

## IRA design issues and challenges

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### Background

The Local Government Code or LGC (Republic Act 7160) of 1991 and the Organic Act for Muslim Mindanao (Republic Act 6734) of 1989<sup>1</sup> jointly define central-local relations in the Philippines. Both pieces of legislation include provisions that increased the share of local government units (LGUs) in central government revenues, broadened LGU taxing authorities, and devolved to LGUs functions that used to be assigned to central government agencies.

As is the case in other countries, there is a mismatch between the revenue-raising capacities and expenditure needs of various levels of local government in the Philippines (Table 1). Many types of taxes are either easier to administer at the central level or are deemed to be unsuitable for local subnational

government imposition because their tax bases are geographically mobile. On the other hand, the principle of subsidiarity implies that many functions are best assigned to local governments. In this context, intergovernmental transfers are generally viewed as an instrument that may be used to correct for the imbalance in the tax and expenditure assignment.

In the Philippines, intergovernmental transfers or central government transfers to LGUs are of three types: formula-based block grants (i.e., internal revenue allotment or IRA), origin-based share in central government revenues (i.e., share in national wealth and other taxes), and *ad hoc* categorical grants. In principle, LGUs have almost full discretion

<sup>1</sup> This law was subsequently amended in 2001.

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**Table 1. LGU revenues and expenditures relative to general government revenues and expenditures**

	Ratio of LGU Revenues to General Government Revenues (%)	Ratio of LGU Expenditure to General Government Expenditure Net of Debt Service (%)
1985	5.93	12.17
1987	4.52	10.67
1989	4.85	11.20
1991	4.55	12.74
1993	6.36	20.20
1995	5.89	22.38
1997	6.53	22.04
1999	7.30	23.55
2001	7.24	26.33
2003	8.10	26.96
2005	7.60	25.76
<b>Average</b>		
1985–1991	4.86	11.00
1992–2005	7.09	21.23

in the utilization of their IRA. In contrast, the categorical grants are conditioned on their use for specific purposes.

This *Policy Notes* focuses on the IRA and looks into some issues and challenges regarding its design.

### Issues in design of the IRA

Under the Local Government Code, the aggregate IRA of LGUs is set at 40 percent of the actual internal revenue tax collections of the central government three years prior to the current year.<sup>2</sup> The aggregate IRA is then divided among the different levels of local government as follows: 23 percent to provinces, 23 percent to cities, 34 percent to municipalities, and 20 percent to barangays.<sup>3</sup>

In turn, the IRA share of each tier of local government is then apportioned to individual LGUs on the basis of population (50 percent), land area (25 percent), and equal sharing (25 percent).<sup>4</sup> The IRA is transferred as a block grant and, as such, LGUs enjoy considerable discretion in its utilization.

Intergovernmental transfers in the Philippines, however, have been criticized for (i) vertical imbalances leading to the inadequacy of the IRA to fund the expenditure functions assigned to them; (ii) lack of an equalizing feature in the IRA distribution formula so that disparities in the fiscal capacities of LGUs are not adequately addressed, thereby widening the geographic disparities in human development outcomes and level of economic development; (iii) disincentive effects on local revenue generation; and (iv) poor predictability in the size of the IRA which undermines the ability of LGUs to effectively plan and manage their expenditures.

### *Vertical imbalance*

A matching of the aggregate IRA levels with the expenditure responsibilities of LGUs

<sup>2</sup> In comparison, the share of LGUs in national taxes was equal to 20 percent of internal revenue taxes *at the maximum* during the pre-Code regime. The amount of IRA that was actually appropriated in the pre-Code era was 13 percent of net BIR tax receipts on the average in 1987–1990.

<sup>3</sup> Prior to the implementation of the Code, the inter-tier allocation of the IRA was: 27 percent to provinces, 22 percent to cities, 41 percent to municipalities, and 10 percent to barangays.

<sup>4</sup> In the pre-Code period, the intra-tier allocation to individual LGUs was determined as follows: 70 percent on the basis of population, 20 percent based on land area, and 10 percent based on equal sharing.

(including devolved functions, additional mandatory positions, unfunded mandates, and the budgetary requirement for the 20% development fund) in 1993, 1994, and 1995 shows that while the concern about the vertical balance was not justified in the aggregate in these years, such was not the case in 1996, 1997, and 1998. During these latter three years, the salary adjustments under the Salary Standardization Law were so hefty that the increases in the IRA were not able to keep up with the rising cost of devolved functions, unfunded mandates, and the increasing pressure for additional expenditures due to population growth (Manasan 2006). On the other hand, a similar analysis for 1999–2003 indicates that during this period, the increase in the IRA is more than sufficient to fully cover the inflation, population growth, and salary adjustments in the cost of devolved functions for all LGUs combined. This is due to the fact that the mandated increase in salaries of government employees in the latter period was moderate compared to that in the earlier period. It should be emphasized, however, that the estimates used in the latter period did not include the newer mandates given to LGUs in the interim such as the contributions for the health insurance premiums of indigent residents and population management, among others.

Said analysis is also limited by the fact that in the computation, the cost of devolved functions refers only to the cost of personnel and facilities that were actually transferred to

the LGUs as well as the maintenance and operating expenses associated with such devolved facilities. There are cases, however, where functions were transferred to LGUs without any corresponding devolution of personnel and facilities from the central government. This is true in the case of public works and, to a large extent, in the area of environment and natural resource management. In this sense, the estimates of the cost of new LGU expenditure responsibilities used in this analysis would tend to underestimate their true cost and, consequently, overestimate the vertical balance for all LGUs in the aggregate. Moreover, the cost used in the estimation refers to the cost of the devolved functions as budgeted by the central government prior to devolution. As such, they do not necessarily reflect local preferences.

#### *Horizontal imbalance*

Variations in net resource transfer<sup>5</sup> across levels of local government are substantial. In the aggregate, the net resource transfer for cities is consistently larger than those for provinces and municipalities (Manasan 2006) as seen in the consistently positive transfer for cities in 1995–2003 and the negative transfer for provinces and municipalities in 1995–1999. This analysis suggests that

<sup>5</sup> The net resource transfer for any given year is computed as the difference between the IRA for said year, on the one hand, and the sum of the adjusted cost of devolved functions, cost of other mandates including the provision for the 20 percent Development Fund and sectoral representation, and the 1992 IRA, on the other hand. Adjustments on the cost side were made to take into account population growth and inflation.

*...While the increase in the IRA share of some LGUs is not enough to finance the functions devolved to them, others have received additional resources beyond their requirements.*

provinces and municipalities in the aggregate are relative net losers while cities are relative net winners from fiscal decentralization.

This situation is more clearly shown in the following. Provinces absorbed 37.0 percent of the total cost of devolved functions, municipalities, 38.5 percent; cities, 5.7 percent; and barangays, 18.8 percent.<sup>6</sup> When this is contrasted with the mandated share of LGUs in the IRA (provinces, 23 percent; cities, 23 percent; municipalities, 34 percent; and barangays, 20 percent), it becomes immediately apparent that there is a mismatch in the resources transferred and the cost of additional expenditure responsibilities that were devolved to the different levels of local government.

In addition to the vertical imbalance across levels of local government, an imbalance also exists across LGUs within each level. Thus, while the increase in the IRA share of some LGUs is not enough to finance the functions devolved to them, others have received additional resources beyond their requirements. For instance, in 2001, per capita net resource transfer was negative in 45 (57%) out of 79 provinces, 772 (52%) out of 1494 municipalities, and 17 (15%) out of 113 cities (Manasan 2006).

### *Lack of equalization*

At the same time, when all LGUs are aggregated at the provincial level, their combined per capita IRA is found to be positively related to per capita household income in 1995–1999, suggesting that the IRA distribution formula has been counter-equalizing with respect to the fiscal capacities of LGUs (Manasan 2006). In contrast, the IRA was found to be equalizing in 2000 (as indicated by the negative correlation coefficient between per capita IRA and per capita household income in that year).<sup>7</sup> However, even in 2000, the combined equalizing effect of the IRA and categorical grants is not sufficient to compensate for the inherent disparities in the tax base (as indicated by the positive correlation coefficient between the per capita household income and the sum of the LGUs' per capita own-source revenue and per capita IRA aggregated at the provincial level).

Given the wide disparities in the distribution of the local tax base across regions, this

<sup>6</sup> Barangays received P1.5 billion in Barangay Administration Fund under the National Assistance to Local Government Units (NALGU) in 1991. This assistance, which was used to pay for the salaries of barangay officials, was discontinued with the implementation of the Local Government Code and barangays are then expected to pay said salaries out of their own IRA share.

<sup>7</sup> The difference in the sign of the correlation coefficient between per capita IRA and per capita household income in the years 1995–1999, on the one hand, and the year 2000, on the other, suggests that the implementation of the Local Government Service Equalization Fund (LGSEF) scheme in 1999–2000 may have resulted in some equalization. Note that the LGSEF provided additional transfers to lower-income class LGUs in 1999–2000. The LGSEF transfers were also treated as part of the IRA in the financial statements of LGUs.

result further highlights the potential for continuing, if not increased, disparities in human development outcomes across LGUs with greater fiscal decentralization unless part of intergovernmental transfers are designed to have an equalization role. For instance, an analysis of division level data for 2005 indicates that a positive and statistically significant relationship exists between the elementary level cohort survival rate, on the one hand, and per capita education expenditures of LGUs, on the other. In like manner, an analysis of regional level data for 2003 reveals a positive and statistically significant relationship between the number of children given complete immunization and number of mothers given two doses of tetanus toxoid vaccine, on the one hand, and LGU spending on health, on the other.

#### *Disincentive effect of the IRA on revenue generation*

While intergovernmental transfers had a neutral effect on local revenue performance in 1985 (prior to the Code), there is some evidence that the IRA tended to substitute for local tax revenues of provinces and cities in the post-Code period (1992–2000). The analysis suggests that LGUs which received higher IRA (whether in absolute terms or relative to their expenditure responsibilities) tended to be lax in their tax effort. Thus, there appears to be a need to alter the IRA distribution formula so as to provide incentives for local tax effort.

Consistent with *a priori* expectations, the analysis also shows that per capita local tax revenue is positively and significantly related to per capita household income for both real property tax and local business tax for cities, municipalities, and provinces alike. This finding confirms that local tax effort is largely determined by the ability to pay.

#### *Predictability and timeliness in the release of the IRA*

Notwithstanding the formula-based determination of the aggregate IRA share of LGUs and its distribution to individual LGUs as well as the LGC provision for the *automatic release* of the IRA, the IRA evolved to be a highly unpredictable revenue source for LGUs between 1998 and 2004 as the central government, faced with severe fiscal constraints, persistently reduced the amount of intergovernmental transfers to LGUs (Table 2). In those years, the mandated IRA share was

**Table 2. Comparison of IRA appropriations and IRA obligations (in billion pesos)**

	1998	1999	2000	2001	2002	2003	2004
(1) Mandated IRA share: 40% of net BIR revenues three years back <sup>a</sup>	81.0	96.8	121.8	131.9	134.4	141.0	143.4
(2) Appropriations	81.0	96.8	111.8 <sup>b</sup>	111.8	134.4	141.0	141.0
(3) Obligations	76.9	95.3	114.3 <sup>c</sup>	115.8	134.4	141.0	141.0
(1) less (3)	4.1	1.5	7.5	16.1	0.0	0.0	2.4

<sup>a</sup> as indicated by IRA level proposed in the President's Budget

<sup>b</sup> P10 billion of the P121.8 billion mandated share was put under "unprogrammed funds" in the GAA

<sup>c</sup> in the course of the budget year, P2.5 billion was transferred from the "unprogrammed funds" to the "programmed" portion of the budget

either not appropriated in full, the amount appropriated for IRA was not released in full, the IRA appropriation was not released on time, or the IRA share was effectively cut due to the re-enactment of the budget.

After two Supreme Court rulings in 2000 and then in 2004 upholding the automatic release of the IRA and its distribution strictly as per the provision of the LGC, a significant shift in the treatment of the IRA became evident. Although the GAA was re-enacted once again in 2006, a supplemental budget (Republic Act 9358) was passed into law in July 2006 providing for, among other things, additional IRA to augment the amount that was deemed re-enacted. Furthermore, Republic Act 9358 stated in very clear terms that the IRA shall henceforth be automatically appropriated. In line with this, the aggregate IRA share of all LGUs is expected to increase by 10 percent from PHP166 billion in 2006 to PHP183.9 billion in 2007. Subsequently, it will grow by another 15 percent to PHP210.7 billion in 2008.

At the same time, to further improve transparency and timeliness in the release of the IRA,

the DBM has instituted the posting of the LGUs' IRA shares on the DBM website in January 2007 and every January thereafter. Monthly releases of the Notice of Cash Allocations (NCA) will also be posted along with the comprehensive allotment release within the first quarter of every year.

### *Impact of unpredictability in IRA and LGU spending.*

A review of the trends in the size and composition of LGU revenues and expenditures in 2001–2005 reveals how economic uncertainties and the fiscal constraints faced by both the central and local governments have diminished not only the size of the overall LGU spending pie but also the budget share of basic social service sectors during that period. The concomitant decline in LGU spending on basic social services in real per capita terms (Table 3) is a cause of concern because it has been associated with the stagnation, if not deterioration, in service levels of these sectors as well as human development outcomes (Tables 4 and 5). These trends highlight the need to design grants that will help ensure that LGUs are able to deliver health and education services that are at least equal to minimum service standards.

*Given the above perspectives, there is a need to reassess the tax and expenditure assignment across different levels of local government in order to provide a better match between them. The first-best reform agenda should involve primarily addressing vertical imbalance through greater tax decentralization—the assignment of more tax bases to LGUs—so as to improve accountability at the local level.*

### **Recommendations**

Given the above perspectives, there is a need to reassess the tax and expenditure assignment across different levels of local government in order to provide a better match between them. The first-best reform agenda should involve primarily addressing vertical

**Table 3. Real per capita MDG expenditures of LGUs (in 2000 prices), 1996–2006**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Basic education	86.9	110.8	108.6	96.5	99.7	103.8	63.8	76.3	67.2	64.0	77.2
Basic health/Nutrition	121.0	140.2	134.6	134.1	148.5	134.0	121.3	126.0	120.1	111.6	105.6
Social welfare and development	31.8	36.5	35.7	35.6	41.8	42.7	37.1	42.3	38.3	36.5	37.6
Water and sanitation	4.4	5.0	4.3	4.7	4.3	4.9	3.7	3.9	3.8	3.6	4.0
<b>Basic Social Services</b>	<b>244.0</b>	<b>292.6</b>	<b>283.2</b>	<b>270.9</b>	<b>294.3</b>	<b>285.3</b>	<b>226.0</b>	<b>248.5</b>	<b>229.5</b>	<b>215.7</b>	<b>224.3</b>
Roads and bridges	215.4	245.3	205.5	226.3	246.4	223.6	183.7	192.2	182.8	166.8	190.4
Livelihood	3.1	1.7	1.2	3.7	1.6	2.5	1.5	1.6	1.7	1.5	1.7
Land redistribution	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>MDG Expenditures</b>	<b>462.5</b>	<b>539.6</b>	<b>490.0</b>	<b>501.0</b>	<b>542.3</b>	<b>511.4</b>	<b>411.2</b>	<b>442.3</b>	<b>414.0</b>	<b>384.0</b>	<b>416.3</b>
<b>Memo Item:</b>											
Total education	109.4	135.3	137.7	121.3	131.2	132.1	88.7	109.1	94.9	90.7	109.7
Total health and nutrition	180.4	204.5	202.9	199.2	206.9	200.2	173.8	188.9	179.5	163.7	156.9
Total social services	392.8	450.5	444.9	428.3	456.9	464.1	368.4	423.6	384.7	360.3	349.6

imbalance through greater tax decentralization—the assignment of more tax bases to LGUs—so as to improve accountability at the local level. Subsequently, intergovernmental transfers would then have to be redesigned to help close the disparities in the fiscal capacities of LGUs.

However, it should be emphasized that a redesign of the IRA distribution formula with the aggregate IRA share fixed at current level is not going to be easy. First, such modifications involve a zero-sum game where some LGUs will be winners while others will be losers. Second, there is understandably reluctance on the part of the govern-

**Table 4. Selected education indicators, 1990–2005**

	1990	1996	2000	2002	2003	2004	2005	2006
Elementary level participation rate	84.6	85.2	92.7	90.3	88.7	87.1	84.4	75.6
Secondary level participation rate	54.7	56.8	62.3	59.0	60.2	60.0	58.5	45.0
Elementary level cohort survival rate	69.7	68.7	69.3	72.4	71.8	71.3	70.0	64.3
Secondary level cohort survival rate	76.4	71.4	71.0	76.8	71.7	72.4	61.0	60.1
Elementary level achievement score <sup>a</sup>	40.1 <sup>b</sup>	44.5	51.4			58.7	54.7	59.9
Secondary level achievement score <sup>a</sup>	35.6 <sup>b</sup>	42.6	51.9		44.4	46.8	44.3	46.6

<sup>a</sup> based on NEAT and NSAT for 1994–2000 and on NAT for 2003–2006

<sup>b</sup> refers to 1994

ment fiscal managers to even consider moves in this direction because of the expected pressure from LGUs to increase the aggregate IRA share.

In view of these, there may be a need to consider a second-best reform option. This will involve the design of matching grant programs that will help ensure that LGUs get

**Table 5. Selected health indicators, 1999–2006\***

	1999	2000	2001	2002	2003	2004	2005	2006
% of pregnant women with 3 or more prenatal visits	65.6	64.8	62.9	60.5	64.3	64.7	62.3	61.5
% of pregnant women given tetanus toxoid vaccination at least twice	59.4	62.5	54.2	54.3	59.6	60.0	58.8	59.1
% of lactating mothers given Vitamin A	54.6	57.0	55.3	52.9	61.6	53.2	54.7	59.3
% of livebirths attended by medical professional, including trained <i>hilot</i>	95.0	95.4	96.0	93.4	95.2	95.6	96.3	96.3
% of fully immunized children under 1	87.9	86.5	81.7	76.7	83.7	84.8	83.7	82.9
% of infants given 3rd dose of Hepa B	45.2	6.2	41.9	38.5	45.2	45.6	42.9	72.9
% of diarrhea cases among children under 5 given ORS	25.9	24.1	22.4	17.7	17.8	15.5	14.2	14.0
% of pneumonia cases among children under 5 given treatment	94.5	93.9	94.2	94.7	97.3	99.9	95.3	96.0
% of children under 1 given Vitamin A	74.0	76.9	74.6	74.7	89.8	79.2	80.0	81.0
% of children between 1 and 5 given Vitamin A	84.1	101.3	95.1	94.1	106.1	111.1	97.8	95.7
TB morbidity rate <sup>ab</sup>	203.9	174.1	149.9	154.1	120.3	133.3	137.1	169.9
Malaria morbidity rate <sup>a</sup>	91.8	66.6	39.1	50.3	36.5	24.9	43.3	27.6

\* data shown for entire Philippines but data by province and city also available

<sup>a</sup> per 100,000 population

<sup>b</sup> respiratory plus other forms of TB

Source: Field Health Service Information System, various years

the appropriate financing for them to achieve minimum service standards for key basic social services.

The rationale for such a grant program and/or the establishment of minimum service standards stems from the fact that some services like basic health and environmental protec-

tion generate externalities (i.e., benefits spillover beyond the boundaries of the local jurisdiction) or are services which are considered meritorious and in which the central government has a strong interest to achieve an overriding national level outcome (e.g., merit goods). National standards can be enforced in several ways, e.g., by enticing local governments to spend more on the specified service with a matching grant program (McLure and Martinez-Vazquez 2002). Alternatively, the problem could also be addressed by designing equalization transfers aimed at providing sufficient resources to enable all local governments to provide a basic package of local services (Bird and Smart 2001). 

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