategies, Regional Planning Studies Series, 1 (Manila, 1978), p. 6.

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

an area is the proportion of income earned outside the agricultural sector--from wages and salaries, manufacturing or retail activities.[1] Again Bulacan stands out as being, by far, most highly developed. Iloilo and particularly Sorsogon appear to be much more dominated by agricultural activity, but with average income levels well above that in Albay.[2] Chartered cities as might have been expected, are more highly urbanized, less dependent on agriculture, and have higher average income levels.[3] A rough way to gauge the relative wealth of these four provinces is by comparisons of per capita assessed property values. Again Bulacan and the chartered cities stand out as showing a much greater level of wealth.

The interpretation of nationwide comparisons requires care, given that the nationwide data include Manila as well as all cities. However, the provinces shown here may be reasonably representative of the average levels of income and population in areas covered by provincial and municipal government. The average per capita income in these four province-municipal areas is ₱938 as compared to ₱975 in the Philippines excluding Manila but including chartered cities.

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

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

[3]Not all of the chartered cities outside Metropolitan Manila have been used here due to lack of data from the 1975 Census at the time this report was prepared. Appendix II-A lists all cities included in the analysis.

The lower two panels of Table II-3 provide additional evidence on the types of variability found across the specific municipalities and cities included in the sample.[1] The middle panel shows unweighted averages of the several socio-economic characteristics measured at the municipal and city level. The same general pattern of variation emerges.

On average, Albay municipalities are poorer, less wealthy, and less urbanized, while the reverse is true in Bulacan. Iloilo, again, has a greater level of property wealth than its (relative) per capita income would suggest. Finally, the Albay and Bulacan municipalities are, on average, quite a lot larger than those in Iloilo and Sorsogon. As above, cities tend to be bigger, of higher income, more urban and less agrarian than municipalities. The bottom panel of Table II-3 addresses the issue of whether there are large variations across municipalities *within* provinces. An affirmative answer is suggested by the coefficients of variation (the ratio of the standard deviation to the mean of the variable) shown there.

Some interesting conclusions might be drawn from these rather simple calculations. First, there is a great range of urbanization being analyzed here, hence one might look for differences in urbanization to matter a great deal in differential fiscal performance. Second, there is much less uniformity in the per capita property tax base in Iloilo and Bulacan where the level of the base is high on average. We are presently unable to explain this finding. Third, even though the general levels of these

[1]These differ from the first panel since they are essentially a weighted average across municipalities with the weights reflecting either population or income.

variables differ considerably across the provinces, the coefficients of variation for the pooled sample (all municipalities considered as a single group) are not considerably greater than the coefficients within provinces. For example, per capita incomes across the municipalities within Iloilo and Albay vary relatively more than they do across the entire sample of 98 municipalities This would seem to suggest that analyses based upon relative variations (correlation and regression analysis) across the pooled sample will provide results not entirely due to differences in the levels of development across provinces. In other words, the inclusion of higher income Bulacan and lower income Albay in the same (pooled) sample will not hamper interpretation of the results. Fourth, charter cities appear to be much more homogeneous than municipalities with respect to all variables except population size.

Expenditure Structure and Variations: General Fund

For budgeting and financial record-keeping purposes, General Fund expenditures are classified into four major categories: general government, public welfare and safety, economic development and other. The specific subcategories within each of these groupings are shown in Table II-4. The category titles seem roughly appropriate: general government includes the usual executive and legislative functions of governments; public welfare and safety includes the protection, justice, education and health functions; and economic development spending includes a variety of activities at least tangentially related to development.

TABLE II-4

GENERAL FUND EXPENDITURE CATEGORIES

General Category	Functional Category
General government	Governor or Mayor
	Office of Legislative Council
	Office of Auditor
	Office of Treasurer
	Office of Assessor
	Reserves for Elections
	Interlocal Transfers
	Aid to Rural Improvement
	Aid to Non-government Entities
Public Welfare and Safety	Office of the Fiscal Judge
	Office of Inferior Court
	Office of Legal Officer
	Office of Register of Deeds
	Office of Health Officer
	Office of School Superintendent
	Office of Librarian
	Aid to the INP
	Other Public Welfare Expenditures
	Aid to Hospitals
	Aid to Rural Improvement
	Zoo
	Aid to Non-government Entities
Economic Development	Agriculturalists
	Office of the Veterinarian
	Office of the Engineer
	Office of Development Officers
	Other Economic Development Offices
	20 Percent Development Fund
	Statutory Transfer to the Infrastructure Fund
	Road Network Projects
	Tax Mapping
	Other Development Projects
	Aid to the Agricultural Fund
	Aid to the Barangay Development Fund
	Aid to Rural Improvement Economic Development
	Operations of Markets and Slaughterhouses
	Waterworks
	Cemeteries
	Electric Plants
	Other Public Utilities
	Other Economic Enterprises
	Aid to Non-government Entities
Other	Debt Service
	2 Percent Budgetary Reserve

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

Spending by local governments can be considered with respect to level and composition among these three major functional areas, and in terms of variability across jurisdictions (Table II-5). For the 97 municipalities represented in our sample, average per capita spending in 1977 amounted to ₱17.05 while the 42 cities spent, on average, ₱56.16. The primary reason for this large difference is, of course, that cities are responsible for the range of services that municipalities and provinces together provide.

When the provincial averages are compared, we find the pattern that one would expect--substantially higher spending in Bulacan with its higher level of per capita incomes and its more urbanized population. On average, municipalities in Bulacan spend twice as much per capita as those in Albay and Sorsogon.[1] A number of hypotheses could be offered to explain this pattern: higher income residents demand and are willing to pay for more services; more urbanized areas need to provide more services; it costs more to provide services in higher income provinces; or tax administration, including determination of tax base, is simply better in some provinces and hence there is more to spend.[2] This last hypothesis may help explain why Iloilo was spending, in 1977, at the average of the four provinces even though its income and urbanization levels were below that of Sorsogon.

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

[2]This may also be due to provincial government assistance in assessment and in planning and implementing projects.

TABLE II-5

PER CAPITA GENERAL FUND EXPENDITURES, SELECTED JURISDICTIONS: 1977
(pesos per 1975 population)

Expenditure Category	Albay	Bulacan	Iloilo	Sorsogon	Pooled Municipal Sample	All Cities[b]
	Mean Amounts					
General Government	5.71	10.54	7.78	6.28	7.85	17.91
Public Welfare and Safety	1.98	5.02	5.04	2.07	4.07	20.16
Economic Development	2.40	9.56	4.71	2.41	5.12	18.95
Total Expenditures[a]	9.95	24.51	17.66	11.52	17.05	56.16
Number of Observations in Sample	17	23	43	14	97	42
	Coefficients of Variation					
General Government	33.77	59.31	35.16	20.95	51.05	41.21
Public Welfare and Safety	82.40	73.08	66.12	53.23	79.78	70.07
Economic Development	58.73	105.25	78.82	68.24	118.88	121.41
Total Expenditures	40.53	54.83	39.15	32.47	56.80	63.07
	Percent Distribution					
General Government	56.5	42.0	44.4	58.4	46.1	29.8
Public Welfare and Safety	19.6	20.0	28.8	19.2	23.9	36.9
Economic Development	23.8	38.0	26.9	22.4	30.0	33.3

[a]The totals may not equal the sum of the components since all entries in the table are unweighted averages.

[b]Excluding cities in Metropolitan Manila.

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

Still, we might ask whether spending in Bulacan is uniformly higher and that in Albay and Sorsogon is uniformly lower, or whether a few municipalities have pulled the average up or down by an inordinate amount. This possibility can be examined by comparing the coefficients of variation within each province. Interestingly, the greatest relative variation is among the 23 municipalities in Bulacan (see bottom row of middle panel of Table II-5). This leads one to conclude that all municipalities in a province do not share equally in the fiscal benefits of a strong economic base.

When attention is turned to the composition of spending by function, other implications can be drawn. The biggest share of municipal expenditures appears to go for general government. On average, nearly half of total municipal expenditures went for supporting the general overhead of government (bottom panel of Table II-5). Economic development spending, the cause for mobilizing additional local government resources, claims a much smaller share.

There is variation in the distribution of spending at the municipal level both across and within provinces. The percent allocated to economic development expenditures appears to be a matter of income level (in the case of Bulacan) and, to some extent, the size of the property tax base (in the case of Iloilo). Each of these provinces spends a significantly lower proportion on general government--43 and 44 percent respectively--while in Albay and Sorsogon the shares are 57 and 58 percent. Again a feasible explanation for this pattern is that a local government must spend

some minimal amount to support itself no matter how wealthy or poor the underlying economic base. The amount left over for other functions of government--the residual or "surplus" which is usually associated with public service improvements and economic development--is much smaller for poorer jurisdictions. These data for municipalities as well as cities would seem to support such an explanation. Yet the question remains--is the surplus lower because fiscal capacity is lower or because low income municipalities put forth a lower tax effort? This is a question to which we return below.

On average, these municipalities appear to spend around 20 percent of their General Fund budgets for public welfare and safety. This consistency results from the required 18 percent contribution for police services. A more substantial variation is observed in expenditures for economic development. The richer municipalities spend more per capita and appear to allocate a greater budget share to economic development purposes, e.g., Bulacan municipalities average 38 percent of General Fund expenditures.

It would be tempting to draw the conclusion that there is a direct and consistent relationship between the economic base of a jurisdiction and the budget share it allocates to economic development. There are at least two reasons for hesitation in arguing this point. First, economic development spending tends to be "lumpy", i.e., characterized by abnormally large expenditures in single years; hence, observations in any given year may distort the true long-term pattern. Second, since many economic development-type projects are financed from the Intrastructure Fund, concentration on the General Fund may be misleading. Both qualifications will be dealt with below although neither will cause us to alter this general conclusion.

The coefficients of variation associated with these averages across municipalities suggest relatively more uniform spending for general government than for the other two categories of expenditures. Except among municipalities in Albay, the greatest relative variability in spending is for economic development purposes. This again reinforces the hypothesis offered above: local governments must spend some threshold amount for general operations, and variations in income and wealth do not lead to major variations in the per capita amount of this expenditure.

Chartered cities would seem to be a different matter altogether. Because they have the combined expenditure responsibility and revenue authority of municipality and province, it is not surprising that they spend significantly more on a per capita basis (Table II-5). However, they appear to allocate a markedly smaller share (than municipalities) to general government purposes and a much greater share to public welfare and safety. These differences may be deceiving because of the great variation in financial practices among cities. The coefficients of variation reported in Table II-5 show that there are greater differences in spending patterns among cities than among municipalities in this sample. This variation is especially pronounced for economic development spending.

These patterns might be explored more systematically through the use of correlation analysis. Table II-6 contains simple correlations between per capita General Fund expenditures, per capita personal income, population and the percent of the population living in urban areas. The findings are mixed, but some generalizations are possible.

TABLE II-6

SIMPLE CORRELATIONS BETWEEN PER CAPITA GENERAL FUND EXPENDITURES, PER CAPITA INCOME AND URBANIZED POPULATION, SELECTED PROVINCES: 1977

Province	Total General Fund Per Capita Expenditures	General Government	Public Welfare and Safety	Economic Development	Absolute Value Required for Significance at Level[b] .05	.10
Albay						
Per Capita Income	.480	.311	.093	.543	.53	.46
Urbanized Population[a]	.729	.298	.401	.300		
Population	.668	.459	-.030	.711		
Bulacan						
Per Capita Income	.230	.046	.142	.061	.45	.38
Urbanized Population	.399	-.134	.301	.539		
Population	-.101	-.528	-.190	.175		
Iloilo						
Per Capita Income	-.318	-.288	-.217	-.209	.32	.26
Urbanized Population	-.058	.157	-.016	.079		
Population	-.252	-.418	-.383	.238		
Sorsogon						
Per Capita Income	.082	-.277	-.037	.035	.57	.51
Urbanized Population	.617	.289	.455	.362		
Population	.330	-.242	.322	.210		
Four Province Total						
Per Capita Income	.157	.070	.029	.111	.20	.17
Urbanized Population	.421	.116	.239	.541		
Population	-.003	-.227	-.236	.220		
Cities						
Per Capita Income	.328	.220	.146	.326	.32	.26
Urbanized Population	.390	.324	.223	.319		
Population	.346	.097	.291	.297		

[a]Percent of 1975 population classified as urban.

[b]Critical values based on sample sizes and large sample t-test of correlation coefficients.

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

First, with respect to the 98 municipalities taken together, only the extent of urbanization is strongly correlated with per capita total expenditures (.421) and its economic development subcomponent (.541). Neither population size nor personal income is found to be highly associated with total spending or its component parts.

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

When the components of spending are examined, even less consistency in results is obtained. The only general conclusion that can be reached is that in the provinces other than Iloilo, greater urbanization is associated with higher levels of public welfare and safety and economic development spending.

In the cities, on the other hand, each of these three socio-economic variables is positively associated with total spending. Where income, urbanization and population are higher one may expect to find a higher level of per capita expenditures in general, and per capita economic development expenditures in particular.

Revenue Structure and Variation

Local governments in the Philippines receive grants from the Central Government and have authority to levy a variety of taxes and fees. The available taxes, fees and charges are summarized in Table II-7 below. A detailed description of the rate structures associated with these tax and fee sources is beyond the needs of this analysis; however, it should be noted that, in keeping with the centralized orientation of the finance system in the Philippines, rate ceilings are imposed.[1]

Average per capita revenues of the 98 municipalities and 42 cities included in the sample are shown in Table II-8.[2] Again, there is substantial variation in the total amounts raised, with municipalities in Bulacan (with higher than average per capita income) and Iloilo (with high per capita assessed valuation) raising substantially more on a per capita basis than municipalities in the other two provinces. The difference is most pronounced for Bulacan where both business taxes per capita (₱3.95) and total property taxes per capita (₱4.99) greatly exceed the means in the other three provinces.

As might be anticipated, there is much less difference in the average per capita amounts received from the BIR Allotment. However, it is interesting to note that municipalities in Iloilo and Bulacan, in spite of their higher than average incomes or assessed valuation, receive a greater per capita Allotment thereby reinforcing their per capita tax revenue advantage.

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[1] For a more complete discussion of these local taxes and fees, see A. Yoingco and V. Quintos, Philippine Tax System Under the New Society (Manila: GIC Enterprises, 1979), especially pp. 238-250 and 262-277. For a broader review of the types of local revenue sources used in other developing countries see Larry Schroeder, "Alternative Local Revenue Sources in Developing Countries", Local Revenue Administration Project paper, The Maxwell School, (Syracuse, NY: Syracuse University, forthcoming).

[2] Because of missing financial and socio-economic data for particular variables, there is some minor variability in the sample of jurisdictions used in the several analyses performed in this and subsequent chapters.

TABLE II-7

TAXES, FEES, AND CHARGES AVAILABLE TO LOCAL GOVERNMENTS

Local Government	Taxes, Fees, and Charges
Provincial Governments	Real Property Tax Real Property Transfer Tax Tax on Printing and Publication Business Franchise Tax Sand and Gravel Tax Taxes on Occupations, Amusement Admissions, and Fees for Ceiling and Licensing Weights and Measures, each of which is imposed by the National Government with revenues transferred to the province Peddler's tax Tax on Delivery Trucks or Vans Rental Fees for Using Municipal Waters, Rivers, etc. as Log Ponds
Municipal Governments	Real Property Tax Business Taxes Fees or Charges on numerous activities including parades, large cattle registration, building permits, dog licenses, etc. Fishery Rentals or Fees
City Governments	Cities can utilize any of the taxes listed above for either provinces or municipalities (recall that cities, in essence, enjoy the dual functions of provinces and municipalities).
Barangays	Taxes or fees on stores or retailers with fixed capital investment of ₱5,000 or less, billboards and signs, gamecocks owned by barangay residents and cockfights Charges for services of barangay-owned properties or service facilities. Contributions

SOURCE: A. Yoingco and V. Quintos, Philippine Tax System Under the New Society (Manila: GIC Enterprises, 1979).

TABLE II-8

GENERAL FUND REVENUES PER CAPITA, SELECTED JURISDICTIONS: 1977
(pesos per 1975 population)

Revenue Category	Albay	Bulacan	Iloilo	Sorsogon	Pooled Municipal Sample	All Cities[b]
	Mean Amounts					
Revenue from Local Taxation	2.90	10.49	4.32	3.15	5.34	27.40[c]
Business Tax	1.50	3.95	1.32	1.55	2.00	8.21[c]
Occupation Tax	.03	.08	.02	.01	.03	.27
Residence Tax	.19	.56	.20	.17	.28	1.35
RPT--Current	.59	3.66	1.77	.75	1.85	9.00
RPT--Past Years	.21	1.11	.43	.30	.53	2.47
RPT--Penalties	.04	.21	.09	.07	.11	.44[d]
(RPT-Total)	(.85)	(4.99)	(2.28)	(1.12)	(2.49)	(11.71)[d]
BIR Allotment	5.24	6.71	6.50	5.90	6.24	13.45
Non Tax Revenues	2.31	7.61	7.96	3.25	6.18	18.59
Aids and Contributions	.04	.06	.67	.33	.37	.49
Total Revenue[a]	10.45	24.81	18.77	12.30	17.75	61.41
Number of Observations in Sample	17	23	43	15	98	42
	Coefficients of Variation					
Revenue from Local Taxation	49.85	71.14	78.99	48.72	97.09	82.20
Business Tax	75.53	98.09	101.86	79.26	120.32	88.24
Occupation Tax	64.49	141.04	54.57	97.24	191.83	88.45
Residence Tax	55.70	63.33	46.08	45.19	87.39	79.25
RPT--Current	28.98	84.34	147.64	17.88	136.24	139.01
RPT--Past Years	50.97	95.80	60.89	47.24	119.62	153.74
RPT--Penalties	38.31	75.02	52.25	42.74	95.75	127.07
(RPT-Total)	(25.60)	(78.55)	(117.20)	(17.54)	(119.47)	(143.90)
BIR Allotment	15.57	34.81	28.66	25.36	29.75	53.12
Non Tax Revenues	96.17	107.03	59.34	78.89	92.05	117.95
Aids and Contributions	412.31	260.86	225.03	141.06	287.99	345.64
Total Revenue	34.59	53.65	37.17	30.93	53.95	60.82

[a]Includes sales of assets, borrowing, etc.

[b]Excludes cities in Metropolitan Manila.

[c]Number of observations in sample equals 40.

[d]Number of observations in sample equals 41.

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

Variability within provinces, as measured by the coefficients of variation, suggests that greater diversity is to be found where there are higher levels of per capita revenue generation--in Bulacan and Iloilo. This is not so surprising when it is recalled that urbanization and assessed valuation per capita were greatest in Bulacan and Iloilo (Table II-3) and also the most varied.

The distribution of General Fund revenues, by type of revenue is described in Table II-9. The business tax, property tax and BIR Allotment account for 95 percent of revenues to the General Funds of the represented municipalities. The minor taxes are minor indeed.

When average reliance on various municipal revenues is compared across provinces, some interesting variations emerge. Surprisingly, the business tax is the major source of revenue to municipalities in the Provinces of Albay and Sorsogon whereas in Iloilo and Bulacan the business tax is slightly less important than the property tax. One might attribute this pattern to a kind of "tax handles" argument. At the earlier stages of development, and with lesser degrees of urbanization, local governments may have little to tax other than the few established businesses, or they may find the administration and collection of a broad-based property tax unwieldy. As the local economy develops, the local government may begin to reach more property owners who have a greater capacity and perhaps willingness to pay property taxes.

The other interesting pattern that is suggested by Table II-9 is the extremely great dependence on Central Government assistance, especially

TABLE II-9

PERCENTAGE DISTRIBUTION OF GENERAL FUND REVENUES BY SOURCE, SELECTED JURISDICTIONS: 1977

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

[a]Excluding cities in Metropolitan Manila.

SOURCE: Computed from Table II-8.

in the less urbanized and low property tax base Provinces of Albay and Sorsogon. Municipalities in each of these Provinces receive about half of their total revenues from the BIR Allotment. Non-tax revenues--receipts from markets, slaughterhouses, and other enterprises activities--show up as important and as highly variable as one might expect. Caution has to be exercised in interpreting importance here because gross revenues rather than profits are reported.

Because of their broader taxing powers, chartered cities show much higher per capita revenues in total and from the several specific sources (Table II-8). The fact that municipal and provincial governments share the BIR Allotment whereas cities receive a single, but comparable total, accounts for the nearly doubled level of per capita shares in cities vis-à-vis municipalities. While the mean per capita levels of business and property taxes in cities are considerably greater than in municipalities, the variability among cities is greater.

In terms of relative shares, cities rely more heavily on local taxation than do the municipalities (except in Bulacan), whereas municipalities rely considerably more upon the BIR Allotment and on non-tax revenues.

Consolidated Budgetary Position

A more complete view of the activity of the local public sector requires aggregating revenues and expenditures in the General Fund, Infrastructure Fund and Special Education Fund. A truer picture of total economic development spending can be had by including the Infrastructure Fund and a better

measure of social service spending by including the Special Education Fund. Interfund transfers have been accounted for in making this consolidation. The consolidation in Table II-10 shows actual expenditures to be one-fourth to one-third higher when the Infrastructure Fund and SEF are included.

As noted in Table II-4 above, Infrastructure Fund expenditures are dedicated to the building and maintenance of roads, bridges and other capital projects. For the four provinces studied here, average per capita economic development spending from both the General and Infrastructure Fund is:

Municipalities in	Mean Per Capita Spending: Infrastructure and Economic Development (General Fund)
Albay	₱ 4.30
Bulacan	14.60
Iloilo	9.03
Sorsogon	4.85

The results are not different from those reported above: the more highly developed areas devote a greater share of resources and a greater per capita amount to development spending. If one were to conclude that education spending (SEF expenditures) should also be classified as economic development, the dispersion is even greater (a low of ₱4.60 per capita in Albay to a high of ₱18.58 in Bulacan). These findings raise a couple of interesting hypotheses. The first is that the grant system--which is the main support for economic development spending--is not equalizing and the second is that resource availability is probably the principle determinant of spending variations. Both propositions are investigated below.

TABLE II-10

MEAN PER CAPITA REVENUES AND EXPENDITURES BY FUND, SELECTED JURISDICTIONS: 1977

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

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

Tax Effort

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

Three different tax effort ratios were computed for this sample of Philippine municipalities and cities. *Real property tax (RPT) effort* is defined as the ratio of 1977 RPT collections (current year plus past years plus penalties) divided by 1975 Census estimates of personal income; *business tax effort* is an analogous ratio based on 1977 business license tax collections; while the numerator in the *total tax effort* measure is total 1977 locally-collected taxes. While *total revenue effort*--the ratio of total General Fund revenues less the BIR Allotment to personal income--may be computed, it is less comparable because it includes gross revenues from enterprise activities. It is not reported here.

Table II-11 contains summary data on the jurisdiction-level tax effort ratios. It is clear from these results that local government taxes are quite low. The average effective tax rate for municipalities, even measured against

TABLE II-11

TAX EFFORT RATIOS FOR MUNICIPALITIES BY PROVINCE AND FOR CITIES: 1977
(in percent)

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

[a]Computed as $\frac{\Sigma Tx_i}{\Sigma Y_i}$ where Tx_i = 1977 taxes in municipality i, Y_i = 1975 income in municipality i and the summation is across all municipalities in the province. The resulting ratio is essentially a weighted average of the individual ratios.

SOURCE: Computed by authors.

1975 income, is well below 1 percent.[1] The ranges presented in Column (1), however, suggest a very great deal of variation. To better understand the variation in this relatively crude measure of effort, we concentrate on business and property taxes, which account for the bulk of own source local government revenues.

To get at the issue of variations in local tax effort, a comparison of a municipality's effective tax rate against some norm is needed. We might view the difference between the average effective tax rate in the province ($\bar{E}_p$) and that in the nation ($\bar{\bar{E}}$) as being beyond the control of any particular municipality and more generally due to differences in fiscal capacity and to the goals and leadership provided in the provincial treasurer's and assessor's offices. Hence, the tax effort of the ith jurisdiction (E_i) may be compared to the national average from

$$(E_i - \bar{\bar{E}}) = (E_i - \bar{E}_p) + (\bar{E}_p - \bar{\bar{E}}) \qquad (1)$$

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

For example, the municipality of Pavia in Iloilo collects (municipal) property taxes equivalent to 0.47 percent of personal income. The (unweighted) "national" average collection ($\bar{\bar{E}}$) is 0.28[2] and the provincial mean is also 0.28 (Table II-11). Thus, Pavia's property tax effort is 0.19

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[1] It should be kept in mind here that the municipal share of the property tax is only 45 percent.

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

above the national average, i.e., $(E_i - \bar{\bar{E}}) = 0.19$. All of this may be attributed to local actions, since the average property tax effort in the province is the same as the national average. To describe this above average performance, we construct an *effort index* (I_i) from

$$I_i = \left(\frac{E_i}{\bar{E}_p}\right) 100 \qquad (2)$$

and enter these next to the effective rates, E_i, for each municipality included in Tables II-12a-d and indexes greater than 100 indicate a tax effort performance above the provincial average. In the case of Pavia, Iloilo, the property tax effort index is 168, which is quite high.

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

$$E_i - \bar{\bar{E}} = -0.21 \qquad (3)$$

We may attribute 0.16 of this to the generally lower property tax effort in the province, i.e.,

$$\bar{E}_p - \bar{\bar{E}} = -0.16 \qquad (4)$$

Furthermore, Tabaco exerts a low effort even within the context of its low taxing province, i.e.,

$$E_i - \bar{E}_p = -0.05 \qquad (5)$$

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

TABLE II-12a

MEASURES OF REVENUE EFFORT: ALBAY

Municipality	Property Tax: As Percent of Income[a]	Property Tax: Effort Index	Business Tax: As Percent of Income[b]	Business Tax: Effort Index	Total Local Taxes: As Percent of Income[c]	Total Local Taxes: Effort Index
Bacacay	0.11	85	0.11	52	0.33	78
Camalig	0.08	63	0.15	72	0.25	60
Daraga	0.16	117	0.38	181	0.82	195
Guinobatan	0.11	92	0.13	59	0.27	64
Jovellar	0.15	121	0.07	35	0.28	67
Libon	0.14	116	0.08	40	0.28	66
Ligao	0.15	119	0.40	189	0.69	162
Malilipot	0.06	45	0.11	50	0.21	50
Malinao	0.09	76	0.08	38	0.22	51
Manito	0.19	154	0.17	78	0.54	128
Oas	0.12	95	0.05	25	0.20	47
Pio Duran	0.11	91	0.16	74	0.35	82
Polangui	0.10	79	0.16	77	0.29	69
Rapu-Rapu	0.17	135	0.14	68	0.39	91
Santo Domingo	0.20	160	0.51	239	0.82	194
Tabaco	0.07	57	0.38	178	0.53	126
Tiwi	0.12	95	0.52	245	0.71	168

[a](Real Property Tax/Income).

[b](Business Tax/Income).

[c](General Fund Tax Revenues - BIR Allotment)/Income.

SOURCE: Computed by authors.

TABLE II-12b

MEASURES OF REVENUE EFFORT: BULACAN

Municipality	Property Tax		Business Tax		Total Local Taxes	
	As Percent of Income[a]	Effort Index	As Percent of Income[b]	Effort Index	As Percent of Income[c]	Effort Index
Angat	0.31	63	0.20	55	0.[illegible]	84
Balagtas (Bigaa)	0.66	134	0.70	194	1.46	145
Baliwag	0.29	60	0.75	206	1.35	135
Bocaue	0.22	46	0.39	108	0.70	70
Bulacan	0.97	196	0.36	99	1.50	149
Bustos	0.23	47	0.09	24	0.64	64
Calumpit	0.22	45	0.18	48	0.47	47
Guiguinto	0.73	149	0.96	264	1.87	186
Hagonoy	0.40	82	0.15	41	0.62	62
Malolos	0.34	69	0.48	132	0.93	93
Marilao	1.12	228	1.40	385	2.68	267
Meycauayan	0.34	69	0.52	144	1.09	108
Norzagaray	2.11	429	0.47	130	3.12	311
Obando	0.24	48	0.34	93	0.65	64
Pandi	0.31	63	0.15	40	0.56	[illegible]6
Paombong	0.38	77	0.12	33	0.59	59
Plaridel	0.42	86	0.32	88	0.80	79
Pulilan	0.24	49	0.08	22	0.41	41
San Ildefonso	0.44	89	0.06	16	0.57	57
San Jose del Monte	0.43	88	0.10	28	0.63	63
San Miguel	0.27	55	0.20	56	0.52	51
San Rafael	0.29	58	0.15	41	0.49	49
Santa Maria	0.36	72	0.18	51	0.61	61

[a] (Real Property Tax/Income).

[b] (Business Tax/Income).

[c] (General Fund Tax Revenues - BIR Allotment)/Income.

SOURCE: Computed by authors.

TABLE II-12c

MEASURES OF REVENUE EFFORT: ILOILO

Municipality	Property Tax: As Percent of Income[a]	Property Tax: Effort Index	Business Tax: As Percent of Income[b]	Business Tax: Effort Index	Total Local Taxes: As Percent of Income[c]	Total Local Taxes: Effort Index
Ajuy	0.17	61	0.10	61	0.29	55
Almodian	0.09	31	0.06	34	0.22	42
Anilao	0.33	115	0.08	50	0.44	82
Badiangan	0.19	93	0.07	44	0.42	79
Balasan	0.10	35	0.26	159	0.39	73
Banate	0.16	55	0.11	65	0.36	69
Barotac Nuevo	0.61	213	0.88	544	1.62	305
Barotac Viejo	0.23	79	0.16	98	0.46	87
Batad	0.05	19	0.06	36	0.16	30
Bingawan	0.23	79	0.05	30	0.29	55
Cabatuan	0.16	56	0.05	33	0.29	54
Calinog	0.08	378	0.38	232	1.58	297
Carles	0.09	31	0.06	37	0.17	32
Concepcion	0.07	23	0.02	13	0.14	26
Dingle	0.36	125	0.25	155	0.66	125
Duenas	0.22	78	0.17	105	0.50	94
Dumangas	0.43	153	0.12	76	0.58	110
Estancia	0.11	39	0.29	178	0.86	162
Guimbal	0.15	53	0.17	102	0.55	103
Igbaras	0.13	46	0.05	32	0.24	44
Janiuay	0.27	96	0.24	150	0.55	104
Lambunao	0.14	49	0.02	15	0.18	33
Leganes	0.46	163	0.27	164	0.78	146
Lemery	0.14	50	0.08	48	0.25	48
Leon	0.15	51	0.05	28	0.21	40
Maasin	0.05	17	0.03	16	0.12	22
Miagao	0.10	34	0.05	32	0.29	54
Mina	0.23	82	0.15	91	0.44	83
New Lucena	0.20	69	0.06	40	0.53	100
Oton	0.26	90	0.17	106	0.49	92
Passi	0.19	67	0.09	58	0.30	57
Pavia	0.47	168	0.69	426	1.36	256
Pototan	0.20	70	0.13	80	0.35	67
San Dionisio	0.26	91	0.20	122	0.51	97
San Enrique	0.55	893	0.19	117	2.79	525
San Joaquin	0.10	37	0.04	26	0.31	57
San Miguel	0.21	74	0.20	120	0.46	87
San Rafael	0.20	71	0.22	136	0.46	86
Santa Barbara	0.12	42	0.09	53	0.30	56
Sara	0.18	63	0.27	166	0.52	97
Tigbauan	0.11	39	0.04	27	0.34	64
Tubungan	0.24	86	0.11	67	0.42	80
Zarraga	0.40	141	0.21	129	0.67	126

[a](Real Property Tax/Income).

[b](Business Tax/Income).

[c](General Fund Tax Revenues - BIR Allotment)/Income.

SOURCE: Computed by authors

TABLE II-12d

MEASURES OF REVENUE EFFORT: SORSOGON

Municipality	Property Tax		Business Tax		Total Local Taxes	
	As Percent of Income[a]	Effort Index	As Percent of Income[b]	Effort Index	As Percent of Income[c]	Effort Index
Bacon	0.07	58	0.07	41	0.18	51
Barcelona	0.20	159	0.18	103	0.43	119
Bulan	0.09	73	0.27	156	0.43	121
Bulusan	0.13	99	0.26	147	0.51	142
Castilla	0.22	171	0.16	91	0.41	114
Dansol	0.11	85	0.05	27	0.17	47
Gubat	0.11	83	0.16	88	0.30	83
Irosin	0.16	123	0.29	168	0.50	139
Juban	0.12	96	0.11	65	0.27	76
Magallanes	0.10	77	0.11	63	0.25	69
Matnog	0.10	75	0.06	32	0.19	54
Pilar	0.09	68	0.08	43	0.18	51
Prieto Diaz	0.11	87	0.12	69	0.35	98
Santa Magdalena	0.14	108	0.13	75	0.33	91
Sorsogon	0.18	140	0.59	335	0.88	245

[a](Real Property Tax/Income).

[b](Business Tax/Income).

[c](General Fund Tax Revenues - BIR Allotment)/Income.

SOURCE: Computed by authors.

The index and relative effort for business taxes are interpreted in an analogous way. The three columns of Tables II-12a-d give us an opportunity to assess the reasons for a relatively high/low effort and to examine tradeoffs in the intensity of use of business and property taxes. Let the total effective rate (E) be equal to the sum of the effective rates for property taxes (E_1), business taxes (E_2), and other taxes (E_3). Hence for the ith jurisdiction in province p,

$$E_i = E_{1i} + E_{2i} + E_{3i} \tag{6}$$

Define

$$E_{1i} = \frac{T_{1i}}{Y_i} = r_{1i} \tag{7}$$

and

$$\bar{E}_{1p} = \left(\frac{\bar{T}_{1p}}{\bar{Y}_p}\right) = \hat{r}_{1p} \tag{8}$$

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

Now actual tax yield in the ith municipality (T_i) is

$$T_i = r_{1i}Y_i + r_{2i}Y_i + r_{3i}Y_i \tag{9}$$

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

$$\hat{T}_i = \hat{r}_{1p}Y_i + \hat{r}_{2p}Y_i + \hat{r}_{3p}Y_i \tag{10}$$

The index of tax effort I_i, then is

$$I_i = [E_i/\bar{E}_p]100 = \left[\frac{r_{1i} + r_{2i} + r_{3i}}{\hat{r}_{1p} + \hat{r}_{2p} + \hat{r}_{3p}}\right]100 \tag{11}$$

and

$$I_i - 100 = \left[\frac{r_{1i} - \hat{r}_{1p}}{\sum \hat{r}_{1p}} + \frac{r_{2i} - \hat{r}_{2p}}{\sum \hat{r}_{2p}} + \frac{r_{3i} - \hat{r}_{3p}}{\sum \hat{r}_{3p}} \right] 100 \quad (12)$$

The first term in equation (12) may be interpreted as the contribution of the property tax to an above or below average tax effort index and the second and third to the business and "other" tax contributions, respectively. Returning to the examples of Pavia, Iloilo and Tabaco, Albay, we may calculate these components from the data in Tables II-12a-d. The results show that Pavia's high effort is due to an above-average performance for all taxes (Table II-13). This may indicate a generally strong local tax administration. Tabaco offsets a below-average property tax effort with a very high business tax effort. This suggests that the commercial/industrial sector is easily taxed, perhaps because of the presence of a few large firms or a generally stronger commercial base, and this might have reduced the pressure to increase property tax effort.[1] Malinao, a poorer municipality in Albay, makes a very low tax effort in total and for each tax, though business tax effort accounts for most of its poor performance.

Do these results provide any clues as to what community characteristics lead to higher/lower tax effort? To begin exploring this question we have computed the simple correlations between the tax effort indexes and per capita income, urbanization and population for the municipalities in each province as well as for the sample of cities (see upper panel, Table II-14).

[1]Similarly, especially large earnings from enterprise activities such as markets and slaughterhouses may lower pressures on property tax effort.

TABLE II-13

ILLUSTRATION OF CALCULATION OF COMPONENTS OF TAX EFFORT:
PAVIA, ILOILO, TABACO, ALBAY AND MALINAO, ALBAY

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

SOURCE: Computed by authors.

TABLE II-14

SIMPLE CORRELATIONS OF MUNICIPAL AND CITY PROPERTY AND BUSINESS TAX EFFORT INDEXES AND EFFECTIVE TAX RATES WITH SOCIO-ECONOMIC VARIABLES: 1977

	Simple Correlations With Tax Effort Indexes[a]			
Province	Per Capita Income	Population	Urban Population[b]	Non-agricultural Share of Income[c]
Albay				
RPT Index	-.690	-.334	.336	-.412
Business Tax Index	-.184	.176	.404	.567
Total	-.417	.121	.258	.048
Bulacan				
RPT Index	-.174	-.312	-.116	.173
Business Tax Index	.211	-.173	.263	.540
Total	-.006	-.308	.020	.261
Iloilo				
RPT Index	-.266	-.054	-.221	-.304
Business Tax Index	-.335	-.056	.135	.374
Total	-.358	-.089	-.124	.092
Sorsogon				
RPT Index	-.824	-.096	.039	.064
Business Tax Index	-.282	.460	.664	.439
Total	-.469	.300	.688	.262
Four Provinces				
RPT Index	-.258	-.111	-.085	-.018
Business Tax Index	-.183	.015	.205	.201
Total	-.281	-.065	.069	.109
Cities				
RPT Index	-.090	-.094	-.031	-.091
Business Tax Index	.179	.125	.191	.313
Total	.027	.179	.267	.146

	Simple Correlations With Effective Tax Rates			
Province	Per Capita Income	Population	Urban Population[a]	Non-Agricultural Income
Four Province				
RPT Rate	-.084	-.081	.032	.222
Business Tax Rate	.016	.112	.354	.456
Total Tax Rate	-.073	-.010	.224	.387

[a]See Table II-6 for significance levels.

[b]Urban population in 1975 as a proportion of total population.

[c]Manufacturing, retail and wage income as a proportion of total income.

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

There are several interesting implications that can be inferred from these results.

For the provinces taken separately there is a consistent negative relationship between per capita income and tax effort. This would seem to suggest that within a province, those jurisdictions with a larger income base tax relatively less of it than do lower income municipalities. On the other hand, total local taxes and especially business taxes are positively related to the relative share of income earned from non-agricultural sources--manufacturing, retail and wage incomes. There is a plausible explanation for these seemingly mixed findings. Given that the bulk of these jurisdictions are rural in nature, the findings concerning per capita incomes and non-agricultural shares of income may reflect the fact that farms are exempt from business taxes and that the RPT is not easily collected from the agricultural sector. With respect to the latter, absentee ownership, controlled below-market prices, inadequate assessment and records, land reform and the physical problems of getting the tax collected are some of the important impediments. If nearly all jurisdictions in a province are basically rural in nature (as is especially true in Albay and Sorsogon), the higher incomes in some cannot be "captured" by the tax system thus leading to the negative correlations.

Most obvious from the chartered city analysis is the lack of association between these demographic/economic characteristics and tax effort, though larger cities or cities with stronger non-agricultural economic bases, make a greater business tax effort.

The bottom panel of Table II-14 provides a different perspective regarding tax effort in municipalities in the pooled sample, by correlating the effective tax rates (T_i/Y_i) with the socio-economic characteristics. Given the differential average effective tax rates across the four provinces (see Table II-12), it is not surprising to find the rather strong positive association between total taxes and both urbanization and non-agricultural incomes. The municipalities of Bulacan are likely a strong influence on this result.

The evidence here thus seems to suggest that local government taxes in the Philippines are urban taxes. The effective rate of business taxation (business tax effort) tends to be higher where there are higher levels of per capita non-agricultural income and urbanization. The pattern of property tax effort is less clearly seen from these relationships. One explanation is that the pattern is more complicated than can be picked up by simple, zero order relationships, i.e., some important explanatory characteristics have been omitted.[1] About the only consistent finding is that where per capita income is high--and especially if a large share of this income is earned in the agricultural sector--property tax effort will tend to be low.

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[1]This possibility is explored more fully in Chapter III.

Measuring Tax Effort: A Digression

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

To correct for this we have constructed a tax effort model in the traditional form used in cross-country studies.[1] If taxable capacity varies not only with income level but with per capita nonagricultural income (NY_p), urbanization (U) and population size (P), we may estimate

$$T/_Y = f(NY_p, U, P) \tag{13}$$

where

$T/_Y$ = total local taxes as a percent of personal income (see Tables II-12a-d).

[1] See, for example, Joergen Lotz and Elliott Morss, "Measuring Tax Effort in Developing Countries," IMF Staff Papers 14 (1967): 478-99; Roy Bahl, "A Regression Approach to Tax Effort and Tax Ratio Analysis," IMF Staff Papers 18, No. 3 (November 1971): 570-612; Harley Hinrichs, A General Theory of Tax Structure Change During Economic Development (Cambridge, Mass.: Harvard Law School, 1966); Alan Tait, Wilfred Gratz, and Barry Eichengreen, "International Comparisons of Taxation for Selected Developing Countries, 1972-1976," IMF Staff Papers 26, No. 1 (March 1979): 123-156; Roy Bahl, "A Representative Tax System Approach to Measuring Tax Effort in Developing Countries," IMF Staff Papers 19, No. 1 (March 1972): 87-124; Raja Chelliah, Hessel Baas and Margaret Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969-1971," IMF Staff Papers 22, No. 1 (March 1975): 187-205.

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

$$EE_i = \frac{(T/Y)_i}{(\hat{T/Y})_i} \tag{14}$$

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

Several different forms of the relationship between socio-economic variables and $(T/Y)_i$ have been estimated with the results shown in Table II-15. Unfortunately, there is such considerable underlying variability in the effective tax rates that none of the regressions can be considered very reliable.

The first set of regression results show per capita non-agricultural incomes significantly related to effective tax rates (measured as total local taxes per ₱1,000 personal income) while neither urbanization nor population are significant. The second regression suggests that variations in effective tax rates are closely related to province-specific factors. Three dummy variables have been introduced to delineate among the four provinces (Bulacan is used as the standard of comparison). Under this formulation none of the three economic variables is significant while each of the dummy variable coefficients is. This suggests an underlying difference in local taxation across municipalities in the Philippines

TABLE II-15

ORDINARY LEAST SQUARES REGRESSION RESULTS: EFFECTIVE TAX RATES[a] RELATED TO LOCAL SOCIO-ECONOMIC CHARACTERISTICS

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

[a]Measured as the ratio of total local taxes to personal income (in ₱1,000).

*Significant at less than the 0.05 level.

**Significant at less than the 0.01 level.

SOURCE: Computed by authors.

that depends more on regional levels of development or perhaps provincial government operations than on particular characteristics of the localities.[1]

There are several possible explanations for these results. One explanation grows out of the centralized nature of local tax administration. The role of the provincial treasurer may be so dominant that it swamps the influence of local economic conditions on tax effort and results in no systematic variability in tax effort across jurisdictions within a single province.

Second is the possibility that the independent variables used here are too crude to pick up subtle differences in stages of development which account for differences in tax efforts. While mean income in Bulacan is greater than in the other provinces, the simple measures of socio-economic characteristics used here are incapable of sorting out why some municipalities exert greater efforts than others. Third is that basically random local forces, e.g., an especially active municipal mayor, have greater influence on taxing behavior than do the more traditional economic-based variables. Fourth, there is the possibility that a larger sample--including more provinces--is necessary to get a valid result.

Cash Balances and Surpluses

The discussion of revenue and expenditure structure and variations, and tax effort, sheds some light on the relative fiscal performance of local governments; however, the question of fiscal health might also be

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

studied by considering trends in the annual surplus/deficit and in the accumulated cash position of local governments. One possibility is a pattern of continuing deficits, exhausted reserves and general insolvency. Though this scenario is not unheard of in developing countries, it would not appear to describe the situation in the Philippines; at least it would not appear so in the four provinces we have studied. This is no doubt because of the centralized nature of the system and the tightness of expenditure controls.

The problem in the Philippines is quite the opposite. Accumulated balances and continuing surpluses seem too large to be due solely to precautionary motives, i.e., "playing it safe" in anticipation of some future emergency. The evidence on this trend, and some explanatory hypotheses, emerge from analysis of cash balances and the surplus/deficit position of municipalities during the 1977-1979 period.

Cash Balances. Municipalities can hold cash either in their own treasuries or in a trust fund administered by the provincial treasurer. In this analysis, we assume that the amounts held locally are minimal--no more than is necessary for the day-to-day operation of the government--and concentrate on studying the balances held at the provincial level.[1]

For a number of reasons the use of COA data are not adequate for this purpose. To study movements in the cash position of municipalities, we have gathered information based on site visits to a small number of munici-

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

palities in the Provinces of Iloilo, Bulacan and Albay.[1] The results of these case studies are summarized in the top panel of Table II-16.

The top rows in each panel show the General Fund balance, in total and as a percent of General Fund income. The next two rows give the same information for the combined General and Infrastructure Fund positions. In each case the balances are those held in the provincial treasury.

For municipalities in Iloilo, cash balances are quite large and have been increasing. Even the smallest (1977) balance, relative to revenues, is in excess of 22 percent (Tigbauan, General Fund) or equivalent to more than two and one-half months of revenues. The weighted average of these six municipalities (weighted by the amounts of revenue) in 1977 is approximately 57 percent for the General Fund and 61 percent for the two funds combined--an amount equivalent to over one-half of the total year's income. By any stretch of the imagination these balances are inordinately large.

The Bulacan municipalities also have been holding large cash balances, a weighted average for the General Fund of 23.22 percent in 1977.[2] However, there is considerable variation across the municipalities within this province. Malolos, Obando and Santa Maria each had relatively large cash balances in both years while these stocks in Balagtas and Baliwag were quite low in 1977 but grew substantially in 1978. The cash position for the Albay municipalities is much less strong, though it did grow during

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[1] The "sampling" scheme was, admittedly, non-random; however, no attempt was made to choose either the "best" or "worst" cases.

[2] Unfortunately, we were unable to obtain the necessary data for 1979 in Bulacan, so the most recent growth or decline in these stocks cannot be ascertained.

TABLE II-16

CASH BALANCE AND SURPLUS POSITION: SELECTED MUNICIPALITIES AND CITIES
(in pesos)

Year	Cash Balances	Iloilo[a]					
		Dingle	Dumangas	Guimbal	Passi	Pavia	Tigbauan
1977	General Fund	211680	366957	166760	689132	234910	77131
	Percent of Revenue	45.5	65.0	93.5	61.4	46.8	22.9
	General plus Infrastructure Fund	291677	449631	212749	844886	262582	149192
	Percent of Total Revenue	47.5	69.0	96.3	65.4	48.1	32.8
1978	General Fund	121584	456686	159407	1606760	234179	88756
	Percent of Revenue	26.8	72.0	85.7	133.4	41.8	21.8
	General plus Infrastructure Fund	225368	620406	241521	1785224	312949	160058
	Percent of Total Revenue	41.9	92.0	89.9	126.9	55.9	30.8
1979	General Fund	48735	437595	151580	1512060	296513	75267
	Percent of Revenue	9.6	66.0	85.3	146.0	42.2	17.0
	General plus Infrastructure Fund	164202	673862	306855	1858355	341538	192533
	Percent of Total Revenue	26.1	80.0	113.9	141.1	44.6	30.3
	Surplus						
1977	General Fund: Unappropriated	110066	169782	31869	37294	115079	36771
	Percent of Revenue	23.7	30.0	90.3	33.2	30.9	10.9
	General plus Infrastructure Fund	121710	231589	78271	427919	204481	143370
	Percent of Total Revenue	19.5	35.0	123.1	33.1	33.9	27.6
1978	General Fund: Unappropriated	40255	261912	42169	112760	219374	55223
	Percent of Revenue	8.9	41.0	18.0	9.4	39.2	13.5
	General plus Infrastructure Fund	61082	279191	88571	273649	248399	134768
	Percent of Total Revenue	11.4	41.0	31.2	19.4	41.4	
1979	General Fund: Unappropriated	72258	226839	47938	531982	65575	78337
	Percent of Revenue	14.3	34.0	18.6	51.4	9.3	17.7
	General plus Infrastructure Fund	171438	230842	43720	672621	89927	232520
	Percent of Total Revenue	27.2	28.0	37.6	51.1	11.7	36.6

TABLE II-16 (Cont.)

Year	Cash Balances	Albay			
		Camalig	Libon	Malinao	Tabaco
1977	General Fund	1729	1777	15345	505315
	Percent of Revenue	0.4	0.5	7.8	37.3
	General plus Infrastructure Fund	1729	41093	21514	511558
	Percent of Total Revenue	0.3	9.7	8.9	36.0
1978	General Fund	1162	53692	33482	685787
	Percent of Revenue	0.2	14.3	14.4	46.5
	General plus Infrastructure Fund	1162	154571	38651	744262
	Percent of Total Revenue	0.0	36.8	13.8	48.1
1979	General Fund	38864	18539	5891	848019
	Percent of Revenue	6.4	4.4	2.4	51.5
	General plus Infrastructure Fund	113983	142009	28994	946347
	Percent of Total Revenue	14.5	22.1	7.4	47.9
	Surplus				
1977	General Fund: Unappropriated	14054	865	10643	875
	Percent of Revenue	0.2	0.2	5.4	0.1
	General plus Infrastructure Fund	16161	36279	39217	7641
	Percent of Total Revenue	3.2	8.6	16.2	0.5
1978	General Fund: Unappropriated	41502	13863	21471	18082
	Percent of Revenue	7.5	3.7	9.3	1.2
	General plus Infrastructure Fund	54963	75164	57993	36912
	Percent of Total Revenue	9.0	17.9	20.6	2.4
1979	General Fund: Unappropriated	NA	NA	15403	NA
	Percent of Revenue			6.6	
	General plus Infrastructure Fund			28642	
	Percent of Total Revenue			7.3	

TABLE II-16 (Cont.)

Year	Cash Balances	Bulacan				
		Balagtas	Baliwag	Malolos	Obando	Sta. Maria
1977	General Fund	718	76394	1427056	273852	234353
	Percent of Revenue	0.08	3.15	38.43	34.45	28.12
	General plus Infrastructure Fund	6121	102016	1534163	423631	237226
	Percent of Total Revenue	0.67	3.94	40.32	50.81	26.62
1978	General Fund	71611	565854	1509528	276558	270422
	Percent of Revenue	7.14	21.00	35.91	45.89	28.66
	General Plus Infrastructure Fund	77729	590161	1619970	450862	285810
	Percent of Total Revenue	5.61	17.81	36.64	66.49	27.95
	Surplus					
1977	General Fund: Unappropriated	1023	25999	215841	126750	64907
	Percent of Revenue	0.12	1.07	5.81	15.94	7.79
	General plus Infrastructure Fund	14963	30897	248405	149814	68681
	Percent of Total Revenue	1.64	1.19	6.53	17.97	7.71
1978	General Fund: Unappropriated	45483	170200	747866	126750	74222
	Percent of Revenue	4.54	6.32	17.79	21.03	7.87
	General plus Infrastructure Fund	59613	170369	758850	149814	84969
	Percent of Total Revenue	4.31	5.14	17.16	22.09	8.31

TABLE II-16 (Cont.)

Year		Legaspi City			Iloilo City		
		Cash			Cash		
		On Hand	Interest Bearing	Unappropriated Surplus	On Hand	Interest Bearing	Unappropriated Surplus
1977	Total General Fund	331335	1556938	2038012	634976	7716550	1371624
	Percent of Revenue	6.8	31.8	41.6	3.8	23.9	8.3
	General plus Infrastructure	342113	1623780	2062787	744416	9069653	1427770
	Percent of Total Revenue	6.1	28.9	36.7	4.2	50.6	8.0
1978	Total General Fund	271700	2774622	2933482	5172224	1816500	2393066
	Percent of Revenue	4.9	49.8	52.6	27.3	9.6	12.6
	General plus Infrastructure	271723	2914151	2973609	5172224	1816500	2517186
	Percent of Total Revenue	4.3	46.2	47.2	25.5	9.0	12.4
1979	Total General Fund	111493	1723672	1831833	2525670	1816500	1434209
	Percent of Revenue	1.9	29.7	31.6	12.2	8.8	6.9
	General plus Infrastructure	349333	2268236	1885787	2525670	1816500	1634344
	Percent of Total Revenue*	4.0	26.2	21.8	9.6	6.9	6.2

*Infrastructure Fund "Income" in 1979 was ₱4,934,343 in Legaspi but included a loan of ₱2,079,812. The loan is excluded in the computation of these percentages.

SOURCE: Data gathered during field visits to individual municipalities.

the 1977-1979 period. Casual inspection suggests that there is a size bias. The largest municipality, Tabaco, has by far the most substantial cash holdings.[1]

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

The cash position of these local governments is so strong that it causes some questions to be raised. The obvious one is the opportunity cost associated with holding these balances. Apparently, only treasuries of provincial and city governments hold assets in the form of interest bearing time deposits. Municipalities thus incur a real resource loss when these balances become excessive.[2]

There are both efficiency and redistributional effects associated with this policy. For municipalities there is no direct incentive to accumulate excess reserves since it does involve a resource loss. Yet, the evidence

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

[2]Municipalities can earn interest on excess cash balances only with the joint approval of the provincial and municipal councils. Only in the sub-province of Guimaras did we observe this action to have occurred.

suggests that, at least in some localities, this disincentive has been overcome through the strong leadership of provincial treasurers. If such is the case, there has been no resource loss associated with the policy, at least when viewed from the perspective of the entire province; however, to the extent that the interest proceeds are not redistributed to the contributing municipalities, there is a resource redistribution. Again whether this is desirable depends upon one's perspective. Such redistribution may also affect local tax compliance. To the extent that taxpayers in a locality comply with the tax laws but do not observe corresponding increases in public service quantities and qualities, they may become less willing to comply. If the current statutory arrangements cannot be altered, a reasonable administrative policy would be to redistribute some portion of interest proceeds in proportion to the deposits held in the provincial treasury. In any case, these excess balances suggest that a cash management program needs to be initiated.

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

Two different types of "surpluses" are included in the post-closing balance--appropriated and unappropriated. The former includes those funds which, while appropriated for projects, have not yet been spent. Included here are any unspent funds from the 20 percent Development Fund. Unappropriated reserves are, however, essentially free reserves and therefore provide another view of the fiscal reserves of the municipality. These discretionary funds are found in both the General Fund and Infrastructure Fund. These are the amounts reported in the bottom panel of Table II-16 for the years 1977-79.

One must conclude from the data on the six Iloilo municipalities that there are substantial financial resources available and not being utilized. By 1979, free reserves averaged[1] 32 percent of total General plus Infrastructure Fund income. While comparable averages in 1978 in Albay (12.4) and Bulacan (11.4) are lower than in Iloilo, the levels in the larger and more urbanized places--Tabaco (Albay) and Obando (Bulacan)--are quite large.

The unappropriated surpluses are also very large in Legaspi City--exceeding 50 percent of General Fund income in 1978 and exceeding 20 percent of revenues in all years. These surpluses were not so large in Iloilo City, but nevertheless remained at a substantial level throughout the three year period.

Implications. An obvious question that arises from the finding of these strong cash and reserve positions is, why? Several answers might be suggested. First, it may simply be that these jurisdictions do not "need" these resources and they truly are surplus funds. This explanation doesn't square with stated needs for public service improvements.

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[1] Unweighted.

Second, the accumulation of balances may be due to a conservative financial management philosophy, espoused at both higher and lower levels of the government. At the Central Government level there is earmarking of funds for contingency reserves and for capital formation. Moreover, local government consumption expenditure increases are limited by law, as are wages and salaries. Local treasurers may also contribute to this conservatism in spending by consciously underbudgeting. Local treasurers seem to feel that they have some personal liability in cases of budget deficits and in any case see their performance rating as being based on the fiscal performance of their jurisdictions. One of the few generalizable statements in this world is that in the financial management community, surpluses get good marks. Provincial treasurers have little incentive to revise this conservative practice, for many of these same reasons and because the interest returns on local cash balances accrue fully to the provincial treasury.

Third, it may be that these reserves would not accumulate if more imaginative uses of local funds were pursued. That is, there may be "needs" for additional local services to be provided, but the system for ascertaining these desires does not effectively work to reflect them in actions. If residents have no effective way of voicing their demands for public services, there is likely to be a tendency to remain with the status quo in terms of services provided rather than undertaking new policy initiatives at the local level.

Fourth, and possibly the most relevant answer is that while localities have accumulated some reserves, the kinds of spending that would be necessary to meet the public service demands of the citizens are such that considerably greater amounts of resources must be made available. The balances shown above may be substantial, but not by comparison with what is required, for example, to build a market. The solution to removing this constraint may lie in making possible an increased use of credit financing--a solution we consider in Chapters IX and X.

Conclusions, Recommendations and Policy Directions

Three general conclusions may be drawn from the discussion above. The first is that local government financing is highly centralized in the Philippines, not just in terms of taxing authority and expenditure responsibility but also in terms of the day-to-day influence on fiscal decisions and administrative procedures. The second is that the fiscal importance of the local government sector has declined during the past decade, there is a wide variation in fiscal structure and tax effort among municipalities and cities, and there appear to be serious inefficiencies in local government fiscal operations. The third is that Central Government policy may have to share the blame for the failure of local governments to mobilize more resources or to contribute more to capital formation, some of the inefficiencies in local government operations, and perhaps some of the wide variation in tax effort.

If increased local government participation in governmental financing is indeed a national objective, the Central Government needs to remove certain disincentives to more efficient local government financing and to create incentives for locals to increase tax effort and development spending. The discussion in this Chapter suggests areas where such reforms would seem called for: local budgeting and financial management practices, the Central Government oversight process, the relaxation of expenditure mandates and the reduction or management of local government cash balances.

Budgeting and Financial Management Practices

Budgets must be used as an instrument to plan and control the spending of local governments. This means that local governments must be required to approach budgeting with the view that the annual budget is a planning and control document that, only under exceptional circumstances, can be altered during the fiscal year. The practice of issuing numerous supplemental budgets should be discontinued. However, the elimination of supplementary budgets and the general goal of more effective local budgeting will raise new problems which require Central Government attention. A first, important need will be for training of local budget officers. While such training can concentrate upon the more technical aspects of budget preparation, including the submission of budget requests, revenue forecasting, and the use of the budget as a fiscal planning device, the training should also be attitudinal in nature to illustrate to its makers and users the benefits attainable from a well designed budget document.

A second need will be to strengthen the budget monitoring and technical assistance capabilities in the MOF/MOB. The elimination of the regular practice of supplemental budgets will require a more careful scrutiny and approval process of local budgets by Central officials and a new set of instructions regarding local government budget preparation and execution.

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 the future is to see additional use of credit financing and an increased focus on capital spending by local governments, well-designed capital budget statements will be essential. Capital budgets, in specified form and including financing plans, should be a general requirement for at least the larger local governments and certainly for all of those applying to borrow for capital projects.

The Oversight Problem

Central Government control over government finances raises two important barriers to more efficient local government financial management. The first is a lack of coordination in Central Government supervision and direction and the second has to do with restrictive expenditure mandates imposed by the Central Government.

Coordination. To an outsider, the reliance upon numerous Central agencies and Ministries to oversee the financial affairs of local governments is somewhat perplexing. Given the centralist orientation of the governmental

structure in the Philippines, one should expect a greater use of such oversight activities than might be found in a Federal system of governments. Nevertheless, there should be the recognition that as the oversight function becomes more and more fragmented there is a greater likelihood that different objectives or criteria will be used by different agencies and the efficiency of local government operations may be compromised. We would suggest that, 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 Governments and Community Development and the Commission on Audits--be reviewed periodically to ensure that the review processes are not at odds with each other or with overall Central Government objectives. NEDA or the Office of the President would be a likely location for such responsibility.

Expenditure Mandates. Local government control over budgets is limited because of a number of Central Government expenditure mandates. There are two problems here. 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. This is one of the major disadvantages of fiscal centralization and one that the government apparently has taken into account.

The second problem relates more directly to the nature of the expenditure mandates imposed. One of the simplest, albeit at times misguided, methods to ensure that particular objectives be pursued is to require that local governments spend certain amounts on specific activities. The

more or less uniform application of such rules to over 1600 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 objectives are being attained and whether reform is necessary.

The expenditure mandates in question here can be divided into several classes--cost reimbursements, required reserves, budgetary initiatives and specific uses of funds. The contribution to the Integrated National Police, Aid to Hospitals, and Election Reserves are forms of cost reimbursements. The INP is the most important and, since the 18 percent rate was established several years ago, a review would seem appropriate. In particular, is an amount as much as 18 percent of general revenues still necessary for covering INP costs and is distribution of costs as a fixed percent of general revenues an equitable way of spreading the INP financing burden? At first glance, 18 percent seems quite high; indeed, it is more than the percentage of general revenues required for development expenditures.

A statutory, contingency Reserve Fund requires an annual contribution of 2 percent of "regular" revenues. There are two issues in need of review here. In the first place, the need is to create a reserve *fund* of a certain size and not to claim a share of annual revenues. A second issue is the reasoning behind the 2 percent amount. The more relevant question is what size fund would fit potential contingencies and how might this fund be established and maintained? A fund equivalent to a specified share of the previous year's budget might be a more reasonable requirement.

Budgetary initiatives, especially in the form of channeling funds into development projects (the statutory transfer to the Infrastructure Fund, the Barangay Fund transfer, and the 20 percent Development fund), are in keeping with the Central influence over local government finances and the development orientation of the Central Government. Yet, the question may be raised as to whether these directives are the most effective way of stimulating development spending. For example, the mandated transfer from the General Fund to the Infrastructure Fund may be unnecessary in light of the recent increase in specific tax rates on petroleum products and therefore in Infrastructure Fund revenues. This also raises the question of whether development expenditures from the Infrastructure Fund somehow have a higher claim than development expenditures in the General Fund. An in-depth review of this policy is needed to ensure that the original purpose is still being served. The required 20 percent of the BIR Allotment earmarked for development expenditures may be an inefficient, and unnecessary practice. It is not clear that this earmarking has actually stimulated development spending because recipient local governments have had difficulty preparing capital project plans and gaining access to credit. Moreover, there is the question of why *20 percent?*

The restriction on spending for wages and salaries is apparently not onerous; but it would be useful to observe whether this limitation is, in fact, a binding constraint and, in those cases where it apparently is, why. While mandating that a locality not become overly labor intensive may be desirable on grounds of promoting investment expenditures, the nationwide application of such restrictions may reduce the budgetary flexibility that is necessary for effective resource allocation.

More important, however, is the application of nationwide uniform salary standards. In an economy as large and heterogeneous as the Philippines it is difficult to imagine that standard salaries, even if set as ranges, can encompass the variety of local labor market conditions that are likely to exist. Again, however, determination of whether or not these restrictions are, in fact, binding on many jurisdictions is an empirical question that must first be answered before any definite conclusions regarding the desirability of altering the system be reached.

Tax Effort

Increased revenue generation is a central goal in the reform of local government finances. We believe that important increases in tax effort may be generated through incentives built into the Allotment system (Chapter V) and incentives to generate more local borrowing (Chapter X) and enterprise activity (Chapters, VII, VIII). Also important to stimulating tax effort, however, is the relaxation of Central Government controls recommended above.

Since about 40 percent of all local revenues are in some way restricted, local governments may be less enthusiastic about increasing tax effort than they otherwise might be. The lesson from successful barangay campaigns seems to be that if taxpayers can see some direct benefits to their payments, if they feel some control over how the funds are spent, they will be more willing to comply.

Cash Balances and Surpluses

Our field surveys suggest that some municipal governments are accumulating substantial cash balances and unappropriated surpluses. Cash balances equivalent to 30 percent of General Fund revenue were not at all unusual among the sample of jurisdictions that we studied. Nationwide, local government deposits (in PNB, LBP, PVB) were equivalent to 42.5 percent of total local government spending and 69.7 percent of local government spending from own sources in 1979. Such accumulations, obviously well beyond contingency needs, raise two kinds of issues. The first is that it may be hard to encourage taxpayers to make a greater effort, or there may be less incentive for local officials to do so, when the local government is already unable to spend what it has on hand. Second, the balances may well signal some inadequacies in cash management practices.

Among the possible reasons for such accumulations are (a) no need for the resources, (b) conservative and unimaginative management philosophy, or (c) the need to accumulate relatively large surpluses before a jurisdiction can undertake the large capital expenditures required for development projects. We doubt the first of these explanations, given the comments and concerns over deficient public services expressed to us in the course of the field interviews. To the extent that the second reason is applicable, it would suggest the need for a different set of incentives than simply

punishing the financial manager when he fails to produce a surplus. Rewards might also be provided to those managers who initiate effective new uses of the funds. Under the current arrangement the principle indicator of success would seem to be a large positive amount at the bottom of the closing balance, while innovative program initiatives are less likely to be noticed or rewarded.

Finally, if surplus accumulation is due to the need to accumulate internal financing before undertaking new capital investments, it would seem that a major need would be to develop credit policies that would allow the jurisdiction to undertake these projects immediately, rather than waiting until sufficient reserves have been accumulated. This issue is addressed more fully in Part Three below, but it should be noted here that even this policy initiative will not succeed if financial managers are held accountable only for failures and not rewarded for success. In such an environment, the most rational course for the manager to follow is one of extreme fiscal conservatism.

Regardless of the underlying causes of the accumulation of cash balances and reserves, they obviously exist. As purely liquid cash they constitute a resource that cannot be used by either the public or private sector to further economic development. It is therefore desirable that a more effective cash management program be used to ensure that these balances are a resource made available for development purposes. Thus a final recommendation is that cash management techniques be implemented at the local government level so as to maintain a minimum level of purely idle reserves and that cash reserves, to the extent they exist, be mobilized for either public or private development purposes.

APPENDIX II-A

LIST OF JURISDICTIONS INCLUDED IN THE SAMPLE

A. Cities by Region

Region	Cities
Region I	Baguio Dagupan Laoag San Carlos
Region III	Angeles Cabanatuan Olongapo Palayan San Jose
Region IV	Batangas Cavite Lipa Puerto Princesa Tagaytay Trece Martires
Region V	Iriga Legaspi Naga
Region VI	Iloilo Roxas
Region VII	Bais Canlaon Cebu Danao Dumaguete Lapu-Lapu Mandaue Tagbilaran Toledo
Region VIII	Calbayog

Region	Cities
Region IX	Dapitan Dipolog Pagadian Zamboanga
Region X	Butuan Cagayan de Oro Gingoog Oroquieta Ozamis Tangub
Region XII	Iligan Marawi

B. Municipalities, by Province

Province	Municipalities
Albay	Bacacay Camalig Daraga Guinobatan Jovellar Libon Ligao Malilipot Malinao Manito Oas Pio Duran Polangui Rapu-Rapu Santo Domingo Tabaco Tiwi
Bulacan	Angat Balagtas (Bigaa) Baliwag Bocaue Bulacan Bustos Calumpit Guiguinto Hagonoy Malolos Marilao Meycauayan

Province	Municipalities
	Norzagaray
	Obando
	Pandi
	Paombong
	Plaridel
	Pulilan
	San Ildefonso
	San Jose del Monte
	San Miguel
	San Rafael
	Santa Maria
Iloilo	Ajuy
	Alimodian
	Anilao
	Badiangan
	Balasan
	Banate
	Barotac Nuevo
	Barotac Viejo
	Batad
	Bingawan
	Cabatuan
	Calinog
	Carles
	Concepcion
	Dingle
	Duenas
	Dumangas
	Estancia
	Guimbal
	Igbaras
	Janiuay
	Lambunao
	Leganes
	Lemery
	Leon
	Maasin
	Miagao
	Mina
	New Lucena
	Oton
	Passi
	Pavia
	Pototan
	San Dionisio
	San Enrique
	San Joaquin
	San Miguel
	San Rafael
	Santa Barbara
	Sara

Province	Municipalities
	Tigbauan
	Tubungan
	Zarraga
Sorsogon	Bacon
	Barcelona
	Bulan
	Bulusan
	Castilla
	Dansol
	Gubat
	Irosin
	Juban
	Magallanes
	Matnog
	Pilar
	Prieto Diaz
	Santa Magdalena
	Sorsogon

CHAPTER III

THE REAL PROPERTY TAX

As in many countries, the real property tax (RPT) in the Philippines is a principal revenue source for local governments and, as elsewhere, it is laden with administrative and structural problems. It is costly to administer, arbitrary in its assessment and grows slowly relative to income and prices. On the other hand, it has some important virtues. It might be reasonably equitable in the burden distribution it imposes and above all it is the most important tax base which has been allocated to the local government sector. The proper assumption would seem to be that the property tax will remain a major revenue source for local governments, hence its problems must be addressed. The substantial progress made in recent years in the Philippines is convincing evidence that the problems of the property tax are surmountable.

In the Philippines, some form of a tax on the land or its products extends back to the Spanish era; the first use of a property tax similar to that imposed today was implemented in 1901. At that time, Acts 82 and 83 were passed by the Philippine Commission which provided for the organization of municipalities and provinces, and allowed municipalities to levy a real property tax of not less than 1/2 of 1 percent, with provincial treasurers given the responsibility of supervising assessment and tax collection.[1]

The current system of real property taxation in the Philippines is documented in two major Presidential Decrees--PD 76 issued on December 6, 1972 and PD 464 issued May 20, 1974. The first of these focused on

[1]Department of Finance, Manual on Real Property Tax Administration in the Philippines (Manila, 1975), p. v.

particular changes in the valuation of property with special emphasis on insuring that all property liable for the RPT was declared by property owners. PD 464 constitutes the overall basis for the RPT as it is currently imposed in the ROP.[1]

Under PD 76, owners of real property were required to file sworn statements of the current value of their property. Accurate reporting is to be aided by PD 1533 which specifies that the declared values would be used by the government in determining fair value of the property, if the parcel is involved in an eminent domain proceeding. In addition, PD 76 stressed uniformity of assessment. Among its features were requirements that provincial and city assessors prepare schedules of fair market values for different classes of property within their jurisdictions using rules issued by the Ministry of Finance and that they revise assessments every five years starting in 1979. This was amended under PD 1621 to every three years.

But it is PD 464 (and its more recent amendments and Letters of Instruction) that constitutes the Real Property Tax Code. It defines the base of the property tax, the methods by which assessors are to value property, the timing of reassessments, the rate structure, and it even outlines how the property tax is to be collected and administered. In studying the operation of RPT, we have relied heavily upon PD 464, supplementing it whenever possible with data and observations obtained from inter-

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[1] A good discussion of the property tax vis-à-vis other Southeast Asian countries is contained in A. Yoingco and V. Quintos, Philippine Tax System Under the New Society (Manila: GIC Enterprises Co., Inc. 1979), pp. 253-261.

views and field work.

In the remainder of this chapter, we consider the three major problem areas of property taxation: determination of the tax base, tax rate structure and collection efficiency. These three sections contain a heavy dose of descriptive material, particularly on how the property tax is assessed and collected. The number of steps we had to take in getting this description convinced us that few analysts in the Philippines have an understanding of all aspects of property taxation, and that this detail is a necessary first step toward formulating a proper reform program. Our understanding is far from complete, but it might be a reasonable beginning to a thorough description of how the Philippine property tax works. Another reason for documenting our understanding of the system is that it underlies our assessment of the more important problem areas.

Following this description, we turn to an analysis of the revenue performance of the property tax: the factors underlying its growth and the variation in its performance within the nation. A reform program for real property taxation, in its broadest outlines, is offered in a concluding section.

Determination of the Tax Base

A number of steps are required in the determination of the property tax base: legal definition of the base; discovery and verification of property ownership; determination of assessed values; and revisions in property values. Problems in each of these areas in the Philippines have

slowed the growth in the taxable property base, constrained it from reaching its potential yield, and may have had other unfavorable effects.

Definition of the Real Property Tax Base

Taxable property under the Real Property Tax Code includes all land, buildings, machinery and other improvements (including such features as productive trees on forested land) except those lands, buildings, machinery and improvements that are expressly exempt from the tax. Agricultural land is included in the base.[1] Among exempt properties are those owned by the Central Government or any of its political subdivisions, non-profit cemeteries, charitable and religious institutions, real property with a value less than 1,000 pesos belonging to a single owner in any one city or municipality, certain statutorily exempt properties including land used for conversion to dairy farms, machinery of pioneer and preferred industries, certain pasture lands, and trees and plants that are not the principal use of the land.[2]

The Problem of Exemptions. There are basically four categories of exemptions: government property, "preferred investments", charitable and religious property, and property of low income persons. The latter two are common practice and probably are not a high priority for reform. Both the government and the preferred industry exemptions, however, provide some unnecessary giveaways and should be rethought.

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[1] Since there are no unincorporated areas within provinces, the tax rolls of the municipalities and cities include agricultural lands, even though such properties may benefit relatively little from municipal services.

[2] PD 464, Section 40 as amended by PD 1621, PD 1383, and PD 939. From The Real Property Tax Code Annotated (PACTAA).

Government property is often exempt from local taxation under the principle that government institutions should not tax one another. Nevertheless, local services are rendered to such installations therefore some payment could be justified. A payment-in-lieu of property taxes would cover some of the servicing costs incurred and not be out of line with the practice in other developing countries.[1]

The same general technique could be used in the case of local tax exemptions granted to "preferred industries" by the National Government. While it is likely true that the economy of localities benefits from additional economic activity resulting from such tax holidays, the nature of the local tax system is such that it is unlikely that the *local government* will reap revenue benefits from this activity. Increased personal and business incomes may be captured by the Central Government tax system, but likely show up in increased local revenues only after a long lag, if at all. Moreover, the exemptions may substantially erode the local tax base (see p. III-31 for estimates), yet the locality must bear the increased public expenditures attributable to such projects. There is a long list of industries with exempt status, at least for initial development periods. It includes dairy farms, pasture and grazing lands acquired from the public domain, machinery of a "new and preferred industry" as certified by the Board of Investments, new investments in tourism-oriented industries (PD 535), and subsidized housing provided to employees and workers of tax exempt corporations and partnerships (PD 745). Again, payments-

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[1] For a description of systems in other countries, see Roy Bahl, "The Practice of Urban Property Taxation in Less Developed Countries," in The Taxation of Urban Property in Less Developed Countries, ed. by Roy Bahl (Madison: University of Wisconsin Press, 1979).

in-lieu of taxes from the Central Government which promulgated these exemptions would seem to be a reasonable solution to this tax base erosion.

Charitable organization exemptions may be justified on grounds that they are providing certain services that benefit the community--services that would be decreased were taxes levied on their property. Still, care must be taken to insure that the organizations are truly non-profit and not competing with similar privately owned facilities. One problem we encountered with respect to delinquency on the local property tax was a case of the Catholic Church refusing to pay taxes on one of its profit-making ventures. The law should be made very clear about what constitutes taxable and non-taxable activities. Otherwise, local treasurers are placed in an impossible political position.

The low-income exemption may be justifiable both on grounds of equity and administrative efficiency since the record processing and collection costs associated with extremely low valued parcels may exceed the actual tax yields. On the other hand, one does not want to go too far with such exemptions because of the need to maximize the coverage of the tax roll and hence the involvement of the population in the governmental process.

The Problem of Fractional Assessments. The legal base of the real property tax is the capital value of land and improvements with provision for assessment at fractions of current market value. The classes of property to which different assessment ratios are applied are set forth in PD 76. Under this scheme all land is classified and assessed according to the

following schedule (as amended in PD 1383):

Land Use	Assessed Value as a Percent of Current Market Value
Residential	30%
Agricultural	40
Timber and Forest	40
Commercial and Industrial	50
Mineral	50

Furthermore, all land is to be valued according to its *actual* use (rather than according to its best use). This classification may initially be based on the use class indicated on the Declaration of Real Property form submitted by the taxpayer. Ocular inspections made by assessors are used as well, and when there is a conflict with the use indicated by the owner, the land use class is usually changed to reflect that determined by the assessor.

Reliance upon actual rather than best use and the use of fractional assessments have potential economic effects that should be recognized in an evaluation of the property tax system. As is the case for nearly all taxes, property taxes can alter choices which individuals would, in the absence of the tax, have made. These distortions of economic choices are not necessarily a disadvantage, e.g., some forms of property taxation may be used to discourage land speculation.

The distortions induced by the Philippine system probably do not serve important social goals. Property tax assessments based upon actual rather than best use have the effect of discouraging conversion of the use of property from its current use to an alternative that, at least as judged

by the market, is more productive. For example, a parcel of rice land near the edge of an urbanized area may more productively be used as a commercial plot. In this case the potential market price will reflect that fact. Under actual use assessment, however, the land would be assessed the same as a parcel of rice land far from the urban area. If the owner would be assessed on the basis of the price the parcel would fetch in the market, i.e., a "highest and best" use valuation, there would be an incentive to convert the land to its more productive use. On the one hand, this policy results in more rice land under cultivation, but on the other, it results in higher prices of urban land and perhaps eventually a windfall profit to the landowner.

Fractional assessments also have built-in incentives and disincentives. While the higher fractional assessment of agricultural lands provides an incentive for conversion to residential usage, the higher fractional assessment for commercial or industrial properties discourages conversion to these uses.[1] Most likely the fractions noted above were originally applied to promote equity, possibly under the assumption that ability to pay was greatest for commercial and industrial landowners and least for residential property owners. Nevertheless, the potential inefficiencies of such a system must be recognized.

Buildings, machinery[2] and other improvements are also assessed at fractional rates. For buildings and other improvements, the fractional

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[1] The strength of these disincentives depends on the rate at which the tax is imposed. The rates in the Philippines, by comparative standards, are not high.

[2] For machinery, the fractional system is based only upon usage, with percentages set at:

Agricultural	60%
Residential	70%
Commercial and Industrial	80%

values depend both upon use and market value. The fractional assessments (as amended in PD 1383) are as follows:

Market Value of Buildings and Improvements	Use		
	Residential	Commercial Industrial	Agricultural
₱ 30,000 or less	15%	50%	40%
30,000 - 50,000	20	55	45
50,000 - 75,000	25	60	50
75,000 - 125,000	35	65	55
125,000 - 175,000	45	70	60
175,000 - 250,000	55	75	65
250,000 - 350,000	65	80	70
350,000 - 500,000	75	80	75
more than 500,000	80	80	80

Once again, there is an apparent attempt to adjust assessments according to the ability of the taxpayer to bear the burden and once again a potential inefficiency results. This time the tax introduces a bias against investing in improvements. The cause of this bias is that the fractional assessment ratio associated with land is less than the ratio applied to nearly all commercial, industrial and agricultural improvements and less than the ratio applied to a large portion of residential improvements.

Under the current property tax system, total tax liability (T) on a parcel of land and its improvements will be

$$T = r_L \alpha_L V_L + r_I \alpha_I V_I \qquad (1)$$

where

α = fractional assessment ratio
V = market value
r = tax rate
L, I = land, improvements.

In any investment decision involving land and improvements, there will be a bias in favor of projects that rely more heavily upon land as long as the value of the improvement is such that the assessment ratio on improvements exceeds that for land. For example, consider a commercial venture where the land is valued at ₱1 million. The investor is trying to determine the type of improvement to place on the land. If he chooses an improvement with a market value of anything more than ₱250,000 (almost a certainty) we can write his tax liability as

$$T = .5\ r_L V_L + .8\ r_I V_I \tag{2}$$

If $r_L = r_I = 0.01$, then

$$T = .005\ V_L + .008\ V_I \tag{3}$$

and the improvement will be taxed more heavily than the land. Indeed, in the case of commercial and industrial properties, it is only for the very smallest of improvements, i.e., those valued less than ₱30,000, that the effective tax rate on improvements is not greater than that on land.

One could think of a number of inefficiencies that result from such a system. For example, an investor wants to develop prime downtown land by replacing an old structure with a new office building. If he does so, he will face a penalty of a higher tax rate on the newer, more expensive structure. Such a system does not work in the interest of promoting development and has long been recognized as a violation of good property tax practice.

A related problem with fractional assessments on improvements is the possibility that, in order to be placed in a lower assessment bracket, a property owner will attempt to pressure assessors to lower valuations. This may be done directly with pressures placed upon the assessor (or his staff) or, indirectly, with pressures placed on politicians for lowered assessments. The point here is that there is a double incentive to push for a lowered assessment: a lower overall tax base and a lower effective tax rate. Elimination of fractional assessments would leave only the first incentive.

We recommend elimination of fractional assessments for improvements (see the final section of this chapter).

Discovery and Determination of Property Ownership

The base of the RPT is more easily defined than it is measured. A first and often very difficult step in this measurement process is to discover and document the characteristics of a property and its ownership. As in many developing countries this is a major problem of property taxation in the Philippines, and it has recently been exacerbated by the land reform program. The base determination problem has been addressed through tax mapping, required owner declarations of value, and procedures for handling duplicate records.

Tax Mapping. It has been argued that

> Tax maps are the single most important tool of the assessment process. It is impossible to establish an adequate property tax record and accounting system without tax maps, for they are the basic foundation of the system. They establish a per-

> manent link between the real property in the field and the tax records in the office. They are indispensable to the discovery of property and the identification of property ownership. They simplify the task of property description and tie together all property records, including appraisal cards, tax rolls, and collection registers.
>
> They also serve the additional important purpose of providing the public with vital real property information. Finally tax maps make possible the establishment of a system of records that is easily adapted to automatic data processing techniques.[1]

Tax mapping procedures establish a complete inventory of all real property and assign to each parcel a property identification number (PIN) such that (theoretically) every parcel in the nation has a unique PIN associated with it. This aids property tax administration by providing a simple means to keep track of all parcels and by linking assessment and billing records. Only when such record-keeping is made systematic can one expect the property tax system to work efficiently.

As might be expected, however, tax mapping is a tedious and costly process. Often the resources necessary are beyond those available to a local jurisdiction, even though it could prove to be a profitable investment in the long-run.

Recent estimates of the costs of tax mapping range from ₱10 - ₱20 per parcel--a substantial amount for many jurisdictions.[2] Furthermore, the mapping process requires, at the very least, several months to carry out. For example, plans in Albay scheduled 267 working days to complete

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[1] Department (Ministry) of Finance, Republic of the Philippines, Assessment Regulations 1-78 (March 16, 1978), Section 3.01.

[2] See Daniel Holland, Michael Wasylenko, and Roy Bahl, "An Evaluation of the Real Property Tax Administration Project," Local Revenue Administration Project, The Maxwell School (Syracuse, New York: Syracuse University, 1981), p. 34.

the mapping in Tabaco--a municipality with approximately 14,500 parcels.[1] Thus, by the time the results of mapping are reflected in tax revenues, at least a year or two will have passed. Thus mapping can be thought of as an investment--an expenditure undertaken at one point in time with payoffs that accrue over a considerably longer period. Local politicians, who understandably are interested in investments with more visible short-term payoffs, are not always enthusiastic about increasing taxes to fund tax mapping projects. A recent study has identified municipal governments as contributing 23 percent of the cost of tax mapping and provincial governments 40 percent.[2] In light of the discussion above, the locally financed share seems quite high. One might speculate that relatively progressive local governments with more secure political leadership would choose to be involved in tax mapping early and that such voluntary participation will diminish as the coverage of the mapping project increases. This suggests the need for loan and/or grant financing and possibly for external (foreign) assistance.

In fact, tax mapping has been financed through such channels. One source of loan funds has been the ₱50 million Revolving Fund begun in 1976 (under PD 1002) and administered by the Ministry of Finance. Under this program, money may be borrowed by localities at no interest for a period of five years.[3] The funds are released as needed in three installments--50 percent, 30 percent, 20 percent, with later installments accruing

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[1] Multi-Year Plan for the Systematic Installation of the RPTA System (undated).

[2] Eduardo Aguinaldo, "Tax Mapping: Its Significance in Real Property Tax Administration," unpublished Masters Degree Thesis, submitted to the National Defense College of the Philippines, 1980.

[3] See Department (Ministry) of Finance, Republic of the Philippines, Assessment Regulation No. 4-77 (Manila, May 23, 1977).

only after it has been certified that previous installments have been expended.[1] As of December 31, 1980 over ₱24 million in loans had been approved under this program with over ₱18 million released.[2] Aguinaldo's study reports that 35 percent of the financing of tax mapping in his sample was from the MOF Revolving Fund.[3]

A second source of funds for tax mapping is outright grants. One project that has provided tax mapping resources is the Real Property Tax Administration Project funded by USAID and administered through the Ministry of Local Government and Community Development (MLGCD). While other activities concerning property tax administration were a part of this project, tax mapping was its primary component.[4] This project, which provided seed money for mapping operations, had accounted for only about 3 percent of the funds used in those communities that had completed mapping by the end of March 1980.[5]

A major problem has been the almost complete lack of coordination between these two programs. This has led to problems of coordination and duplication, delays in implementation and just plain annoyances.[6] The problems and some

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[1]Specified in Assessment Regulations 4-77 issued by Ministry of Finance (Manila: May 23, 1977).

[2]Data obtained from the MOF.

[3]Aguinaldo, "Tax Mapping: Its Significance in Real Property Tax Administration."

[4]See Holland, Wasylenko and Bahl, "Evaluation of Real Property Tax Administration Project."

[5]Ibid.

[6]These problems are not restricted to tax mapping but involve all facets of RPTA. Illustrative of the minor annoyances is the existence of two prescribed sizes for tax maps, two approved systems of Property Index Numbers, and two sizes of the Post Mapping Control Roll. A more major impediment to progress has been a long delay in the preparation of the tax collection manual.

of their origins are reviewed in the Holland-Wasylenko-Bahl Report and will not be repeated here in any detail. The major issue is that the USAID financed program is administered through MLGCD, but MOF has responsibility for the assessment and collection functions and for preparing manuals and administrative orders for the carrying out of these functions. Moreover, the local treasurers and assessors report directly to, and are evaluated by, MOF. As an ongoing proposition, all property tax administration must be at least coordinated through MOF if it is to have any chance for success.

Both the USAID program and the MOF program have been underutilized because of a lack of information about their availability or terms. In the course of our interviews, we encountered this problem time and again.

As of August 1980, tax mapping had been completed in 4,820 barangays located in 160 cities and municipalities and had been begun in another 3,710 barangays in 138 localities.[1] Though these achievements are notable, one must keep in mind that there are 1600 local governments in the Philippines. In other words, tax mapping has not even begun in 80 percent of the local government areas in the Philippines.

Are the returns from mapping worth the investment? The evidence suggests that they are. While not a full-scale quantitative evaluation of the effects of tax mapping on property tax revenues, the Holland-Wasylenko-Bahl evaluation of the RPTA project suggests some of the principal outcomes that might be expected from mapping.[2] Based on a non-random sample of 19 mapped municipalities in three provinces it was found that the number of taxable

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[1] Data supplied by MOF.

[2] Holland, Wasylenko, and Bahl, "Evaluation of Real Property Tax Administration Project," p. 51.

properties increased by more than 10 percent in 11 and was essentially unchanged in 2. There was a decrease in parcels in 6 of the 19--reflecting the existence of duplicate records. Assessed valuations were positively affected by mapping in 11 of 14 municipalities (where data could be obtained) and collection efficiency was found to improve in 11 of the 19.

These findings suggest that mapping can have an important positive effect on property tax revenues, but that mapping alone will not do the job. It must be accompanied by adequate records management, assessment, and collection procedures. At the same time, obtaining a tax roll that accurately reflects the tax base of a jurisdiction is the foundation for increased revenue yield and for an efficient administration of the tax. It is the essential first step.

Tax Declarations. In a different approach to determining property ownership, PD 76 required a self-declaration. PD 464 (and its amendments, PD 1383 and PD 1621) later required that such declarations be filed every three years, or within sixty days after any improvement to a property. To be included on these declarations are sworn statements regarding the true value of the property, and a description of the property "...sufficient in detail to enable the assessor or his deputy to identify the same for assessment purposes."[1] While this approach--if performed accurately and promptly by all property owners--would vastly improve the assessment system, it has not proven to be useful. Tax mapping remains the most reliable basis for enumerating properties and identifying ownership.

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[1] PD 464, Section 6.

Duplicate and Missing Records. One of the most frequently cited problems associated with the assessment (and therefore the collection) process for property tax purposes is that of duplicate and missing records. While accurate tax mapping should alleviate many of these difficulties, the problem could continue to arise in the future.

Apparently there are several different reasons for the existence of duplicate records on the property tax roll.[1] One of these is related to the original filing of tax declarations under PD 76. Apparently, there were cases where different people filed tax declaration statements for the same parcel. These duplications were not detected at the time of filing and many still have not been discovered. This has the effect of inflating collectibles over that which realistically can be collected and therefore resulting in an understatement of collection efficiency. To provide some idea of the magnitude of this problem, it was stated that in one Albay municipality with 14,000 tax declarations, 2,000 duplicate tax declarations had been detected *after* tax mapping had been completed.[2]

A second situation leading to duplicate tax declarations is when a property buyer correctly files a tax declaration for a newly purchased property, but the tax declaration form in the name of the seller is not removed from the file. Under Section 11 of PD 464 it is the duty of a property owner to inform the assessor of property transfer within 60 days of the transaction, thus the responsibility lies with the previous owner. Obviously if this notification is not carried out, duplicate records can occur. There are no penalties for failure of the property owner to inform the assessor

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[1] We use the term "duplicate records" to refer to the case where the same parcel is listed as belonging to more than one owner.

[2] Based on conversations with the Provincial Assessor of Albay.

and in most cases there are no cross-checks to pick up this problem. Coordination between assessors and registrars of deeds could eliminate this problem.

Missing records are also a problem. New property buyers are to (a) pay the property transfer tax, (b) register the property with the registrar of deeds, (c) pay a fee for registration and (d) fill out a property declaration form. Sometimes this final step in the process is omitted. Again, the problem lies with a lack of effective coordination between the registrar of deeds and assessor.

Another reason cited for record-keeping difficulties is related to the ownership of estates. As in many countries, settlement of estates is often a time-consuming process. During the interim period ownership of property is uncertain and there is an unwillingness on the part of potential beneficiaries to pay property taxes. PD 464 requires that the administrator of a property (administrator of an estate) must file a tax declaration, but this requirement is not always met.

Problems with Land Reform. Another source of record-keeping and records management problems, cited in many of the rural areas we visited, relates to the land reform program.[1] On the surface, the problem would seem a relatively simple one to sort out. Land was transfered (sold) from large landholders to tenants, through the Ministry of Agrarian Reform (MAR). Local assessors do not have good records of the particulars of the reformed properties, the previous owners are not willing to pay the tax on behalf

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[1] Appendix A to this chapter elaborates on the methods used in land reform and how it affects property tax administration, and provides additional detail on why record-keeping is a problem in land reform areas.

of their former tenants, and the new owners seem unconvinced of their tax-paying responsibilities. The problem is further complicated because some owners were delinquent in payment of property taxes at the time of reform.

The Ministry of Agrarian Reform (MAR) admits that complete mapping of the affected areas has been a continuing difficulty.[1] This creates obvious problems with respect to the identification of parcels and ownership, and therefore with assessing and collecting the property tax. Apparently MAR considers mapping to be a primary activity for the early 1980s, but the cost of this activity will be very high. This raises the possibility of even further delay. The continued absence of these maps will remain a major impediment to resolution of this problem.

Previous landowners and tenants have also contributed to the problem. Large landowners have known since 1972 that it was only a matter of time before some of their lands would be confiscated under land reform. Under the statutes, farmers could receive payments for their land from the Land Bank upon showing, among other things, proof of payment of all real property taxes on their holdings through October 1972. Property tax delinquency after 1972 should have been expected--from that time forward any payment of the property tax on affected lands became little more than a voluntary contribution.

If one assumes that tenants were aware of their legal requirements (to file a tax declaration and pay property taxes), then theoretically this is the primary group of taxpayers acting directly contrary to the law. Yet

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[1]The Bureau of Lands together with MAR share the responsibility for this mapping. Mapping for land reform purposes involves surveying the tenanted land and determining the boundaries, parcel size and land use.

several aspects of the land reform system itself make it unlikely to expect any significant amount of compliance from tenants. First, there has been a great deal of uncertainty associated with the land reform process. If a tenant is uncertain that the reformed lands will remain in his possession, it is unlikely that he will be willing to pay the taxes. Second, the provision that tenants cannot transfer the land to anyone other than heirs or the government makes ownership of these properties unlike that of other taxed assets and suggests a different pattern of tax compliance behavior. Third, many tenants were not aware that their rental payments since 1972 would, in fact, be counted as payment towards the purchase of the land. Hence, it is unlikely that they were aware of any property tax payment responsibilities that accompanied such "ownership". Fourth, there may have been a lack of understanding concerning legal responsibilities associated with property ownership, even in cases where the tenant realized he was the owner of the property. Finally, there was an ability to pay problem. Many of these former tenants found themselves quite suddenly the owners of property (on which they still had to make payments), but the prices and/or yields of the crops associated with the lands were quite low--perhaps too low to permit property tax payments.

Finally, the local financial officers must bear some of the blame, at least for a lack of action. First, there did not seem to be a good understanding, on the part of local assessors and treasurers, of the administrative processes involved in land reform. Such an understanding would be essential to dealing with the problems which arise from land reform. Second, we found little evidence of explicit campaigns being

carried out in land reform areas to encourage the new landowners to declare their property for tax purposes. Since campaigns appear to be effective in tax delinquency cases (see the discussion below), this would seem to be an effective method for beginning to treat this record-keeping problem. While collection of property taxes in land reform areas will continue to be difficult, there is no doubt but that effective property tax administration cannot occur until the proper owners are identified.

The Assessment Process

The property valuation system is highly systematized. Rather than relying upon the purely subjective judgments of an assessment officer who unilaterally assigns a value to each parcel, a complete schedule of market values per unit (e.g., per hectare of land or per square meter of a building constructed of a particular building material) is compiled before valuation or revaluation occurs. These schedules, constructed for each province and chartered city, are then approved by the Ministry of Finance.

Valuation Techniques. As in most property tax assessment schemes, three different methods are used to estimate market values--comparative sales, income capitalization, and reproduction or replacement cost. The comparable sales approach tends to be the principal technique utilized by assessors in determining the schedule of current market values. Assessors obtain much of this information by asking knowledgeable persons, e.g., bankers and realtors, their opinion concerning current prices in certain areas, and many also their own knowledge of the local realty market.[1]

[1] This is not at all an unusual practice in developing countries. For a survey, see Bahl, "The Practice of Urban Property Taxation in Less Developed Countries."

It is interesting to note, however, that the self-declarations of market value discussed above are seldom relied upon because it is assumed that self-assessment naturally yields downward biased market value estimates. Likewise, property values recorded at the time of sale, by the registrar of deeds, are felt to understate the actual sales price. This information is usually discounted by local assessors.

In cases where the income capitalization approach is used, a "normal" rate of return must be determined. In a memo dated July 25, 1977 to all provincial, city and municipal assessors from the Ministry of Finance, it is noted that the capitalization rate should be "...a selected rate prevailing in the locality."[1] No further specification is provided.

The capitalization approach to valuation is apparently not used to any great extent for commercial property, owing to the difficulties inherent in obtaining adequate financial records from property owners.[2] The approach is, however, utilized in the case of improvements to agricultural lands, e.g., coconut trees. Since agricultural prices are readily available, this price times productivity of the trees per hectare (the product of nuts per tree and trees per hectare) yields an annual gross income estimate which can easily be capitalized. The capitalization rate used in Iloilo Province in the latest schedule of values was 14 percent[3]--not an unreasonable rate given rates of inflation in the range of 7-10 percent (Table III-1).

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[1] The Real Property Tax Code Annotated, compiled by Conrado G. Sabater and Roberto B. Millena (Provincial City and Municipal Treasurers and Assessors, Association of the Philippines, Inc., Manila, 1979), p. 140.

[2] One exception is in the case of negotiated sales of properties to the government, where the assessor is called upon to determine a fair market value.

[3] Data from interviews with Iloilo Provincial Assessor.

TABLE III-1

CONSUMER PRICE INDEX FOR THE PHILIPPINES: 1960-1979

Year	CPI	Percent Increase
1960	76.5	
1961	79.8	4.3
1962	82.4	3.2
1963	89.1	8.1
1964	96.9	8.8
1965	100.0	3.2
1966	104.8	4.8
1967	110.6	5.5
1968	113.0	2.2
1969	114.5	1.3
1970	131.5	14.8
1971	160.2	21.8
1972	173.4	8.2
1973	116.5	16.5
1974	156.3	34.2
1975	166.9	6.8
1976	182.3	9.2
1977	200.4	9.9
1978	215.0	7.3
1979	250.5	16.5

SOURCE: 1960-1972 (Base year 1965): Central Bank of the Philippines, Statistical Bulletin, Vol. XXVII, 1975; 1973-1979 (Base year 1972): National Census and Statistics Office.

The replacement cost method of assessment involves estimating the current cost of replacing a building and requires two steps. The first is to estimate the current cost of constructing the building or purchasing the equipment. To obtain these estimates, assessors usually gather cost information from lumberyards, hardware stores, building contractors, engineers, etc. The second step estimates the depreciation to be subtracted from the result of the first step. This requires information regarding the age of the structure and an assumed depreciation rate. The Ministry of Finance has suggested that assessors use a table of depreciation schedules contained in the 1963 Philippine Assessors Appraisal Manual.[1] These rates range from 2 to 8 percent and, based upon our interviews, are apparently used by many assessors.

Even with these detailed instructions, considerable subjectivity can enter into the determination of assessed valuation. A good example is the case of the classification of agricultural lands. A Ministry of Finance memo of July 25, 1977 establishes productivity classifications for nine different categories of agricultural crops, e.g., rice land (lowland) with irrigation facilities, rice land (lowland) without irrigation facilities, coconut land, etc. Within each crop category, several different productivity classes are established. For example, coconut land is classified into First Class (more than 70 nuts annually per tree), Second Class (50 to 70 nuts per tree) and Third Class (less than 50 per tree).[2] The assessor's discretion can then be used to determine the

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[1] The Real Property Tax Code Annotated, p. 149.

[2] Ibid., pp. 145-146.

class of land to which a particular parcel belongs. It was noted in one interview that parcels are seldom placed in the First Class group. Thus, while in practice, the Philippines has gone far to remove capricious valuation of property, there is still a degree of judgment required under this system.

Equity Implications of the Assessment Process. While not addressed in any great detail in our on-site analysis, the equity effects of the property tax can be closely related to the assessment process. At least two different forms of equity can be considered--interpersonal and interjurisdictional.

Within a jurisdiction, interpersonal inequality will occur whenever two parcels of like value are assessed differently. While the use of value schedules applied in a similar manner to all properties within a jurisdiction should minimize such inequities, the previous example of assessor discretion when judging the productivity of agricultural property suggests that inequalities could nevertheless creep into the system. Likewise, if there are systematic biases built into the schedule of values, e.g., if rice land values are understated relative to their actual values while coconut lands are valued accurately, inequities across property types will result. We had neither the time nor resources to study this aspect of property tax administration even though its implications are extremely important in an overall evaluation.

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[1] The Real Property Tax Code Annotated, pp. 145-146.

Interjurisdictional inequalities will almost certainly arise in a property tax system which is administered at the local government level. This not only can be deemed an unfair aspect of the tax system, but also can affect the location choices of businesses and residents. Such tax differentials, however, may not be so important in the Philippines where the effective rate of property taxation is not high and where centralized assessments tend to minimize these variations.

Revisions in Assessed Valuations. As noted above, PD 76 required revaluation of all property on the tax roll every five years. In PD 464 this was altered to every three years with the most recent reassessments to be completed by January 1, 1979. This deadline was extended for one year (except in Metropolitan Manila) by PD 1384. While uniform revaluation cycles are in keeping with the centralized nature of the RPT administration process and certainly produce greater interjurisdictional equality than randomly scheduled reassessments, there are several problems with lump-sum revisions in assessed valuations. The most significant relates to the large jumps in tax liabilities which occur when the new roll takes effect.

It was estimated that values increased on average by about 80 percent between the 1973 and 1977 revaluations[1] and many properties experienced from 80-120 percent increases in valuation in 1980. In the absence of a proportional rate reduction, taxpayers will experience single period increases in tax liabilities that cannot help but create more

[1] Data supplied by MOF.

problems in an already troublesome collection environment.[1]

Some form of phasing-in of these revaluations would cushion the impact on the taxpayer. Furthermore, under the current triennial reassessment cycle, the interim period between reassessments will yield no increases in the tax base. Thus, if a locality is already taxing at maximum rates, it can obtain no natural annual growth in property tax liabilities. Yet the resource needs of jurisdictions increase due to factors such as population growth and inflation.

A second problem concerns the workloads associated with such efforts. To give some perspective on the level of this additional workload, the Provincial Assessor of Albay indicated that of his staff of 29 permanent employees, 20 were assigned to the general revision process with an additional 15 casual employees also working on reassessments (out of a total of from 70 to 120 casual employees hired). The number of parcels in Albay in 1979 totaled approximately 180,000. In the Province of Iloilo, 64 permanent employees are assisted by several casual employees. Thirteen of the permanent employees were assigned to tax mapping while apparently many of the remainder were involved with the general reassessment of the approximately 362,000 properties in that province. Obviously the scheduling of reassessments at particular dates has the effect of creating fluctuations in workloads that would not arise if the process could be spread more

[1]The problems associated with large increases in assessed values are recognized by the Philippines authorities; LOI 800 (January 30, 1979) provided tax discounts of 5 percent for those experiencing 100-200 percent increases in assessed valuation; 10 percent discounts for those with increases in assessments of 200-300 percent; 15 percent discounts for those with 300-500 percent increases; and 20 percent discounts for those with greater than 500 percent increases in assessed valuation.

evenly over time. On the other hand, the current mandated scheduling of reassessments provides better insurance that all properties will be revalued periodically thus strengthening the equity of the property tax system.

It is therefore useful to consider alternative schemes that could provide both greater elasticity in the potential revenue yields without the large single-year increments in assessed valuations. Several possibilities arise.

1. The current schedule could be maintained with the increment phased in over the three year reassessment cycle. That is, if a parcel was reassessed at a level 90 percent above its previous value, the total increment could be divided by three (assuming the 3-year cycle is maintained) with the fractional increment added each year. This approach would not, however, avoid the excess workload associated with single year reassessments.

2. To avoid the peak-load work scheduling problem, all parcels in a jurisdiction could be divided into three subgroups of parcels with each subgroup being reassessed every third year. While this would smooth the workload, it would not avoid the single year jump in a property owner's assessed valuation. Furthermore, the approach should be accompanied by an annual updating of the schedule of values. Since this is a major undertaking, a general price index or indexes such as the CPI and construction price index could be used for interim periods and the full schedule could be updated every third year.

3. The approaches in alternatives (1) and (2) could be combined. One third of the parcels could be reassessed each year but schedules of values could be updated annually by phasing in an individual's tax increase over the three year reassessment cycle.

Growth in the Property Tax Base

With revenue yields a primary concern and with property tax rates essentially fixed (or at least limited in range), the principal source of revenue growth is in the tax base. Growth in the tax base comes about through property reassessment. Since the Second World War, general reassessments have taken place in 1949, 1960 (partial), 1974, and 1979. Interim growth in the base can be due to the construction and assessment of new buildings, equipment and improvements, or to discovery of previously untaxed properties (e.g., as might result from tax mapping).

Examination of the growth in the property tax base for different jurisdictions provides some insight into the potential revenue effects of general reassessments. Table III-2 shows the year-to-year percentage changes in assessed valuations for both taxable and exempt property for the period 1970-79 in the Provinces of Iloilo, Albay and Guimaras (until 1979 a sub-province of Iloilo). Most obvious from this Table is the massive increase in assessed valuations between 1972 and 1973 in the wake of PD 76 (December 6, 1972). The less drastic increases in Albay were apparently due to the longer time period associated with getting the new assessed valuations recorded.

The 1979 general reassessment was completed in time in Iloilo and Guimaras, but not in Albay. The dramatic increases shown in the Table for the two completed areas suggest that if tax rates were to be held constant and if collection efficiency did not fall, municipalities could

TABLE III-2

GROWTH IN TAXABLE AND EXEMPT ASSESSED VALUES, SELECTED JURISDICTIONS: 1970-79

Year	Iloilo Province Percentage Change		Guimaras Subprovince Percentage Change[a]		Albay Province Percentage Change		Legaspi City Percentage Change	
	Taxable Assessed Values	Exempt Assessed Values	Taxable Assessed Values	Exempt Assessed Values	Taxable Assessed Values	Exempt Assessed Values	Taxable Assessed Values	Exempt Assessed Values
1970-71	0.2	-0.4	NA	NA	0.1	-2.9	7.2	0.1
1971-72	3.9	0.8	NA	NA	4.9	0.2	11.4	5.8
1972-73	203.7	98.9	NA	NA	55.9	0.9	109.6	38.8
1973-74	11.3	60.9	NA	NA	36.3	4.1	1.8	35.4
1974-75	17.9	1.4	-0.3	6.4	19.4	39.4	4.7	51.2
1975-76	0.1	9.0	3.3	.8	11.8	67.4	3.7	3.5
1976-77	5.8	4.8	11.7	0.1	3.0	0.7	2.9	-0.1
1977-78	2.2	-1.9	0.6	1.2	18.5	43.6	22.3	43.4
1978-79	80.3	96.6	189.5	80.1	6.2	1.7	47.8	6.2

NA: not available.

[a]The subprovince of Guimaras became independent of Iloilo Province in November 1979, but prior to that many administrative offices had operated independently of Iloilo Province.

SOURCE: Data supplied by Provincial and City Assessors.

anticipate considerable increases in revenues during the 1980 fiscal year. It is doubtful that collection efficiency could remain constant in light of an approximate doubling in tax liabilities.

During the interim periods, there is relatively little growth in the property tax base. For example, in Iloilo increases in the taxable base were less than 6 percent in each year between 1975 and 1978. This growth is slow in comparison to inflation rates (CPI) of between 7 and 9.9 percent during the same period. If property tax revenues did not keep up with inflation, but municipal expenditures did--an outcome that seems likely in light of the data presented here and above--then the pressure on municipal budgets during the late 1970s were in no small measure attributable to the low elasticity of the property tax base.

As noted above, the granting of exemptions imposes a substantial opportunity cost on local governments in terms of revenues lost. In 1979 the ratio of exempt assessed values to the total (exempt and taxable) was:

Iloilo:	7.4%
Albay:	13.8%

Using the 1 percent tax rate applicable in both of the provinces, these exemptions are equivalent to a ₱1.2 million revenue loss in Iloilo and a ₱0.5 million loss in Albay. To place these costs in some perspective, the Provincial Government of Iloilo collected only ₱2.4 million in real property taxes in 1979; thus, if all of the exempt property had been taxable and the collection rate had been 100 percent, the Province could have increased its property tax collections by nearly 25 percent.[1] An

[1] Assuming a continued provincial government share of 45 percent of collections.