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1. Introduction

One of the principal reasons why federalism proponents have pushed for this reform in the Philippines lies in te perceived dominance of "imperial Manila" over the economic and political affairs of local governments. Among the main complaints are that imperial Manila benefits disproportionately from both public and private sector spending and investments; that it controls public spending allocations to LGUs; and that it also passes on unfunded mandates to local government units (LGUs), further shrinking their elbow room to finance and craft their homegrown development strategies.

Furthermore, the political science literature acknowledges how the Philippine Presidency is a "winner-take-all" contest that hands over the keys to imperial Manila and control over the country's still largely centralized public finances to the occupant in Malacanang. In large measure, this concentration of authority over public finance fuels the view regarding "imperial Manila". Regardless of whether the government is reformist or predatory, federalist proponents contend that this over-concentration of fiscal power breeds bad center-periphery politics and undermines the spirit of decentralized political power in the country.

On the other hand, the Philippines' geographic periphery—supposedly the antithesis of imperial Manila—also faces intense governance challenges. Political dynasties are expanding among the LGUs, and when expressed as a share of total local government leadership, the latest calculations on political dynasties suggest that, at an average expansion of about 4 percentage points per election, dynasties may comprise almost 70 percent of all total local government leadership by around 2040 (Banaag and Mendoza 2016). Dynastic expansion, in turn, is associated with weaker political competition, deeper poverty and much lower human development outcomes. Recent studies also emphasize how dynastic leadership patterns are associated with distortions in public finance—curbing local public finance allocations in favor of family ties rather than economic development and poverty reduction objectives.

Thus the present system is characterized by a perverse center-periphery relationship. The periphery depends heavily on the central government for resources, while showing very mixed results on the implementation of policies and laws. On the other hand, the central government fails to support decentralization, and often ends up consolidating power by controlling much of the public resource allocations. In the end "imperial Manila" and the dynastic periphery are often found in collusion, and this does not necessarily bring about sustained reforms nor strong development outcomes.

This situation has not produced stronger accountability and fiscal autonomy despite well over 25 years of decentralization in the country. While a variety of factors come into play, there is little doubt that malfunctioning public finance was one of the key reasons behind what ails decentralization in the Philippines. The question this paper raises is whether and to what extent fiscal federalism can be aligned with greater fiscal independence as well as accountability, both for the central government as well as the LGUs.

It is important to note that the term "fiscal federalism" does not necessarily imply a full-fledged federal system—rather it covers various forms of central-local fiscal public finance reforms that enable more effective governance.[1] Other reforms will be necessary to enhance fiscal federalism; but those are beyond the scope of this paper and will be briefly acknowledged as part of a possible broad package of reforms.

In what follows, section 1 of this paper briefly reviews the experience behind the Local Government Code which was introduced in 1987 and by now has over 25 years of track record. Section 2 then provides a comprehensive review of the fiscal data, with a view to analyzing whether and to what extent local governments have managed to improve fiscal autonomy. A final section develops a proposal for reinventing the country's intergovernmental fiscal transfers in order to better align this with stronger independence and accountability over time.

2. Review of Evidence on Decentralization Gains

In 1991, the country inaugurated the Local Government Code, reflecting aspirations towards greater decentralization, and in part as a response to counter centralized power under the Marcos dictatorship and perhaps even the administrations prior to that (Rivera 2002; Tayao 2016). Decentralization, at least in principle, was expected to bring government closer to the people by empowering local government units to respond to the

[1] Fiscal federalism is a subfield of public economics, focused on the analysis of public sector functions and instruments which can be best centralized or decentralized (see Oates 1999).

needs of citizens, with policies and interventions that best fit their local conditions. Local authorities could be expected to enhance the efficiency of government response, compared to a centralized structure, given their knowledge of, and flexibility to adjust to local conditions. Devolution of public services would continue to the lowest governance unit feasible, while ensuring that there would be few if any spillovers from these services across other jurisdictions.[2]

Given spending, taxing and borrowing powers among other functions devolved to LGUs, their challenge would be to match resources with spending priorities. And many saw this as the key to stronger governance and accountability. Analysts saw how "real autonomy (in the sense of subnational governments being able to link their spending decisions with their revenue/tax decisions) promotes fiscal responsibility" (Manasan 2004:2). Functional autonomy continues to be elusive in many LGUs in the Philippines for a variety of reasons.

A. Mixed Results from Decentralization

Today almost 25 years after, the Philippines' experience with decentralization has produced mixed results. Some analysts credit decentralization with various reform gains. It has contributed to grassroots empowerment and citizens' participation at the community level; and it has helped to enhance transparency at the local level (in turn feeding into more informed citizens' engagement). They also observe how decentralization spurred greater cooperation and exchange across LGUs, notably the Leagues of Cities and Municipalities as well as other LGUs. Under this environment, the recognition of good local government practices also emerged as a means support better managed LGUs (e.g. Galing Pook Awards and Most Competitive City under NCC). More localized development plans also emerged from a number of LGUs, along with more women leaders as local officials.[3]

In addition, the beginnings of performance management systems have been introduced at the local level in various degrees, and in partnership with different actors (notably donors and civil society groups). In the 1980s, the Department of Interior and

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[2] See Tanzi (1996) and Oates (1996;1999) for an elaboration of the efficiency gains from decentralization.
[3] Dela Rosa Reyes (2016) and Llanto (2012).

Local Government introduced the Local Productivity and Performance Measurement System (LPPMS) (later revamped and updated in 2000 in partnership with donor agencies) in order to provide the LGUs with an assessment tool for their performance. Data underpinning this performance assessment system is still incomplete and scattered, notwithstanding recent efforts to rationalize these and link them to public finance allocations (see ADB 2005 and Panadero 2011).

Nevertheless, a number of malfunctions also characterized the decentralization process. First, there continues to be a significant mismatch between the absorptive capacity of LGUs and their expanded responsibilities. This was further aggravated in many LGUs with the off-loading of unfunded mandates to the LGUs. In addition, many LGUs were caught in a trap whereby their underdeveloped financial capacity contributed to their dependence on intergovernmental transfers (primarily the Internal Revenue Allotment of IRA). The transfers likely crowded-out any capacity building and fiscal autonomy efforts (as will be elaborated in the next section), in turn leading to further dependence of these LGUs. Under these conditions, central government continued to dominate local public finance—either by design or by default—providing the bulk of support for LGU expenditures. This has, in turn, continued to fuel the size of the central government which has dwarfed the bureaucracy of local government, despite decentralization. Finally, and perhaps most importantly, poverty reduction and development in the countryside has remained elusive. Instead, political clans have emerged as powerful political patrons, particularly in the poorest regions furthest from imperial Manila.[4]

While a variety of factors come into play, there is little doubt that malfunctioning public finance is one of the key reasons behind what ails decentralization in the Philippines. Llanto (2012:1) argues for a "clearer and more accountable assignment of expenditure by eliminating particular sections of the [Local Government] Code, which serve as a route for national government agencies to be engaged in devolved activities, and for politicians to insert funding for pet projects, which distort local decision making and preferences." In particular, Llanto identified certain departments (e.g. Agriculture and Health) which continued to maintain large bureaucracies despite being devolved. Sections 17c and 17f of the Local Government Code, combined with Executive Order 53

[4] See among others ADB (2005), Dela Rosa Reyes (2016), Llanto (2012) and Mendoza et al (2016).

provided “national government agencies the excuse to implement devolved public works and infrastructure projects and other facilities, programs, and services provided these are funded under the General Appropriations Act (GAA), other special laws, pertinent executive orders, and those wholly or partially funded from foreign sources (ibid: 9).” These loopholes also provided opportunities for corruption as legislators in charge of budget oversite could collude with their local government counterparts in order to place insertions in the budget. Indeed, the political economy of this budgeting environment encouraged continued dependence on spoils from the budget, rather than developing greater fiscal autonomy for local area development.[5]

Moreover, extensive analyses of fiscal indicators suggest very mixed results as far as efforts to achieve enhanced fiscal autonomy. Manasan (2005), for instance, examined data on fiscal indicators (e.g. own source revenues, fiscal transfers, etc) spanning 1985-2003 and found inconsistent results in this area. First, the resources needed for the devolved functions (including some added on to the LGUs over time) did not match the resources provided to the LGUs, suggesting vertical fiscal imbalance. Provinces, municipalities, cities and barangays accounted for 37 percent, 39 percent, 6 percent and 19 percent of the total cost of devolved functions. However, the mandated share of the LGUs of IRA was 23 percent for provinces, 34 percent for municipalities, 23 percent for cities and 20 percent for barangays, suggesting that only in cities were the figures relatively better matched (ibid:77).

In addition, the mismatch between revenue means and expenditure needs across various levels of local government appears to have worsened over the period of Manasan’s study, at all level of local government (e.g provincial, city and municipal). The fiscal deficiency for all LGUs grew from around 7 percent in 1985-1991 to almost 17 percent by 1992-2003 (ibid:74). Finally, horizontal fiscal balance—the balance achieved across jurisdictions through appropriately calibrated transfers—also failed to improve over time. If all LGUs are aggregated at the provincial level, the per capita IRA was positively correlated with per capital household income in 1995-1999. This implied that the transfers were counter-equalizing, from the point of view of the LGUs’ fiscal

[5] Llanto (2012) further added that the tax assignment also needs to be reviewed, in order to offer more revenue generating options for LGUs.

capacities (ibid:80).

Hence, on enhancing both vertical and horizontal fiscal balance over time, the evidence suggests deterioration over time. Section 2 of this paper examines these indicators using updated and comprehensive data; and it also shows how many LGUs failed to improve their fiscal situation over the decentralization period.

B. *Political Inequality and Public Finance*

Furthermore, as noted earlier, decentralization has not always produced development-oriented local leadership. Indeed, decentralization has ushered the entry of stellar leadership by the likes of Jesse Robredo; but also debilitating impunity such as that of Andal Ampatuan.

Increasingly, leadership patterns in Philippine local government reflect the dominance of a few—notably from political clans that have amassed both name-recall, political capital and wealth over time—signaling weaker democratic competition and greater political inequality (between the politically powerful and their constituents) in many parts of the country. Analysts trace the emergence and persistence of political dynasties from a variety of factors. Some point to name recall and incumbency advantages that easily translate into self-perpetuation.[6] Stark inequality in socio-economic conditions and the absence of a truly democratic electoral and party system also contributes to a weakness in the supply of non-dynastic leadership options, as well as the higher demand for patrons.[7] As regards the latter, a generally weak institutional environment combined with low human development and high deprivation among a significant swathe of the population further fueled the demand for local patrons, feeding into the political strength of these local elites. And even as political dynasties won by higher margins of victory and tended to be wealthier on average (Mendoza et al 2012),

[6] Querubin (2016), for instance, examined Philippine leadership data spanning 1946 to 2010; and he found that over 50 percent of legislators in the Philippine Congress and Philippine governors have a relative who was also in Congress or served as a governor in the previous 20 years. His empirical analysis suggests that the ability to self-perpetuate by Filipino legislators elected in the 1990s was three times higher than that of legislators in the United States.

[7] And even as political dynasties won by higher margins of victory and tended to be wealthier on average (Mendoza et al 2012), they also proliferated in the poorest parts of the country, with some of the lowest per capita incomes, highest infant mortality and weakest primary education outcomes (Collas-Monsod et al 2004).

they also proliferated in the poorest parts of the country, with some of the lowest per capita incomes, highest infant mortality and weakest primary education outcomes (Collas-Monsod et al 2004).[8] And provinces with weak political competition—as signaled by the proliferation of political clans—also demonstrated the weakest income growth and lowest human development outcomes.

The empirical literature suggests that weak political parties and strong political clans tend to produce skewed resource allocations, not necessarily in favor of development goals. Instead, clan ties tend to figure prominently.

Ravanilla (2015) for example, examined data on Philippine Development Assistance Fund (PDAF or more commonly known as "pork barrel") allocations among legislators in 2001, 2004, 2007 and 2010 elections years; and he found that disbursements were made in favor of mayoral partisan allies and members of the same political clan.

Similarly, Atkinson, Hicken and Ravanilla (2015) studied Philippine legislators' allocations of post-typhoon reconstruction funds to municipal mayors using data from 2001-2010. They found evidence that political ties—notably belonging to the same political clan as the local officials—tended to increase reconstruction funds channeled by legislators to municipalities. These authors advocated for limits on discretion, in order to control against political influence over disaster reconstruction funds.

Political clans have also found ways to expand their public finance footprint through gerrymandering. Since the introduction of the Local Government Code, the number of Philippine cities has more than doubled from 60 in 1990 to 122 by 2010. Capuno (2013) examined the correlates of the growth in the number of Philippine cities from 2001 to 2010, using a dataset including fiscal, demographic, socioeconomic and political variables. Based on a model of the decision to convert to city-hood, he found empirical evidence that political payoffs—such as the incumbent mayor's re-election or a political clan member elected to the new city office—are strong predictors of the creation of new cities.

Furthermore, in a forthcoming report by the World Bank, the authors examined the allocation of Philippine road infrastructure budgets in the aftermath of PDAF (aka

[8] For further readings, the reader may turn to Balisacan and Fuwa (2004), Collas-Monsod et al (2004), Hutchcroft and Rocamora (2003), Mendoza et al (2012), Solon et al (2009) and Teehankee (2001a;2001b;2007).

pork barrel) abolition. They analyzed the factors linked to different road investment portfolios covering over 7000 individual road projects, by regressing these allocations on variables capturing several possible dimensions, notably: a) poverty (e.g. small area poverty estimates at the municipality level), b) productivity (e.g. proportion of barangays with access to transportation with higher capacity; proportion of barangays with access to a highway) and c) political (e.g. affiliation by party and affiliation by clan or family, more commonly known as political dynasty).

The empirical analysis revealed very interesting differences in road budget allocation patterns. Farm to market (FMR) roads allocated under the government's bottom up budgeting (BUB) portfolio tended to go to poorer areas (no doubt due to the targeting mechanism integrated in that portfolio); however, the regular FMR allocations in the main budget seemed to go to municipalities with already better road infrastructure. It was also the road portfolio most affected by political variables. In municipalities whose Mayor shared the same political party as the legislator (aka Congressman), they were 4.3 percentage points more likely to receive road allocations compared to the average municipality. In those municipalities whose Mayor shared the same party as the legislator and the President, they were 8.3 percentage points more likely to receive road allocations.

Meanwhile, municipalities whose mayor was from the same political clan as any legislator in the province, these were 14.3 percentage points more likely to receive a farm to market road allocation from general appropriations. The authors acknowledged how the effect of political dynasty affiliation seemed much stronger than the effect of political party affiliation, confirming the weakness of political parties in the Philippines and the strength of familial relations in politics and public finance (Clarete el al 2016).

Under these conditions of skewed public finance allocations and stagnating fiscal autonomy, it is less surprising that stronger progress and development in the countryside has proven elusive, notably where political inequality (read: political clans) have been most entrenched. Mendoza, Beja, Venida and Yap (2016) examined the impact of political clans on poverty across Philippine provinces, utilizing an extensive dataset on political clans spanning 2001 to 2013. They found empirical evidence that the expansion of political clans led to deeper poverty incidence at the provincial level; and that this effect is stronger among provinces that are farther from imperial Manila.

Piecing together the empirical literature, the emerging evidence suggests that strong patronage politics at the local level (as signaled by the continued expansion of political dynasties) is matched by a perverse center-periphery relationship that skews national and local public finance in favor of perpetuating political power among dynastic clans. The next section elaborates on further evidence, drawing on the latest local public finance data.

3. Review of Fiscal Independence Data, 1992-2015

Fiscal decentralization can take many forms but the underlying concept is that it involves devolving revenue generating and spending power from the national to the local government units. In conjunction with the added responsibilities, the Local Government Code enables LGUs to expand their sources of financial resources. Resources are enhanced thru taxing powers at the local level, and increased national assistance to local governments primarily through the internal revenue allotment (IRA). Nevertheless, the attempt to match local resources with the expanded mandate has proven more and more elusive over time. Although local governments possess the legal authority to impose taxes, dependence on central government allocation appears to have become relatively more ingrained over time, instead of attaining fiscal autonomy.

The IRA dependency ratio—measured by the share of IRA in an LGU's total financial resources—provides a useful benchmark on relative fiscal autonomy over time. Looking at the IRA dependence rates of each local government unit from 1992-2015, a majority of the provinces, cities, and municipalities depend on the IRA for more than 50% of their budgets. Further, a significant number of these LGUs rely on IRA for more than 90% of their local budgets. Hence, local governments came to depend heavily on fiscal transfers from the central government.

How independent are the LGUs from the central government?

Table 1. IRA Dependency Rates of Provinces

	1992 (of 73)	1995 (of 77)	2000 (of 77)	2005 (of 80)	2010 (of 81)	2015 (of 81)

< 50%	5	2	1	2	2	1
> 50%	68	75	76	78	79	80
> 90%	21	22	27	30	20	20

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by >50% and >90% are not mutually exclusive.

Table 2. IRA Dependency Rates of Cities

	1992 (of 60)	1995 (of 65)	2000 (of 81)	2005 (of 117)	2010 (of 121)	2015 (of 144)
< 50%	12	16	21	33	32	41
> 50%	48	49	60	84	89	103
> 90%	2	5	3	11	11	14

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by >50% and >90% are not mutually exclusive.

Table 3. IRA Dependency Rates of Municipalities

	1992 (of 1465)	1995 (of 1546)	2000 (of 1441)	2005 (of 1500)	2010 (of 1491)	2015 (of 1485)
< 50%	147	100	60	80	109	65
> 50%	1318	1446	1381	1420	1382	1420
> 90%	281	547	615	640	650	620

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by >50% and >90% are not mutually exclusive.

Under the decentralization process, increased responsibility for the local governments in terms of local public goods and services provision imply an increase in their expenditure responsibility. However, the local government's own revenues were not strengthened to meet the expanded expenditures.

The Internal Financing Ratio (or IFR)—defined as the total income from recurring own-source revenues divided by the total operating (or non-investment) expenditures—provides an indicator of the LGU's ability to sustain its expenditure level based on its recurring own-source revenues. A higher value indicates the LGU's greater ability to finance its own spending. Looking at the historical data, only a small number of provinces, cities, and municipalities have an IFR of more than 50%. In fact, only 5 of 81 (roughly 0.6 in 10) provinces, 65 of 144 (roughly 4 in 10) cities and 107 of 1485 (around 0.7 in 10) municipalities in 2015 attained an IFR greater than 50 percent.

Can LGUs finance their own expenditure?

Table 4. Internal Financing Ratio of Provinces

	1992 (of 73)	1995 (of 77)	2000 (of 77)	2005 (of 80)	2010 (of 81)	2015 (of 81)
> 50%	7	2	3	1	8	5
< 50%	66	75	74	79	73	76
< 10%	18	24	23	34	20	12

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by <50% and <10% are not mutually exclusive.

Table 5. Internal Financing Ratio of Cities

	1992 (of 60)	1995 (of 65)	2000 (of 81)	2005 (of 117)	2010 (of 121)	2015 (of 144)
> 50%	17	17	23	34	47	65
< 50%	43	48	58	83	74	79
< 10%	2	5	4	12	9	8

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by <50% and <10% are not mutually exclusive.

Table 6. Internal Financing Ratio of Municipalities

	1992 (of 1465)	1995 (of 1546)	2000 (of 1441)	2005 (of 1500)	2010 (of 1491)	2015 (of 1485)
> 50%	150	92	70	55	70	107
< 50%	1315	1454	1371	1445	1421	1378
< 10%	295	592	623	700	681	559

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by <50% and <10% are not mutually exclusive.

A core component of fiscal decentralization is financial responsibility. Local governments must have an adequate level of revenues to perform its functions. The ratio of the local income over the total income refers mainly to the percentage of revenues that the LGU collects itself. Local revenues include local taxes on real properties and businesses, service charges, fees and licenses, etc. A low indicator may mean that the LGU has not maximized its taxing powers or collection efficiency. Moreover, by default, it also indicates high reliance on external sources such as the IRA and other grants. For 2005, 2010 and 2015, not a single province generated more than 50% of their own income. Only few local government units generated at least half of their income—26 of 1485 municipalities and 32 of 144 cities in 2015. The bulk of cities and municipalities have local revenue ratios of less than 50% of its total income. Meanwhile, a significant number of local government unites have local revenue accounting for less than 10% of their total income—21 of 81 provinces, 16 of 144 cities and 757 of 1485 municipalities.

Can they generate their own income?

Table 7. Local Revenue Ratio of Provinces

	1992 (of 73)	1995 (of 77)	2000 (of 77)	2005 (of 80)	2010 (of 81)	2015 (of 81)
> 50%	4	1	1	0	0	0
< 50%	69	76	76	80	81	81
< 10%	23	26	23	41	31	21

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by <50% and <10% are not mutually exclusive.

Table 8. Local Revenue Ratio of Cities

	1992 (of 60)	1995 (of 65)	2000 (of 81)	2005 (of 117)	2010 (of 121)	2015 (of 144)
> 50%	12	16	21	27	28	32
< 50%	48	49	60	90	93	112
< 10%	2	5	4	14	17	16

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by <50% and <10% are not mutually exclusive.

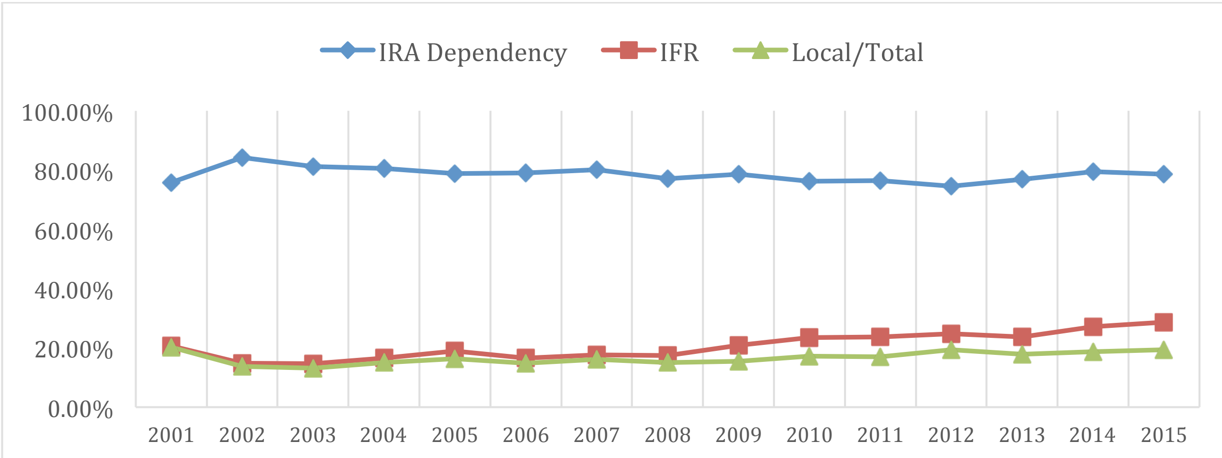
Table 9. Local Revenue Ratio of Municipalities

	1992 (of 1465)	1995 (of 1546)	2000 (of 1441)	2005 (of 1500)	2010 (of 1491	2015 (of 1485)
> 50%	125	76	56	33	28	26
< 50%	1340	1470	1385	1467	1463	1459
< 10%	338	612	660	781	799	757

Source: Authors' calculations based on data from the BLGF.
Note: The groups indicated by <50% and <10% are not mutually exclusive.

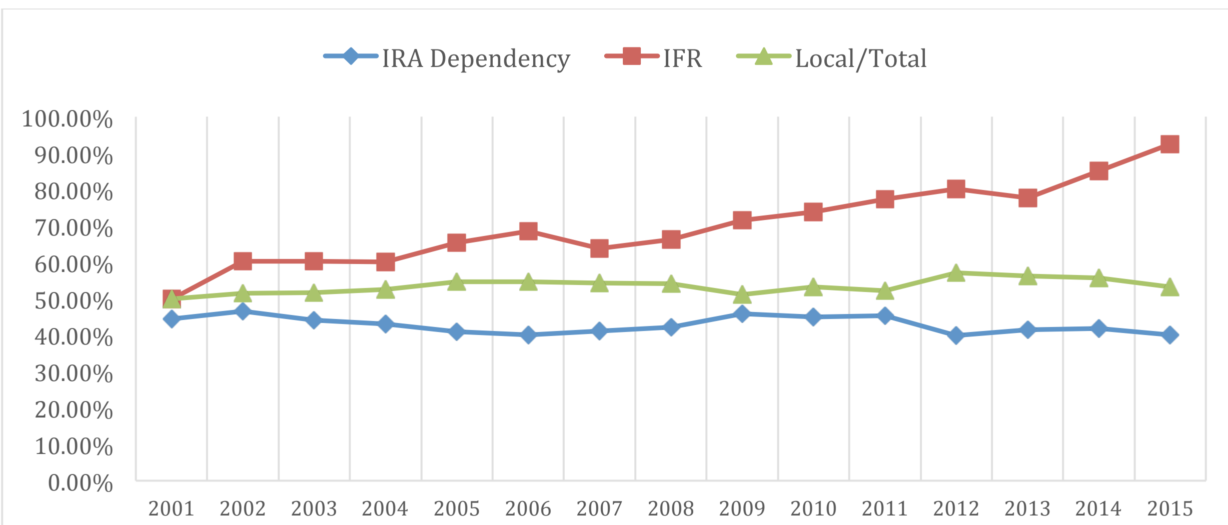
Looking at the historical data of each fiscal independence indicator averaged for each local government unit from 2001 to 2015, IRA dependency of provinces and municipalities fluctuate around 80 percent while cities have significantly lower dependency rates at around 40 percent. IFR and local revenue ratio of provinces and municipalities remain at low levels at about 20 percent, while a remarkably higher IFR and local revenue ratio are observed only for cities.

Figure 1. Fiscal Indicators for Provinces



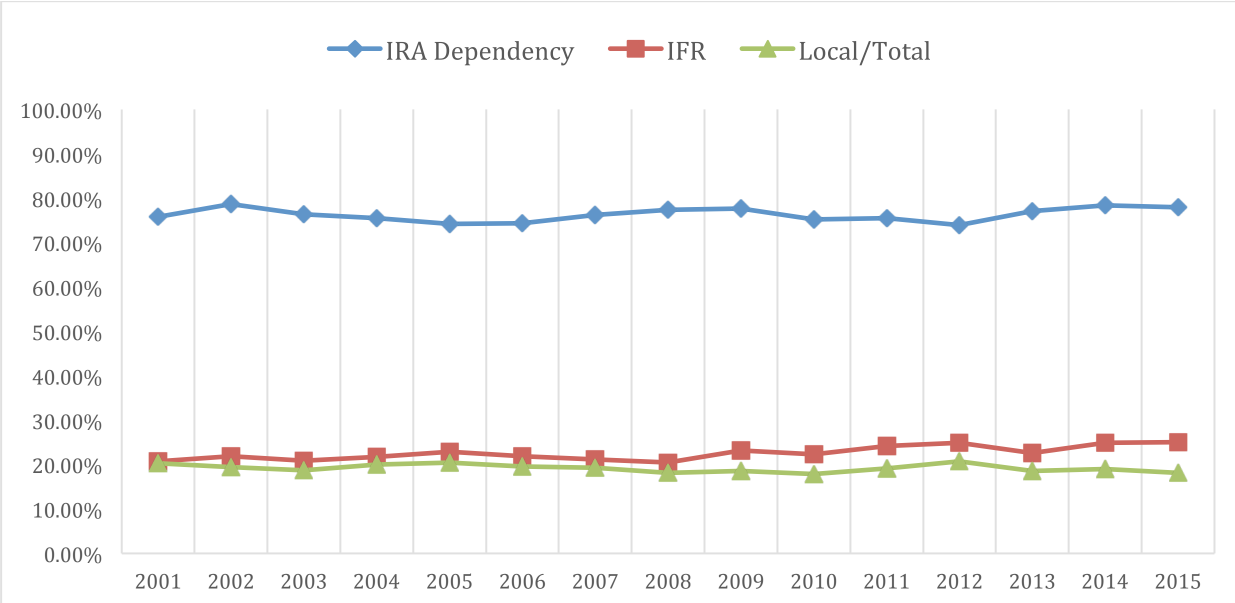
Source: Authors' calculations based on data from the BLGF.

Figure 2. Fiscal Indicators for Cities



Source: Authors' calculations based on data from the BLGF.

Figure 3. Fiscal Indicators for Municipalities



Source: Authors' calculations based on data from the BLGF.

A. Does IRA weaken fiscal autonomy?

If the Philippine decentralization were to be made successful, there should be clear expenditure and tax revenue assignments between the local and national governments. Given the features of the intergovernmental fiscal relationship in the Philippines, the fiscal capacity of local governments is greatly influenced by that of the central government. The nature of the grant given to the LGUs which is embedded in the provision of the LGU Code itself – a formula-based and automatically released grant unrelated to the cost of delivering devolved functions has also faced criticism.

Previous studies—such as by Manasan (2005) and Llanto (2012)—have also highlighted the lack of improvements in fiscal indicators for a vast majority of the country's local government units. Indeed, empirical work by Manasan (2005) reveals how increases in IRA (per capita) is associated with weaker progress in boosting local tax revenues. Manasan considers this part of a possible disincentive effect that IRA may have on the local governments' efforts to mobilize local resources and wean themselves away from IRA dependence.

We replicate that empirical exercise here, updating the dataset to extend from 2006 to 2012. Manasan's reduced form regression model examines the possible correlates of tax revenues, looking at measures of the local tax base (proxied by average family incomes) and the possible influence of transfers due to IRA. We add another variable to this—a measure of the prevalence of political dynasties—in order to examine the possible governance backdrop behind fiscal federalism. In previous research, measures of dynastic prevalence were used as proxies for political competition (or the lack thereof) as well as local governance (Balisacan and Fuwa 2004; Mendoza et al 2012;2016; Teehankee 2001a;2001b;2007).

The hypothesized effect of dynasties on fiscal autonomy could manifest in two different ways. First, many political dynasties are known to build their last names as "brands", associating successful government projects and popular reforms to themselves often with the view to continue this track record through their relatives. In the absence of strong political parties which could more effectively aggregate and continue these reform advocacies, dynastic politicians have filled the void by advancing themselves as a force for continuity and stability (Mendoza et al 2012;2016). Hence, dynastic politicians might be expected to continue and build on top of reforms across time—a necessary ingredient in improved fiscal autonomy.

On the other hand, the rise of many political dynasties could also signal a deterioration in democratic checks and balances, as well as an anti-competitive political environment wherein only a few political clans hold most of the political power, as well as the ability to competitively field political candidates. Here a high concentration of political power signaled by the rise of political dynasties—notably "fat dynasties" or those clans whose members simultaneously hold many political positions notably at the local government level—could be an indicator of weaker accountability and increasing impunity. Because of these two potentially competing effects, the possible relationship between political dynasties and local fiscal autonomy is an empirical question.

The appendix to this paper presents the main empirical results of the abovementioned regression model. Over-all the results show that higher IRA (expressed in per capita terms) is associated with weaker tax revenues. Predictably, a growing tax base signaled by higher average family incomes is associated with stronger tax revenues.

Interestingly, the share of political dynasties in total local government leadership at the province level is associated with improvements in total tax revenues. This could be due to the reputation building and reform continuity possibilities that we acknowledged some dynastic clans may be pursuing. Nevertheless, when we turn to a measure of fat dynasties (proxied by the size of the largest political clan in the province) the results show a negative relationship between dynasties and fiscal autonomy. This tends to suggest that at some level, political clan size is negatively associated with improved fiscal autonomy, likely due to the weakened accountability and political competition that it entails.

B. How might proposed federal states fair?

Today, there's an increasingly popular discussion about shifting from a unitary to a federal government. While advocates see federalism as an avenue to bring economic development to the countryside, critics point to the mixed results of decentralization as a possible signal of continued challenges under full-fledged federalism. Should we adopt federalism? Or just reform the current system? A review of the fiscal performance of selected proposed federal states could help illustrate possible mixed results.

In his proposal for a federal Republic of the Philippines, former Senate President Aquilino Pimentel Jr is eyeing the creation of 11 federal states. The proposed federal states are as follows:

- Luzon: 4 states (Northern Luzon, Central Luzon, Southern Tagalog, Bicol)
- Visayas: 4 states (Eastern Visayas, Central Visayas, Western Visayas, and Minparom)
- Mindanao: 3 states (Northern Mindanao, Southern Mindanao, and Bangsamoro)

The Federal State of Bangsamoro rose from the remnants of the ARMM. Looking at the fiscal performance of its cities compared to the national average, all of its cities are performing below average in terms of the fiscal independence indicators per respective income classification. Thus this federal state can be expected to depend on central government transfers for some years to come. It is unlikely that federalism per se will change this dramatically.

Table 10. Federal State of Bangsamoro Cities' Fiscal Performance, 2015

Class	Province	IRA Dependency	Local/Total	IFR	Performance
3rd Class	COTABATO CITY	81.88%	18.12%	22.96%	Below National Average
4th Class	ISABELA CITY	94.38%	5.58%	7.04%	Below National Average
	MARAWI CITY	86.05%	0.48%	0.68%	Below National Average
6th Class	LAMITAN CITY	95.01%	4.76%	6.33%	Below National Average

Source: Authors' calculations.

Table 11. Federal State of Northern Luzon Cities' Fiscal Performance, 2015

Income Class	City	IRA Dependency	Local/Total	IFR	Performance
Unclassified	ILAGAN CITY	84.62%	12.09%	16.16%	Below National Average
1st	BAGUIO CITY	37.92%	48.67%	83.63%	Below for IFR and Local/Total; Above for IRA Dependency
	SANTIAGO CITY	83.74%	16.26%	29.90%	Below National Average
2nd	DAGUPAN CITY	51.19%	48.65%	73.53%	Above National Average
	URDANETA CITY	46.90%	53.10%	86.37%	Above National Average
3rd	CAUAYAN CITY	69.69%	30.31%	40.11%	Below for IRA Dependency and IFR; Above for Local/Total
	LAOAG CITY	49.16%	38.94%	55.50%	Above National Average
	SAN CARLOS CITY (PANGASINAN)	81.73%	17.53%	27.64%	Below National Average
	SAN FERNANDO CITY (LA UNION)	60.42%	37.28%	46.56%	Above for IRA Dependency and Local/Total; Below for IFR
	TUGUEGARAO CITY	57.20%	42.56%	79.02%	Above National Average
4th	ALAMINOS CITY	77.75%	22.20%	32.50%	Above National Average
	CANDON CITY	59.54%	17.88%	29.41%	Below for IFR and Local/Total; Above for IRA Dependency
	VIGAN CITY	60.66%	34.98%	54.42%	Above National Average
5th	BATAC CITY	77.52%	22.22%	65.53%	Above National Average
	TABUK CITY	93.46%	6.44%	11.22%	Below National Average

Source: Authors' calculations.

Meanwhile, a majority of the cities in the Federal State of Northern Luzon are performing above average on different fiscal independence indicators. If federal groupings are made in such a way that component provinces, cities, and municipalities are performing above average, then the federal state has a fighting chance to be more fiscally autonomous. If on the other hand the grouping is made in a such a way that all units are performing below average, then the federal state is likely to face an uphill climb. One of its possible advantages, however, is the expanded taxable jurisdiction which could offer better economies of scale on development programs, compared to the present highly fractionalized setup of LGUs.

Clearly, the current decentralized system has not been successful in making the LGUs more financially responsible. Instead, LGUs became more dependent on the central government in financing its expenditures. But changing the system entirely entails significant costs. If not designed properly, the new proposed system might produce unintended consequences similar to what transpired since the introduction of the Local Government Code.

4. Towards a New Fiscal Federalism

Addressing some of the failures of decentralization requires a careful recalibration of central-local fiscal relations towards a new fiscal federalism for the country. While the following details are not exhaustive of the economic and political reforms necessary, we outline a few possible areas for focusing reforms, in order to set the stage for greater accountability aligned with enhanced access to resources for LGUs.

To begin, the empirical evidence clearly shows how the system of intergovernmental transfers in the Philippines has not succeeded in boosting fiscal autonomy. The number of local government units that have become dependent on central-to-local transfers has increased across the board. And the empirical patterns indicate that transfers seem to encourage dependence rather than build towards fiscal autonomy over time.

Drawing insights from the foreign aid governance literature, it might be possible to devise alternative fiscal arrangements that would incentivize “graduation” to higher levels of fiscal autonomy. For instance, Collier (2005) outlined a possible aid disbursement strategy that would begin low income and poor governance countries with grants that could be conditioned on governance reforms. And as these reforms are accomplished, and governance improves (as measured by the Country Policy and Institutional Assessment, an indicator developed by the World Bank[9]), conditions could be relaxed and the country could then graduate to tap concessional loan programs, and eventually, towards accessing the international financial markets. Throughout this graduated development financing scheme, the country is expected to mobilize ever higher levels of resources from the international community, incentivizing the upward graduation away from conditionalities, and towards stronger governance and greater access to resources.

In order to align incentives towards greater accountability to match higher access to resources, we think it would be possible to design a similar graduation mechanism for local governments. In lieu of automatic intergovernmental transfers based on a rigid formula like IRA, local government units with low income and relatively weak governance track records[10] could be given access to conditional grants. The conditions could then be geared towards addressing governance conditions or improving allocations towards chronic poverty challenges. And as local government units move to a slightly better governance track record and slightly higher income levels, they could be given access to unconditional (or less conditional) grants and matching grants.

Hence, the goal here is to provide more flexibility in managing local public finance decisions as governance track records become more established, and as reforms are built continuously over time. Finally, local government units that manage to reach the highest rungs in terms of governance and income level indicators could then begin to develop and access debt instruments, including the development of possible municipal bond markets. In addition to capital grants, the latter are critically important sources of infrastructure finance in many federal systems (Boadway and Shah 2007).

In practice, grant mechanisms in federal systems can be designed with a range of features in order to incentivize better compliance with standards of service delivery, as well as minimize the possible crowding out of local resource mobilization. For instance,

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[9] For more details, see http://data.worldbank.org/data-catalog/CPIA.

[10] This could be based on objective and measurable indicators on governance reforms such as transparency practices and favorable audit reports by the Commission on Audit.

output based grants to local jurisdictions are often used to encourage competition and innovation, and improve results-based accountability to citizens at the local level. Conditions are attached to outputs instead of outcomes, given that the latter can involve a variety of factors not fully within the control of the local government. In addition, fiscal equalization programs can include this conditional transfers, marrying performance orientation with equity objectives. For instance, central to provincial/local government transfers for primary education and transportation in Indonesia, per pupil grants to schools and grant bonuses for best performing schools and their teachers as well as grants to municipal governments to subsidize water and sewer access for the poor in Chile, per capita transfers for education in Colombia and South Africa, and primary and secondary education per pupil transfers to states in Brazil (Shah 2007).

One can draw on these rich experiences to create a better architecture for the Philippines' fiscal federalism. A better fiscal federalism could offer a way out of the perverse center-periphery relationship that characterizes much of the country's public finance.

Appendix: Analysis of the Correlates of Local Tax Revenues

We empirically examined the possible factors linked to local tax revenue patterns during part of the decentralization period from 2006-2012. The analysis attempts to update and adapt a similar analysis by Manasan (2005) using earlier data. We turned to a panel data of 79 provinces (i.e. 2 new provinces, Dinagat Islands and Davao Occidental, were excluded due to unavailability of data) that were observed in three periods: 2006, 2009 and 2012. Owing to our interest in examining the possible link to dynastic leadership patterns, and due to the data availability for this factor, the resulting panel dataset covered only part of the decentralization period.

Six regression models estimated the effects of potential correlates to per capita local tax revenues, per capita real property tax and per capita business tax. A panel fixed effects model (as opposed to random effects model) was used since this procedure controlled for the inherent unobserved variation among provinces that would potentially impact the dependent variable and predictors. This reduces the risk of endogeneity and potential omitted variable bias to effectively analyze the net effect of the predictors to the dependent variable. The procedure utilized the following models:

$$pctr_{it} = \alpha_i + \beta_1 pcira + \beta_2 aveinc_{it} + \beta_3 dynshare_{it} + U_{it}$$
$$pctr_{it} = \alpha_i + \beta_1 pcira + \beta_2 aveinc_{it} + \beta_3 dynlar + U_{it}$$
$$pcrpt_{it} = \alpha_i + \beta_1 pcira + \beta_2 aveinc_{it} + \beta_3 dynshare_{it} + U_{it}$$
$$pcrpt_{it} = \alpha_i + \beta_1 pcira + \beta_2 aveinc_{it} + \beta_3 dynlar + U_{it}$$
$$pcbt_{it} = \alpha_i + \beta_1 pcira + \beta_2 aveinc_{it} + \beta_3 dynshare_{it} + U_{it}$$
$$pcbt_{it} = \alpha_i + \beta_1 pcira + \beta_2 aveinc_{it} + \beta_3 dynlar + U_{it}$$

$$where\ i = 1,2, \ldots 79;\ t = 1, 2, 3$$
$$\alpha_i = unknown\ intercept\ \ for\ each\ province$$
$$U_{it} = error\ term$$

pctr = Per capita provincial local tax revenues
pcrpt=Per capita provincial real property tax revenues
pcbt=Per capita provincial business tax revenues
pcira=Per capita provincial internal revenue allotment
ave_famincome=Average family income
dynshare=Share of political dynasties out of the total local government leaders in the province
dynlar=Size (number of family members in elective office) of the largest political clan in the province

The regression results showed a significant and positive association between average family income and per capita tax revenue at the provincial level. This confirmed that local tax revenue was linked to constituents' capacity to pay. The dynastic share variable (expressed as a proxy for the measure of political dynasties prevalence in the province) had a positive and statistically significant link to tax revenue. On the other hand, the share of the size of largest political clan displayed a negative association with local tax revenue. This appeared to validate the hypothesis that political dynasties may help develop fiscal independence at lower dynastic prevalence levels (due possibly to their ability to continue policies over time); but at some point when dynastic prevalence becomes very large, these dynastic clans could also impede healthy political competition, weakens checks and balances, and undermine fiscal autonomy in the long run.

Table 1. Regression on per capita tax revenue

	pctr	pctr	pctr	pctr
Pcira	0.008	0.007	-0.007	0.002
	(0.008)	(0.008)	(0.008)	(0.007)
ave_famincome		0.0004***	0.0003**	0.0005***
		(0.00009)	(0.0001)	(0.00009)
dynshare			1.124	
			(0.594)*	
dynlar				-8.177*
				(4.89)
constant	54.747***	-16.56	-21.567	-0.283
	(9.05)	(16.28)	(16.36)	(18.89)
R^2	0.82	0.84	0.85	0.85
N	237	237	237	237

** Statistically significant at α=0.10;*
*** Statistically significant at α=0.05;*
*** *Statistically significant at α=0.01;*
values in parenthesis () are standard errors

Estimated regression models in Tables 2 and 3 suggest that an increase in internal revenue allotment had a positive effect on the real property tax but yielded a negative impact on the business tax revenue. This would explain why internal revenue allotment yielded an insignificant effect on the total local tax revenue. Furthermore, the effect of dynastic share and size of largest dynastic political clan was statistically significant for business tax revenues and appeared less relevant for real property tax revenues.

Table 2. Regression on per capita real property tax

	pcrpt	pcrpt	pcrpt	pcrpt
pcira	0.023**	0.018**	0.014*	0.018**
	(0.007)	(0.007)	(0.008)	(0.007)
ave_famincome		0.0003***	0.0002*	0.0003***
		(0.00009)	(0.0001)	(0.00009)
dynshare			0.581	
			(0.576)	
dynlar				-5.066
				(4.728)
constant	26.365**	-21.116	-23.704	-11.032
	(8.369)	(15.667)	(15.864)	(18.261)
R^2	0.79	0.8	0.8	0.8
N	237	237	237	237

** Statistically significant at α=0.10;*
*** Statistically significant at α=0.05;*
*** *Statistically significant at α=0.01;*
values in parenthesis () are standard errors

Table 3. Regression on per capita business tax

	pcbt	pcbt	pcbt	pcbt
pcira	-0.016***	-0.017***	-0.021***	-0.017***
	(0.002)	(0.002)	(0.002)	(0.002)
ave_famincome		0.0001***	0.0002	0.0001***
		(0.00002)	(0.00004)	(0.00002)
dynshare			0.559**	
			(0.164)	
dynlar				-2.401*
				(1.38)
constant	24.804***	8.167	5.676	12.946
	(2.498)	(4.603)	(4.512)	(5.337)**
R^2	0.59	0.63	0.65	0.63
N	237	237	237	237

** Statistically significant at α=0.10;*
*** Statistically significant at α=0.05;*
*** *Statistically significant at α=0.01;*
values in parenthesis () are standard errors

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