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REFORM DIRECTIONS ON THE IRA

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Reform Directions on the IRA

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DEVOLUTION AND IRA

The basic policy under devolution is that local governments shall enjoy “genuine and meaningful local autonomy” that will enable them to develop into self-reliant communities and make them effective partners in achieving national goals. With reasonable powers, responsibilities and resources, local governments are in a better position to effectively respond to the needs of its constituents. They are easily held accountable for the provision of public services for which taxes have been paid. And in more mature societies, the performance of local governments should be able to influence the selection of local leaders.

Following the passage of the Local Government Code of 1991, the Internal Revenue Allotment (IRA) or the share of local government units (LGUs) in the total internal revenue collection was increased from 20% (1991) to 40% (by 1994)¹. According to Capuno², the increase in the IRA can be viewed as follows: (1) to promote greater fiscal autonomy since the automatic release of the block-grant effectively limits the tendency of LGUs to lobby for central support for local public programs; (2) to finance devolved functions³; (3) to

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¹ Based on the LGC, the share of local governments was gradually increased to 30% in 1992, to 35% in 1993 and finally to 40% in 1994.

² Joseph J. Capuno, Rationalizing the Internal Revenue Allotment (30 September 1998).

³ Among the devolved functions are public health and hospital care, agricultural extension and research, environmental management and pollution control, water supply and communal irrigation, and repair and maintenance of infrastructure facilities.

promote greater social equity across LGUs through a formula that accounts for differences in population sizes and land areas (see *box*); and (4) to enhance efficiency in the delivery of public services since the IRA is given in lump sum and LGUs are able to provide the mix of services suited to the needs of their constituencies.

IMPORTANCE OF TRANSFERS

Transfers refer to resources granted by the national government to LGUs which they can use to provide public services in their respective jurisdictions. There is no simple, uniform pattern of transfers but they are generally of two types: block-grants and conditional or matching grants. Transfers differ considerably depending on the purposes they serve—i.e., closing the vertical fiscal gap, equalizing differences in fiscal capacities that arise naturally with decentralization, and influencing LGU expenditure programs.⁴

Legal Basis

The Constitution provides that local government units shall have “a just share” in the national taxes which shall be automatically released to them. The determination of the share of each LGU is prescribed in the Local Government Code of 1991.

At present, local governments enjoy a 40% share in the total collection of national taxes. The distribution is done in two steps: *first*, the total IRA is allocated by level of government—i.e., 23% to be shared by all provinces, another 23% by cities, 34% by municipalities, and 20% by barangays; and *second*, the individual LGU share at each level is determined through a formula based on population (50%), land area (25%), and equal sharing (25%). In the case of barangays, each unit with at least 100 residents gets a minimum of P80,000 chargeable against the 20% IRA share of barangays. The balance shall be allocated based on population (60%) and equal sharing (40%).

^R R. Boadway and R. Watts, *Fiscal Federalism in Canada, the USA, and Germany* (Working Paper 2004).

According to Boadway and Watts, vertical imbalance occurs when expenditures are decentralized more than revenues—in which case, transfers are utilized to reconcile the differences in assignment of expenditure responsibilities and taxing powers among various LGU levels. Also, transfers can be used to correct fiscal capacity differences of local governments to enable them to provide a certain level or a “minimum bundle” of public services to their constituents. When equalizing fiscal capacity, transfers have to be based on measures of potential revenue-raising capacity (e.g., taxable assessed values) and not on actual revenues as it may prove to be a disincentive to fiscal effort. Meanwhile, equalizing actual outlays--i.e., raising all expenditures in per capita terms to the level of the richest LGU—can also “discourage both local revenue-raising effort and local expenditure restraint since under this system those with highest expenditures and the lowest taxes get the largest transfers”.⁵

Transfers are not only an important vehicle used by NG to achieve its equity and efficiency objectives, but they are used to influence the expenditure priorities of local governments. Conditional grants can encourage LGUs to design local programs in a way as to be compatible with national objectives. It can promote higher spending on NG-specified types or levels of public services. In most cases, conditional or matching grants are justified by the benefits from a local activity that has spill over effects to other jurisdictions. For example, to achieve universal coverage under the National Health Insurance Program, NG puts up premium counterparts for every indigent that is enrolled by the LGU at PhilHealth. Essentially, conditional transfers make LGUs more involved, committed, accountable and responsible for the aided activities.

⁵ Richard Bird, *Transfers and Incentives in Intergovernmental Fiscal Relations* (1999).

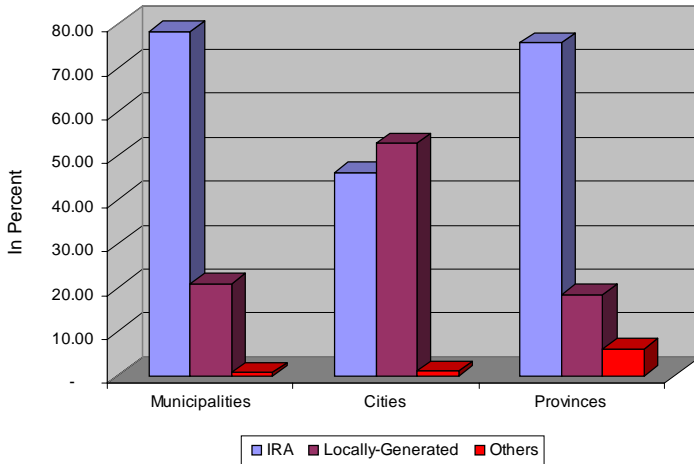
IRA AS A BLOCK GRANT

The Internal Revenue Allotment is a single most important form of transfer by the national government to LGUs. It is a block grant that is untied to any conditionalities, thus, giving LGUs greater flexibility to determine the types and levels of services it will provide. Although the LGC specifically indicates that 20% of the IRA should be earmarked as Development Fund, it has given local governments the discretion to determine the type of infrastructure projects that will be funded. The actual utilization of the Fund, however, has not been clear and may be subject to review.

The IRA is also one of the fastest growing item in the national government budget. In 1991, the IRA accounts for a mere 4% of the NG budget but its share grew to an average of 14.6% (1995-1999) and further up to 17.8% (2003-2007) in more recent years. And since it is pegged at 40% of total revenue collection, the growth in LGU allotments is almost assured (except when withheld due to unmanageable deficit)⁶ unlike most line agencies that have to annually negotiate for bigger budget allocations. The IRA is automatically appropriated which is why technically it is no longer subject to debates during the annual budget hearings in Congress. Any adjustment in the IRA formula that increases the aggregate share of LGUs effectively shrinks the budget left at the disposal of the national government. Correspondingly, it could result in spending cuts for programs and projects of line agencies or of other types of transfers (in-kind or cash) to LGUs.

⁶ Section 284 of the LGC allows NG to withhold at most 10% of the IRA in case of an unmanageable public sector deficit.

IRA VS. LOCALLY-GENERATED REVENUES BY LGU LEVEL (2005-2007)



For LGUs, the IRA is important because it has become their major revenue source. On the aggregate, it accounts for 65% of total income of LGUs (2005-2007). By LGU level, provinces and municipalities rely on the IRA for more than three-fourths of their revenues. On the other hand, cities are less dependent on the IRA at about 46% of their total revenues.

RELEVANT ISSUES ON THE IRA

Several issues have been raised regarding the Internal Revenue Allotment (IRA). *First*, the adequacy of the IRA that will enable local governments to provide adequate levels of public services; *second*, the substitutive effect of the IRA as evidenced by the over-dependence of LGUs on national transfers; *third*, the inequity of its

distribution that further widens the fiscal gap across LGUs; and *fourth*, the equal sharing criterion which encourages fragmentation and creation of additional local government units.

(1) Adequacy of the IRA. There are clamors that the IRA is insufficient to enable local governments to deliver public services adequately. Data shows that, on the aggregate, the IRA grew by P37 billion between 1991 (IRA at 20%) and 1994 when the IRA was fully adjusted to 40% of total internal revenue collection. The increment is more than enough compared with the estimated cost of devolved functions of P6.6 billion. A matching of the aggregate IRA levels with LGU expenditure responsibilities in 1999 and 2000 by Manasan (2004) also shows that the natural increase in the IRA is sufficient to cover the adjusted cost of devolved functions and unfunded mandates (e.g., the salary adjustments under the Salary Standardization Law which were so hefty that increments in the IRA were initially unable to keep up).

However, the cost of devolved functions could have been easily underestimated since these were based on agency budgets (often subject to spending cuts) rather than a detailed examination of the appropriate mix of local public services and the corresponding cost of delivering a certain level or type of service. The CODEF is provided to LGUs according to actual functions, facilities and manpower that they absorbed in 1992, and is initially deducted from the aggregate IRA before the individual LGU shares are determined. It may have been intended to ease the financial burden of LGUs that absorbed the central functions but, in a way, it perpetuated the imbalance in the provision and financing of public services which existed prior to devolution. While some LGUs continue to receive the CODEF (even though pegged at 1992) for the functions/facilities transferred to

them, other local governments that decided to put up facilities (e.g., hospitals) after devolution will have to internally absorb the full cost.

(2) Substitutive Effect. Contrary to expectations of achieving self-reliance under devolution, many LGUs particularly the provincial and municipal governments are heavily dependent on the IRA. In terms of fiscal independence, (measured as a ratio of locally-generated income vis-à-vis total local expenditures), cities rely less on national transfers to finance local programs and projects. On the average (2001-2005), own-sourced revenues of cities took care of more than half (54%) its total expenditures. On the other hand, municipalities and provinces have much lower degree of fiscal independence at 23% and 17%, respectively.

Over-dependence on the IRA may be viewed as inefficiencies on the part of LGUs, however, it would be difficult to determine the inefficiency levels unless there is a clear assessment and accounting of their potential revenue-raising capacity. The issue of over-dependence on the IRA has to be assessed considering the distribution of taxing powers, variations in tax bases (e.g., presence of economic activities and real property assets), and revenue sharing arrangements between LGUs.

Under the Local Government Code, cities may impose all the taxes levied by provinces and municipalities. Tax rates of cities may exceed the maximum allowable rates for provinces/municipalities by as much as 50% (except the rates on professionals and amusement taxes). Even though cities and provinces have comparable taxing powers, city governments generally retain their collections while provincial governments share with municipalities/barangays the

proceeds from certain levies (e.g., RPT, tax on sand, gravel and other quarry resources, and amusement tax).

There are proposals to consider the revenue effort of LGUs in the distribution formula. This is to encourage local governments to maximize the use of their revenue raising powers and to improve local tax administration. While this may necessarily counter the substitutive effect of the IRA, rewarding LGUs with higher collections could on one hand widen the existing disparity between more developed LGUs and the poorer ones. LGUs with higher fiscal capacity are likely to provide better services/facilities that attract businesses and individuals to locate in their area—thus, further widening their tax base.

TAX ASSIGNMENT BY LGU LEVEL

PARTICULARS	CITIES	PROVINCE	MUNI'S	BRGYS
On Transfer of Real Property	✓	✓		
On Business of Printing/Publication	✓	✓		
On Franchise	✓	✓		
On Sand, Gravel and Other Quarry Resources	✓	✓	a/	a/
On Amusement Places	✓	✓	a/	
On Professionals	✓	✓		
On Delivery Vans & Trucks	✓	✓		
On Real Property	✓	✓	a/	ab/
On Idle Lands	✓	✓		
On Businesses	✓		✓	✓
Community Tax	✓		✓	b/

a/ share in collection of provinces

b/ share in collection of cities or municipalities

(3) Fiscal Imbalance. The distribution of the IRA does not match the expenditure responsibilities devolved to local governments. Estimated cost of devolved functions indicates that provinces and municipalities absorbed about 46% each while cities assumed only 8%. The mismatch in transfer of expenditure functions and of resources becomes clear when matched with the mandated shares of LGUs—provinces (23%), cities (23%), municipalities (34%), and barangays (20%). According to Manasan (2004), the imbalance can also be traced to the fact that the IRA distribution formula was decided much earlier (i.e., during the Congressional debate on RA 7160) than the actual assignment of functions and devolution of personnel to different levels of local governments.

Varying revenue-raising capacities of LGUs also contribute to fiscal imbalance across different levels of local governments and among LGUs within each level. The imbalance is worsened by the IRA which hardly accounts the fiscal capacity differences across LGUs. To cite, cities have greater revenue potential especially from taxes on capital assets and income from businesses but receive the same share (23%) as that of provinces. In 2000, Makati City's IRA amounted to P425.6 million which was more than twice the combined IRA (P200.5 million) of 14 fifth class municipalities in Laguna. Under the present IRA sharing, cities have better chances of expanding the coverage of its programs and improving the quality of its services. And since most public facilities (like hospitals maintained by provincial governments) are located in city centers, it would almost be easy for some city governments to depend on other government units for certain types of service that its residents can readily access, and instead invest its funds in other development-enhancing projects.

Based on total tax receipts for FYs 2005-2007, about 39% goes to cities, 36% to municipalities and only 25% to provinces. There are factors such as *compliance cost*, *administrative simplicity*, and *cost recovery* that are taken into consideration in the assignment of taxes, hence, a re-assignment of taxing powers to match the distribution of cost of devolved functions may not be an easy option. Given this, the IRA should be able to bridge the gap between the devolved expenditure functions and the revenue raising powers of LGUs. However, it is important to evaluate the IRA in the context of all the services that have to be delivered and the revenues that could be generated by each LGU.

(4) Fragmentation of local governments. Under the equal sharing criterion, 25% of the IRA is equally shared by LGUs within each level. This criterion may have been intended to equalize the revenues of local units after differentiations in allotments were made based on population and land area. However, it has some unintended results such as the rapid conversion of municipalities to cities on account of a higher IRA, and the unnecessary creation of new political units which increases the per capita cost of local government services.

The equal sharing criterion favors highly fragmented local governments—i.e., sub-dividing a previous composite unit tends to increase the aggregate IRA accruing to the geographic area. For example, the creation of four new municipalities in Maguindanao in 2003 automatically increased the aggregate IRA share of the province (as a geographic unit) from 1.30% (2003) to 1.34% (2004) while that of Lanao del Sur and Sulu dropped.

Apparently, allotments to LGUs can be subject to unpredictable changes due to conversions or creation of new political units. This is

because the initial distribution of the IRA is done by LGU level, such that a conversion to a city by one municipality can effectively reduce the shares of all other cities nationwide, and correspondingly the total IRA accruing to the provinces (except for the province where the conversion occurred). This unintended effect of the present IRA distribution scheme also contributes to uncertainty in local planning and budgeting. Moreover, it tends to further widen the fiscal gap across provinces considering that those that are able to create new political units and convert their municipalities to cities are likely those with higher fiscal capacity (income a major criterion).

REFORM DIRECTIONS

Changing the existing IRA distribution scheme is not only technically complex but it has been politically difficult to pursue. A change in the IRA formula would definitely produce new losers and gainers among local government units. Proposals to raise LGUs' share in the national internal revenue collection (*currently at 40%*) would naturally increase individual LGU allotments and would in a way address the adequacy issue. However, this does not address the inequity in the IRA distribution. Fiscal differences will continue to differentiate the quality (if not the quantity) of public services delivered across LGUs.

There have been proposals to address the inequity of the IRA distribution by introducing poverty indicators and other expenditure-related factors. On the other hand, to minimize the disincentive effect of IRA on LGUs' revenue effort, there are proposals to include in the IRA factors that indicate revenue performance. However, since efficiency and equity objectives are often conflicting, it may not be wise to combine them in one distribution formula. Other forms of

transfers such as conditional grants that are tied to revenue performance can be used. Another option would be to convert the block grant-IRA into a mixed grant—i.e, a portion of the IRA may be set aside for the sole purpose of rewarding revenue collection efficiency but this should be subject to a different distribution formula while the rest of the IRA can be dedicated to promoting other more complementing objectives such as equity and regional development.

To make the IRA more equitable and an effective tool at promoting development, the following may be considered:

- ✦ Minimize disparities in fiscal gap among LGUs by giving greater amounts to those with lower tax bases and/or greater expenditure needs. This requires an examination of all the services that have to be delivered and the revenues that could be generated by LGUs. In assessing the revenue capacity, factors such as real property assets, road density, per capita personal income, and number of business establishments may be considered. On the other hand, some factors affecting expenditure needs may include population dependency ratio and poverty incidence.
- ✦ Allocate the IRA first by province instead of by LGU level before determining individual shares of local units at each level. Allotments by province can take into account differences in development conditions so that a closer link between the transfer system (via the IRA) and local planning may be established. Moreover, allocating by province will necessarily contain within the provincial jurisdiction any adjustments in IRA should any conversion or sub-divisions occur.

- ✎ Reduce the importance of the equal sharing criterion or totally remove it from the IRA formula since it is not in any way related to fiscal capacity factors.

As the country moves further towards greater decentralization, it becomes even more important to develop our transfer system so that its allocation can effectively lead to the achievement of desired objectives. A good transfer system, however, relies on data that objectively profiles LGUs based on its fiscal capacities and expenditure requirements. It is important that any reformulation in the IRA which introduces new measures or criteria is accompanied by efforts to improve the generation of socio-economic data.

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