Internal Revenue Allotment and Regional Disparities in the Philippines*

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Abstract

This paper discusses a need to redesign the intergovernmental transfer in the Phillippines, the Internal Revenue Allotment (IRA), so as to allocate it appropriately among regions with focus on poverty.

The IRA is a distribution across local government units (LGUs) from the proceeds of internal revenue tax collections of the national government in accordance with the formula. Our expected effects of intergovernmental transfer are always to lessen regional disparities in the economy and the fiscal vertical imbalance across LGUs. But the current situation of the disparity isn't still improved even after more 15 years of the enactment of the Local Government Cord of 1991.

To begin with, we simply examine the devolution under the Local Government Cord of 1991. Secondly, the current IRA distribution formula is reviewed and we point out that the IRA distribution doesn't encourage LGUs to further tax collection efforts in each LGU. The third section explains regional disparities in terms of poverty base from available data. Finally, this paper suggests a need to redesign the IRA distribution formula in relation to poverty indicators under LGC 1991.

JEL: H7, H75, H77

Keywords: The Philippines, Devolution, Local Government Cord of 1991 (LGC 1991), Internal Revenue Allotment (IRA)

1. Introduction

The Philippines has 1 autonomous region and four types of local government units (LGUs), which are provinces, cities, municipalities and brangays. Each province includes cities and municipalities and then both of which are further subdivided into barangays, the smallest political units. There are 81 provinces, 136 cities, 1495 municipalities, and 42008 brangays as of March 31th, 2009. These numbers tend to increase year by year.

In 1986 Corazon Aquino established a vibrant democracy after the EDSA Revolution. Around that time, the Council of Europe adopted the European Charter of Local Self-Government in 1985 which had started a global trend. Her government paved the way for the enactment of the Local Government Code of 1991 or LGC 1991 (as it will be referred in this paper), which laid out the policy for pushing the devolution. It transferred the central government's functions, responsibilities, financing resources

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and their personnel to LGUs. The implication of devolution is the principle of subsidiarity, which means powers and responsibilities of the delivery of basic public services that is closest to the people (http://europa.eu/scadplus/glossary/subsidiarity_en. htm, Europe Glossary).

LGC 1991 provided the framework for not only improved intergovernmental relationships in the Philippines but also the participation of non-governmental organizations and people's organizations in local governance. It strongly encouraged LGUs to enhance their administrative capacities and more opportunities for the regional own development in partnership with private sectors. All LGUs are responsible for the provision of basic services and facilities for their regional development. For instance, provinces provide the following administrative services (Congress of the Philippines, 1991):

- (i) Agricultural extension and on-site research services and facilities which include the prevention and control of plant and animal pests and diseases; dairy farms, livestock markets, animal breeding stations, and artificial insemination centers; and assistance in the organization of farmers and fishermen's cooperatives, and other collective organizations, as well as the transfer of appropriate technology;
- (ii) Industrial research and development services, as well as the transfer of appropriate technology;
- (iii) Enforcement of forestry laws limited to community-based forestry projects, pollution control law, small-scale mining law, and other laws on the protection of the environment; and mini-hydroelectric projects for local purposes;
- (iv) health services which include hospitals and other tertiary health services;
- (v) Social welfare services which include programs and projects on rebel returnees and evacuees; relief operations; and population development services;
- (vi) Provincial buildings, provincial jails, freedom parks and other public assembly areas and similar facilities;
- (vii) Infrastructure facilities intended to service the needs of the residence of each province and which are funded out of provincial funds including, but not limited to, provincial roads and bridges; inter-municipal waterworks, drainage and sewerage, flood control, and irrigation systems; reclamation projects; and similar facilities;
- (viii) Programs and projects for low-cost housing and other mass dwellings, except those funded by the Social Security System, Government Service Insurance System, and the Home Development Mutual Fund;
- (ix) Investment support services, including access to credit financing;
- (x) Upgrading and modernization of tax information and collection services through the use of computer hardware and software and other means;
- (xi) Inter-municipal telecommunications services, subject to national policy guidelines; and
- (xii) Tourism development and promotion programs

In addition, LGC 1991 has assigned the taxation power to LGUs and increased the Internal

Revenue Allotment (IRA) from 20% to 40% of internally generated taxes. For instance, provinces are authorized to levy the following (Manasan, 2004)[1]:

(i) Real Property Tax,
(ii) Business of Printing and Publication,
(iii) Franchise,
(iv) Sand, Gravel and Other Quarry Resources,
(v) Amusement Places,
(vi) Professionals,
(vii) Delivery Vans and Trucks,
(viii) Real Property, and
(ix) Idle Lands

It's undeniable that fiscal devolution is conducive to national economic growth as a whole. Furthermore, it is expected to promote genuine local autonomy and self-reliance of LGUs. However, we need to pay attention to the widening internal socioeconomic gap in the many countries for the past two decades. This growing regional disparities in a country is becoming a serious problem. In order to avoid such a problem in the Philippines, LGC 1991 increased IRA that LGUs have discretionary powers to spend.

On the other hand, LGUs have taken over unfunded mandates after the enactment of LGC 1991. These mostly correspond to the salaries of 70,283 employees of the devolved national agencies of Department of Health, the Department of Agriculture, Department of Social Welfare and Development, Department of Budget and Management, and Department of Environment and Natural Resources, etc[2]. In this context, LGUs have the burden of these personnel expenditures with their revenue sources including IRA. The amounts have not been sufficient to cover the cost of devolution despite its transfer from the national government to LGUs.

The next section reviews the current IRA distribution formula and the issues are suggested from the previous studies. The third section explains regional disparities in terms of poverty with available data. Finally, this paper suggests a need to redesign the IRA distribution formula in relation to poverty indicators under LGC 1991.

2. Issues of Internal Revenue Allotment (IRA)

LGUs have discretion how to spend the allocation of IRA. But LGC 1991 mandated each LGU to appropriate no less than 20% of their assigned IRA for development projects. The IRA distribution of

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[1] Provinces shares proceeds of levy of tax items (iv), (v) and (ix) with municipalies and/or barangays.

[2] The number of devolved personnel at the Department of Health is 45,896, the Department of Agriculture is 17,673, the Department of Social Welfare and Development is 4,144, the Department of Budget and Management is 1650, the Department of Environment and Natural Resources is 895, and other executive offfices is 25.

povinces, cities and municipalities is budgeted on the basis of following criteria: population 50%, land area 25%, equal sharing 25% while for the barangay share, it is determined by 60% population and 40% equal sharing.

According to Section 284 of LGC 1991, the total amount of IRA is budgeted at 40% of internal revenue tax collected by the Bureau of Internal Revenue three years before. For example, IRA for FY 2009 is budgeted base on the internal revenue tax collected in FY 2006. This proportion has been increased by 20% to match the amount of devolved expenditures since LGC 1991 was enacted. This amount is distributed to all LGUs, provinces and cities get 23%, municipalities 34% and barangays 20%. The National Statistical Coordination Board (2000) explained that the assigned IRA of a province is computed as follows:

A province's amount of IRA = (P) + (L) + (E)

(P) A province's amount of IRA based on population
= (Population of a province / Total Provincial Population) × (Total IRA×50%×23%)

(L) A province's amount of IRA based on land area
= (Land Area of a province / Total Provincial Land Area) × (Total IRA×25%×23%)

(E) A province's amount of IRA based on equal sharing
= (Total IRA×25%×23%) / Number of Provinces

As can be seen in the formula, the population is the main criterion to distribute IRA to each LGU. But the IRA system has four following issues (Manasan, 2007)[3]:

(i) vertical imbalances leading to the inadequancy of the IRA to fund the expenditure functions assigned to LGUs
(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 and level of economic development
(iii) disincentive effects on local revenue generation
(iv) poor predictability in the size of the IRA which undermines the abilities of LGUs to effectively plan and manage their expenditures.

(i) Vertical Fiscal Imbalance. A vertical fiscal imbalance is the gap between the revenue and expenditure. This implies that LGUs cannot fully provide the services. They resort to borrowing money and issuing bonds to augment their expenditure needs. To lessen the imbalance, IRA is utilized as a critical transfer payment for the LGUs financing as it enhances the equity of basic public service delivery and their fiscal soundness. However, the increase of the total IRA is still insufficient to fully cover the expenditure functions and responsibilities assigned to LGUs. Manasan (2004) mentioned

[3] Diaz-Manalo (2007) also pointed out four relevant issues on the IRA.

Region	Provinces	Per Capita IRA (peso)	Total IRA (million peso)
Cagayan Valley	Batanes	9221.86	147.31
Central Luzon	Aurora	1573.57	295.52
Bicol Region	Catanduanes	1253.28	291.71
Western Visayas	Guimaras	1316.93	199.17
Cenrtal Visayas	Siquijor	2061.35	180.77
Eastern Visayas	Biliran	1351.32	202.74
Northern Mindanao	Camiguin	2064.75	167.85
Soccsksargen	Sarangani	828.37	393.90
Caraga	Dinagat Islands	1595.19	192.72
ARMM	Basilan	788.21	322.00

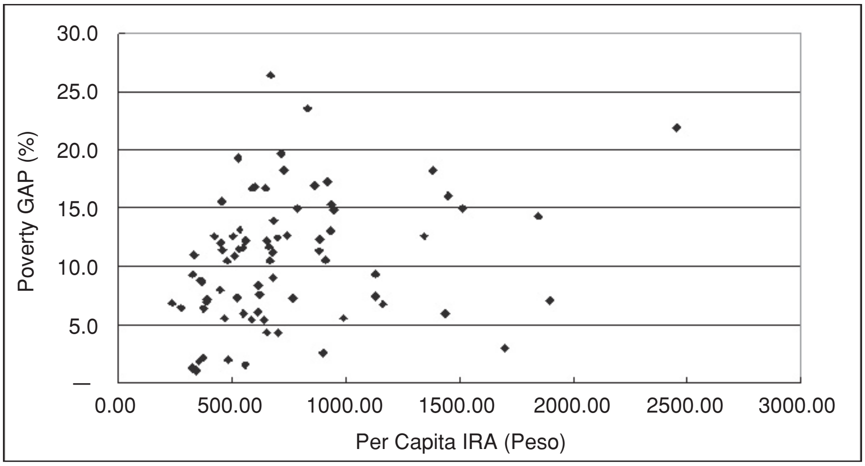
(Table 1) The Smallest Total IRA and The Biggest Per Capita IRA in FY 2007
Souce of Date: Philippine Countryside in Figures 2007

that the vertical fiscal imbalance has worsened at all levels of LGUs despite the total IRA distributions increased under LGC 1991. The aggregate fiscal deficiency for all LGUs increased by 9.47% after LGC 1991 was enacted. This is because the cost of additional expenditure tends to underestimate the actual expenditure. It leads to inequality in the provision of basic public services between poor LGUs and rich LGUs as well as worsens regional disparities.

(ii) Horizontal Fiscal Imbalance. A horizontal fiscal imbalance is the inequity of IRA distribution and the different abilities of LGUs to raise revenue. The share of cities to the aggregate own revenue generated in all LGUs increases, while those of provinces and municipalities decrease, because cities were given broader taxation powers and higher rate of the IRA distribution compared with provinces and municipalities (Llanto, 2009). In addition, basing from the IRA formula shown earlier, if the province is less populated then the IRA share tends to be small. Table 1 listed 10 regions that the province distributed the smallest total IRA amount in each region is the biggest per capita IRA amount in the region in FY 2007. The correlation coefficient between total IRA and per capita IRA by province except National Capital Region (NCR) is -0.413. It indicates that the IRA distribution formula has some failure in equalizing the fiscal revenue, though the value isn't high. That is, some provinces with lower population have received higher per capita IRA in FY 2007[4].

(iii) Disincentive Effects on Local Revenue Generation. IRA has no incentive for LGUs to exert more effort in collecting taxes and tends to be lax, though originally, LGUs derive revenues from local tax sources. This disincentive has a “substitutive effect” caused by over-dependence on the IRA without local revenue tax effort. At the begining, the IRA system and local taxation powers were expected to enhance tax collection efforts of LGUs and to meet the equality of LGUs. But in reality, provinces and municipalities heavily rely on IRA. According to Uchimura and Suzuki (2009), the IRA

4 National Statistical Coordination Board (2008a) reported that the province of Catanduanes, the smallest province in Region V, in term of population and land area, received the highest per capita IRA in 2007.



(Table 2) Per Capita IRA and Povery Gap in FY2006
Souce of Date: Philippine Countryside in Figures 2007

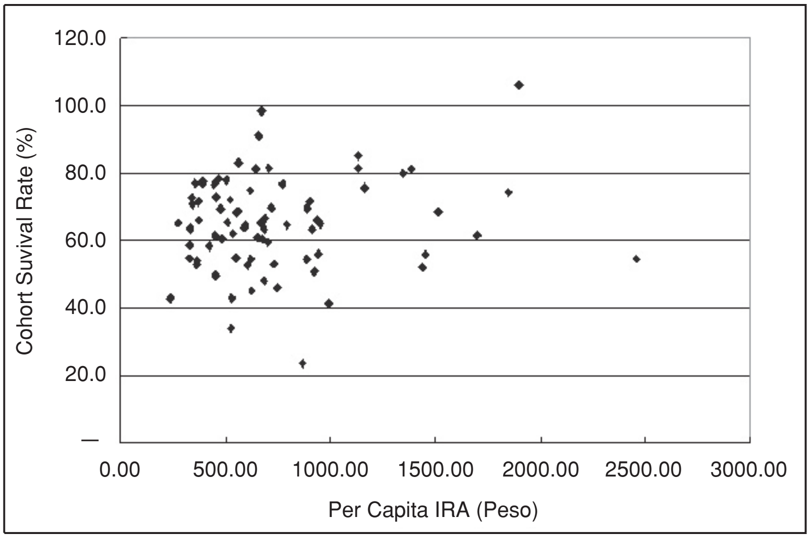
share of provinces and that of municipalities accounts for more than 74.1% of total revenues, while for cities, the IRA share ranges from 42.3% to 47.4% from FY2002 to FY2006[5]. From a view of "LGU own source revenue", Llanto (2009) also pointed that LGUs tend to depend on IRA increasingly. In his study, the share of provinces to total LGU own source revenue is an average of 12.5% from FY 2004 to FY 2006 and that of municipalities is an average of 20.7% during the same period. The shares decreased as compared to 19.9% and 37.1% in FY1992-FY2003, respectively. As a consequence, IRA has caused disincentives on raising local own revenue through their taxation powers. Therefore, the IRA distribution fails to contribute to sound fiscal management.

(iv) Unpredictability of IRA's Amount. Finally, we take unpredictability in IRA and the structure of local public expenditure up as the issue. The national government and LGUs faced fiscal constraints and the budgets have diminished. Manasan (2007) reviewed the amount and structure of LGU's revenue and expenditure in relation with economic uncertainties and the fiscal constraint from FY 2001 to FY 2005. The total amount of IRA to all LGUs has grown, but it is currently less than 20% of the national budget. Thus, LGU spending on basic public services in real per capita has been declining. Consequently, poverty alleviation and education performance are affected. It gives us a hint of amending the IRA distribution formula to be able to deliver the minimum standard level of basic public services by LGUs.

3. Toward Amending the IRA Distribution Formula

After more than 15 years of implementing LGC 1991, the intergovernmental relationship currently needs further improvement, not only to achieve local autonomy, but also to reduce socio-economic disparities between regions. The IRA is not an effective policy instrument to address the

[5] Wikipedia (2008) explained that the IRA for municipalities account for 90% of total revenues and the IRA for cities ranges from 50% to 70% of the total.



(Table 3) Per Capita IRA in FY2006 and Cohort Survival Rate in SY2006-2007
Souce of Date: Philippine Countryside in Figures 2007

quality of the human capital, condition of health and nutrition, and poverty. Moreover, there were various recommendations to amend the IRA formula but the goverment have not really embarked on redesigning the formula[6]. Hence, regional socio-economic disparities are becoming wider.

To make IRA more equitable, Allex Brillantes Jr. (Dean, University of the Philippines's National College of Public Administration and Governance) proposes that the current IRA distribution formula should be amended to include a fourth criterion: poverty index[7]. The Philippines goverment asked the Japan International Cooperation Agency (JICA) to administer the suvey for the improvement of the IRA system. JICA (2009) offered to amend the IRA distribution formura and change the share among three criteria. In addition, they mentioned “Local Own Source”, “Performance”, “Municipal Water” and “Poverty” as the fourth criterion.

In this section, we examine regional disparities with focus on poverty, though available data is limited. We use poverty gap and cohort survival rate.

Table 2 is a scatter diagram between per capita IRA and poverty gap by province except NCR. The poverty gap is the distance below the poverty line as a proportion of the poverty line where the mean is taken over the whole population, counting the non-poor as having zero poverty gap. The correlation coefficient between per capita IRA of provinces and poverty gap is 0.29 in FY 2006.

It highly depends on the home background of pupils, especially family income, whether they can finish school or not. Therefore, poverty has affects education performance indicators. Table 3 is a

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6 According to Igawa (2009), Llanto, G.M. has mentioned that a revision of the allocation formula is promoting at the 3rd International Symposium on Decentralization in Asian Countries held on March 10, 2009.

7 Brillantes also said, “It doesn't lessen poverty because rich LGUs like Makati city get equal share, equal access to the IRA as poor LGUs like Dinglas in Ilocos Norte. The IRA should have a bias for the poorer local governments” (i Reoport Online, 2007). Diaz-Manalo (2007) also explained the Makati's amount of the IRA was more twice the combined IRA of 14 fifth class municipalities in the province of Laguna.

rank	Highest Poverty Gap (2006)	Lowest Cohort Survival Rate (SY2006-2007)	Biggest Per Capita IRA (FY2007)
1	Zamboanga del Norte	Lanao del Sur	*Apayao*
2	Tawi-tawi	Maguindanao	Camiguin
3	*Apayao*	Basilan	Siquijor
4	Surigao Del Norte	Davao del Sur	Quirino
5	Maguindanao	Sulu	Mt. Province
6	Northern Samar	North Cotabato	Kalinga
7	Abra	Sarangani	*Ifugao*
8	Agusan del Sur	Sultan Kudarat	Dinagat Islands
9	Lanao del Sur	Lanao del Norte	Aurora
10	Masbate	Agusan del Sur	Biliran
11	Misamis Occidental	*Ifugao*	Catanduanes
12	Oriental Mindoro	Masbate	Guimaras
13	Kalinga	South Cotabato	Basilan
14	Lanao del Norte	Northern Samar	Eastern Samar
15	*Occidental Mindoro*	Negros Occidental	*Occidental Mindoro*

(Table 4) Poverty Gap, Cohort Survival Rate, and Per Capita IRA
Souce of Date: Philippine Countryside in Figures 2007

scatter diagram between per capita IRA and cohort survival rate by province except NCR. The cohort survival rate is a measure of the efficiency and effectiveness of the delivery of education services in the country, and is defined as the percentage of enrollees at the beginning grade or year in a given school year who reached the final grade or year of the elementary or secondary level. The correlation coefficient between per capita IRA of provinces in FY2006 and cohort survival rate in SY2006-2007 is 0.13.

Additionally, table 4 introduces us the top 15 ranking provinces for the highest poverty gap, the lowest cohort survival rate and the biggest per capita IRA, respectively. Apayao only ranked in all three categories. Ifugao ranked on the lowest cohort survival rate and the biggest per capita IRA, and Occidental Mindoro ranked on the highest poverty gap and the biggest per capita IRA. The top 15 provinces for the biggest per capita IRA seldom ranked the top 15 in the other categories.

According to these tables shown above, the per capita IRA has a weak relation with poverty gap and/or cohort survial rate, though the central government has the responsibility for improving these indicators and LGUs mainly depends on IRA under LGC 1991. Therefore, the IRA formula should be improved to reduce these disparities. To put it differently, we have to achieve human development with the effective IRA distribution formula, which includes not only the indices of population and land area, but also those of poverty and education.

4. Conclusion

This paper discusses the IRA system with focus on amending the IRA distribution formula for the improvement of poverty alleviation. The provision for IRA has been implemented under LGC 1991. LGC 1991 increased the local revenue available to local governments by increasing the IRA distribution and their broadened tax powers. Therefore, it enabled LGUs to deliver basic public services or to make decisions base on the needs of their respective communities with the exception of basic education.

One of the national goals is to narrow regional disparities with transfer payments. As a matter of fact, the IRA system has four issues as mentioned. In terms of the revenue structure of LGU, LGUs always face fiscal imbalances but LGUs don't exert effort in collecting taxes. Their revenue mainly depends on the IRA distribution. It is because the IRA system have no incentive to raise local own source revenue.

Besides, the national government has the primary responsibility for poverty alleviation with the stable provision of basic public services. In fact, cohort survival rate and poverty gap present us with wide disparities among regions. It's arguable that the exciting IRA distribution criteria are include the indices of poverty and education performance.

Therefore, the national government should reform the IRA distribution formula to enhance incentives for local tax collection effort as well as to lessen regional disparities in terms of poverty gap and cohort survival rate. The distribution formula should be included the fourth criteria as Allex Brillantes Jr. Mentioned, to achieve the human development.

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