



2 Breaking Down the LGU Fiscal Performance

A Study on the Budget Utilization Rate

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“...the increased funds of the LGUs due to the Mandanas ruling, without any institutional or structural improvements, will result in the decrease in budget utilization and delay in service delivery and program implementation....Policy, institutional and structural reforms need to be implemented to make decentralization truly work for sustainable development.”



Ground breaking ceremony of the Support to the Barangay Development Program (SBDP) projects at Digos City, Davao del Sur on October 27, 2021. Photo by: DILG Region XI

1. Introduction

Local government units (LGUs) play a significant role in a decentralized system. The Local Government Code of 1991 (LGC) aims to enable local government units to achieve “genuine and meaningful local autonomy.” This is to allow communities to achieve full development. To operationalize this, powers, functions, responsibilities, and resources are allocated between the national government and the various LGUs.

The recent ruling of the Supreme Court on the Mandanas-Garcia petition is a very important consideration in improving decentralization in the country. The decision expanded the bases of the computation of the national tax allotment (NTA) of LGUs. The NTA level for FY 2022 is 263,548,501,000 or 37.89% higher than FY 2021 shares of LGUs (DBM, 2021a). While this is a step towards meaningful decentralization, this development does not necessarily correct the inequitable distribution of the IRA and of fiscal responsibilities. Moreover, this threatens the fiscal sustainability of the national government: thus, the latter has opted to manage the risk by reducing spending on functions already devolved by law to LGUs (The World Bank, 2021).

The Mandanas-Garcia decision nevertheless provides a much-needed infusion of resources to LGUs. Such resources are a windfall that, if used properly and swiftly, bolsters the capability of LGUs to combat the triple threat of the COVID-19 pandemic, climate-related disasters, and conflicts, especially in Mindanao. In the face of these crises, adequate local investment in resilience-building and disaster risk reduction, infrastructure, and social development would be necessary for the Philippines to catch up on its Sustainable Development Goals (SDGs) targets.

However, the ability of LGUs to put their limited resources to use remains wanting. From 2015 to 2018, LGUs on average, utilized about 78 percent of their annual budgets and 64 percent of their capital outlays allocations. Local Development Funds (LDF) and Local Disaster Risk Reduction and Management Funds (LDRRMF) likewise suffer from under-utilization at 82 percent and 59 percent, respectively. Experts explained that the Mandanas-Garcia ruling may likely lead to

lower budget execution rates given LGUs' current absorptive capacity. The vertical fiscal gap may worsen, and horizontal fiscal imbalances may persist (The World Bank, 2021).

Using panel data analysis, this study examines the various factors that are associated with the underspending patterns of LGUs. It specifically looks at the LGUs' budget utilization rates (BUR) and its relationship with the size and composition of their budgets, socio-economic indicators, fiscal management indicators including audit opinions, measures of disaster preparedness and vulnerability, and institutional indices. The study uses data on local finances and audits as compiled by the World Bank (2021), the Seal of Good Local Governance of the Department of the Interior and Local Government (DILG), the municipal and city level poverty estimates and population census of the Philippine Statistics Authority (PSA), and the housing vulnerability index (Healey, Lloyd, Gray, and Opdyke, 2022).

The objectives of the study are the following:

- i. To illustrate the extent of budget underutilization at the local level, generally and for key sectors, such as: infrastructure and disaster risk reduction;
- ii. To identify the factors that are most associated with LGU under-utilization and other key relationships between variables; and
- iii. To recommend further research and possible means to improve the efficiency and effectiveness of public spending and service delivery at the local level.

2. Background and Motivation

In 2019, the Supreme Court promulgated its decision in the case of *Mandanas v. Ochoa*. The decision stated that all national taxes regardless of source—whether collected by the Bureau of Internal Revenue (BIR) or Bureau of Customs (BoC)—should be included in the tax base used for computing the just share in the national taxes of the LGUs. Because of this decision, the IRA—now called the National Tax Allocation (NTA)—has increased by nearly 40 percent or by PhP264.2 billion from 2021 to 2022.

In response to this seminal decision, the national government adopted a policy of full meaningful devolution. Through Executive Order (E.O.) No. 138 issued in 2021, the national government directed all national government departments and LGUs to formulate Devolution Transition Plans (DTPs) which identify the functions and services to be devolved to LGUs, the transition period for such devolution to take place, and the necessary measures, including capacity building, to aid such transition.

This section briefly looks at the context of fiscal devolution and local fiscal performance prior to the seminal ruling.

The legal environment before *Mandanas-Garcia*

Local government units shall endeavor to be self-reliant and shall continue exercising the powers and discharging the duties and functions currently vested upon them, they shall also discharge the functions and responsibilities as are necessary, appropriate, or incidental to efficient and effective provision of the 'basic services and facilities enumerated therein.

- Local Government Code, Book I, Chapter II, Section 17(a).

After years of centralized authority, Republic Act No. 7160 or the Local Government Code (LGC) provided for the much-needed division of powers and laid out a host of policy areas that would be devolved to different tiers of LGUs. The LGC's most prominent feature is the devolution of substantial powers to LGUs "to bring development to the countryside." The LGC attempts to wean

local governments from dependence on the national leadership (Gatmaytan, 2001 p. 630).

To operationalize this through fiscal policy, the LGC stipulated that 40 per cent of tax revenues would be shared with LGUs to fund policy making and implementation (Sarah Shair-Rosenfield, 2016). At the same time, the LGC devolves

or “confers power and authority upon the various LGUs to perform specific functions and responsibilities (LGC Section 17(e)).” Devolved basic services are agriculture, health, social services, maintenance of public works and highways, and environmental protection (see Annex 2.1.). The extent of services to be devolved to them depends upon the nature of the local unit (Tapales, 1992).

Congress attempted to attain this objective by, among others, increasing the financial resources available to local government units. The Code broadens the taxing powers of local governments, provides them with a specific share from the national wealth exploited in their areas, and increases their share from the national

taxes - otherwise known as the Internal Revenue Allotment (IRA) (Gatmaytan, 2001 p. 631). While the LGUs were given the power to generate their own revenues, the more productive sources such as the income tax, value-added tax, and excise tax belong to the national government, dwarfing the revenues to be collected by LGUs (Guevara, 2000).

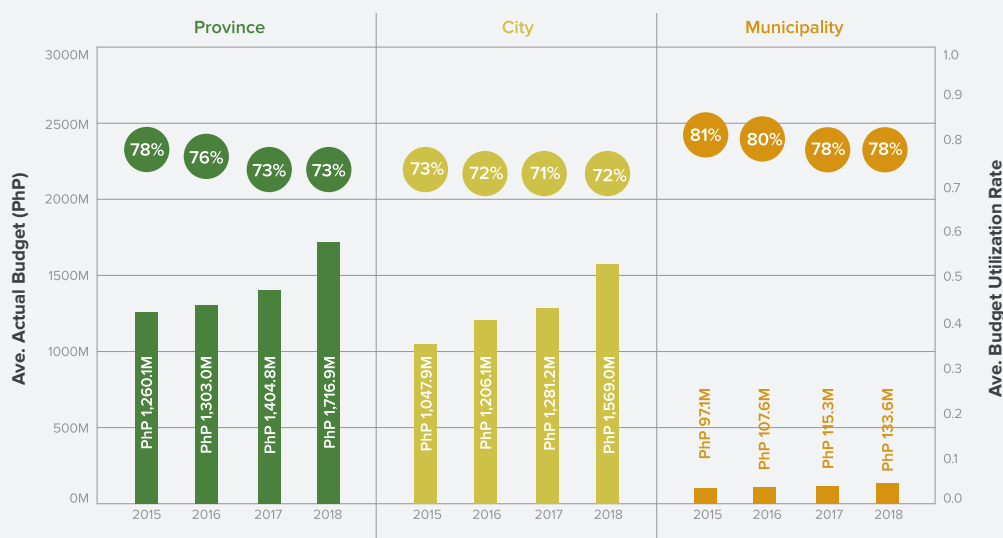
In the case of IRA and other mandatory shares, these are required by law to be automatically released to LGUs quarterly. These shares may not be reduced or impounded by the national government except when it experiences an unmanageable fiscal deficit (Guevara, 2000).

Local Government Underspending

“provinces, cities, and municipalities utilized only an average of 72%, 69%, and 78%, respectively, of their annual budgets from 2015 to 2018.”

Despite receiving a smaller portion of allocations from national taxes before the Mandanas-Garcia ruling, LGUs have not been able to fully utilize these transfers. In its analysis using a novel data set extracted from audit reports on LGUs’ finances, the World Bank (2021) found that provinces, cities, and municipalities utilized only an average of 72 percent, 69 percent, and 78 percent, respectively, of their annual budgets from 2015 to 2018. Under-utilization was worst in capital outlays. In disaster risk reduction, Domingo and Manejar (2018) also observed underspending of funds, short-term planning, and limited mainstreaming of DRR programs. Challenges in technical and financial absorptive capacity of LGUs were observed in other devolved mandates (The World Bank, 2021).

FIGURE 2.1. Average Budget Utilization Rate by LGU Type (2015-2018)



Authors' calculations using a data set compiled by the World Bank (2021)¹

The LGU underspending is the result of the lack of manpower and technical capacity to properly plan, prepare, implement and monitor projects and services (The World Bank, 2021). The absorptive capacity problem of the LGUs which leads to idle resources and delays in service delivery is expected to worsen with the implementation of the Mandanas Ruling (The World Bank, 2021).

However, Monsod (2016) pointed out that the relationship between budget disbursements and inclusive growth are not straight forward. She emphasized that disbursements are “far less important than how resources are used to increase efficiency, expand the productive capacity of the economy, and promote equity” (Monsod, 2016 p.5). At the national context,

Monsod (2016) explained that the reasons for underspending is not bureaucratic incompetence but because planned disbursements have been increasing at a faster rate than actual disbursements. The same may be said for local governments.

Aside from absorptive capacity, other issues that contribute to underspending include “non-alignment of priorities between national and local governments, unclear assignment of functions between national and local governments on fiscal transfers and support and LGU’s autonomy on fund utilization” (ULAP, 2016 p.10). Systemic problems in preparing and executing the budget which includes inflated budget estimation and unexpected price changes also contribute to the problem of underspending (Mamaradlo,

Tang, & Wong, 2021). Mamaradlo et al. (2021) argued that underspending will still occur even if limitations in receiving external funds and in spending on specific categories are removed.

Sicat, Mariano, Castillo, Adaro, and Maddawin (2019) also identified weak compliance with the prescribed planning-budgeting process and the need for stricter enforcement of development plans and substantiation of the prioritization of investment programs as the weaknesses of the local government planning and budgeting practices. These weaknesses may have contributed as well to the current state of the LGU fiscal performance.

Beyond Underspending: Fiscal Equity.

To address the imbalance of revenue assignment between national and local, Congress had decided that local governments should receive share from the collection of national taxes in the form of grants. Such allotments served various purposes (Guevara, 2000 pp. 99-100):

1. They are a means through which the national government subsidizes the delivery of local public services and ensures that a minimum level of basic services is delivered by LGUs.
2. Allotments can be used to adjust for disparities in fiscal capacities among LGUs.
3. Allotments can also be used to influence the fiscal behavior of LGUs. The national government may provide specific purpose allotments, which are tied up to priority programs.

The equity goal of the allotment system is far from accomplished, however. LGUs with more revenues from local sources, higher taxable capacity and more expenditure outlays are unfortunately provided with

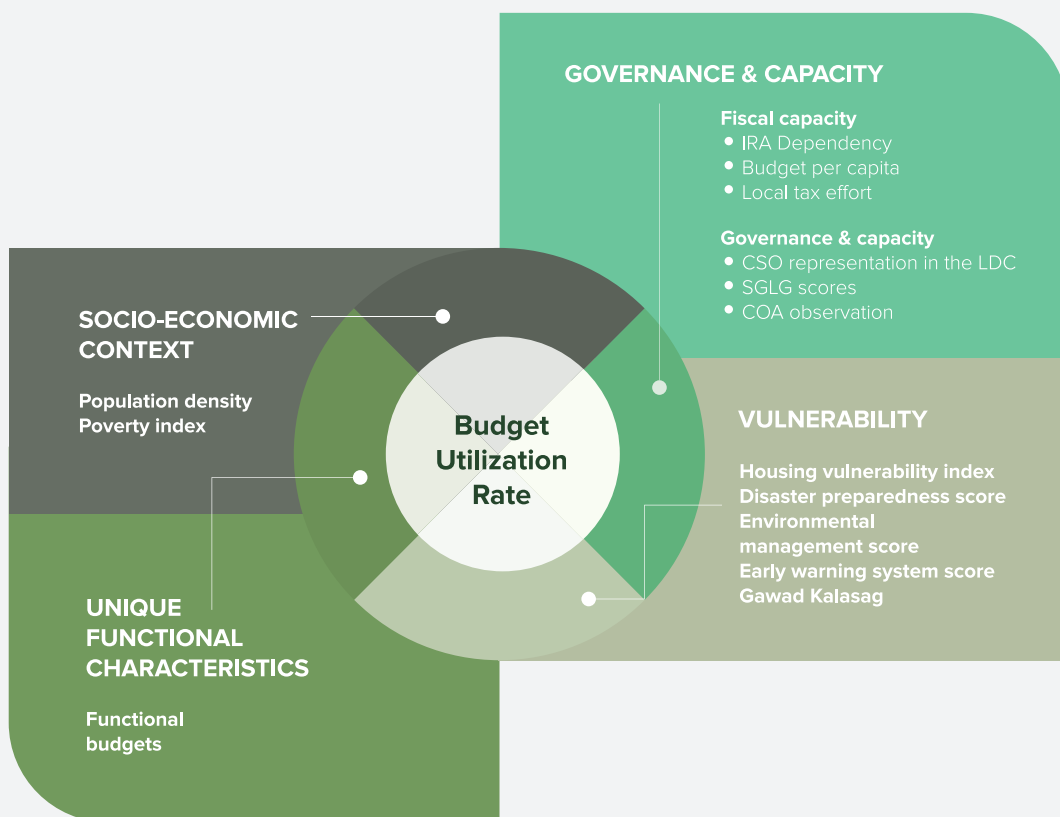
more grants, instead of resources being directed to LGUs that need them most (Guevara, 2000). The IRA distribution, after all, is designed around a formula based only on population, land area, and equal distribution. With an assured transfer, LGUs are not encouraged to generate their own resources locally. The grant formula does not incentivize LGUs to improve their revenue effort (Guevara, 2000).

Such has created a vertical fiscal imbalance, where LGUs have been largely dependent on IRA, which on average represents more than 60 percent of their revenues (The World Bank, 2021). This study's calculations show that municipalities have been most dependent on IRA with an 83 percent dependence rate, closely followed by provinces at 80percent. Provincial governments are affected by municipal level tax effort because they depend on municipal treasurers to collect provincial taxes (Guevara, 2000). Cities are the least dependent on IRA at 63 percent owing to their capability to generate not only real estate taxes, but also business taxes.

3. Analytical Framework

This study examines the relationship between the budget utilization rate of the LGUs and its sectoral budgets, socio-economic profile, financial performance indicators, governance indicators, competitiveness indicators, and vulnerability indicators. It tests the hypothesis that the budget utilization rate is a function of the LGUs' socio-economic characteristics, the inherent uniqueness of the programs and projects related to functions of the LGUs, the LGUs vulnerability and its management capacity. The diagram below summarizes this analytical framework and the indicators used to measure the various factors.

FIGURE 2.2. Analytical Framework



4. Data and Methodology

The Assembled Data Set

In its analysis of the fiscal impacts of the *Mandanas-Garcia* ruling, the World Bank (2021) assembled a novel data set on local government finances. Not only did it draw from Statement of Receipts and Expenditures (SRE)² of the Bureau of Local Government Finance (BLGF), but it also extracted data on approved budgets and actual spending from the LGU audit reports of the Commission on Audit (COA) from 2015 to 2018. The COA data allows for comparison of actual spending (or Actual Budget) against the approved budgets (or Final Budget) not only in the aggregate but also by sector (or function)³ and by expense class, i.e., Personal Services (PS), Maintenance and Other Operating Expenses (MOOE), Capital Outlays (CO), and Unclassified.

Added to this data set were population and poverty data from the PSA, key indicators from the Seal of Good Local Governance (SGLG) of DILG, and a local housing vulnerability index of Healey et al. (2022) which was computed from census data.

The various scores under the SGLG are used to measure the performance of the LGUs. The SGLG is an institutional-

ized award, incentive, honor, and recognition-based program of the DILG. The scores included in the analysis are the Peace and Order Score, the Business-Friendliness Score, Business-Friendliness and Competitiveness Score, Environmental Management Score, Financial Administration and Sustainability Score, Disaster Preparedness, and Early Warning System Score. The SGLG data also include the number of LDC members and the number of NGO members in the LDC, and the COA audit findings on the LGU's financial statements (DILG, 2021).

The 2015 housing vulnerability indicator of Healey et al. (2022) accounts for different dimensions of typhoon-related housing vulnerability. These include housing density, housing quality, crowdedness, tenure security, extreme substandard housing, drinking water source, and structural integrity. The score was computed using the 2015 Philippine census (Healey et al., 2022) (see *Annex 2.2. for further information on the data sources*). This indicator was used as a proxy for LGU vulnerability along with the Disaster Preparedness and Early Warning System Scores of the SGLG.

Empirical Strategy

The following regression model was used:

$$\ln BUR_{it} = \beta_0 + \alpha \ln \ln (U_{it}) + \gamma V_{it} + \delta W_{it} + \epsilon X_{it} + \sigma Y_{it} + \pi Z_{it} + \mu_{it}$$

where BUR_{it} is the budget utilization rate of LGU i at time t , U_{it} is a vector that contains various budget data variables of LGU i at time t , V_{it} is a vector that contains several financial indicators of LGU i at time t , W_{it} is a vector that contains a couple of social data variables of LGU i at time t , X_{it} is a vector that contains the good governance indicators of LGU i at time t , Y_{it} is a vector containing the disaster vulnerability variables of LGU i at time t , Z_{it} is a vector that contains dummy variables indicating whether LGU i is a municipality, city, or province. β_0 is the intercept of the regression equation, α , γ , δ , ϵ , σ , and π are vectors containing the coefficients associated with the variables included in vectors U_{it} , V_{it} , W_{it} , X_{it} , Y_{it} , and Z_{it} , respectively. μ_{it} is the error term of the equation.

The main concern is to examine what correlates with the underspending behavior of LGUs. Several regressions were implemented to look at various variables that are associated with the natural log of the overall budget utilization rate as well as the utilization rate per expense class and per sector or function. The log of the budget utilization rate was computed in order to normalize the skewed distribution of these variables. For the correlates, indicators that represent local fiscal performance (e.g., IRA dependence, sectoral budgets), socioeconomic development (e.g., poverty), good governance (including audit ratings and citizen participation), and disaster vulnerability were also included (*See Annex 2.3. for additional details on the model specification and the complete summary of indicators and data*).

5. Descriptive Statistics

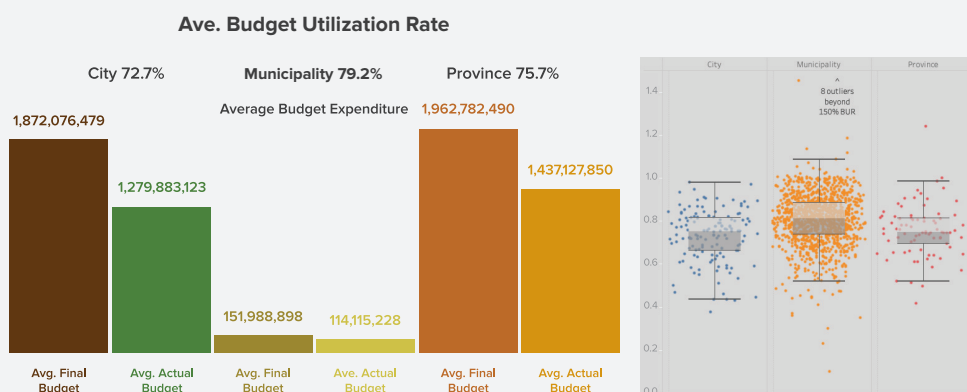
Local fiscal performance

“...the budget utilization rate (BUR) for capital outlays is much lower than the other expenditure classes. It averages 64 percent among all LGUs, with cities having the lowest BUR at 46 percent”

As discussed earlier, there has been a significant gap between LGUs’ budget and actual spending from 2015 to 2018: an average of 78 percent budget utilization rate (BUR) across all LGUs.⁴ Cities—those tended to collect more internally generated revenue than provinces and

municipalities—also tended to have lower budget utilization rates on average. As Figure 2.3. shows, the average budget and expenditure for cities and provinces eclipse the measly average budgets and expenditures of municipalities.

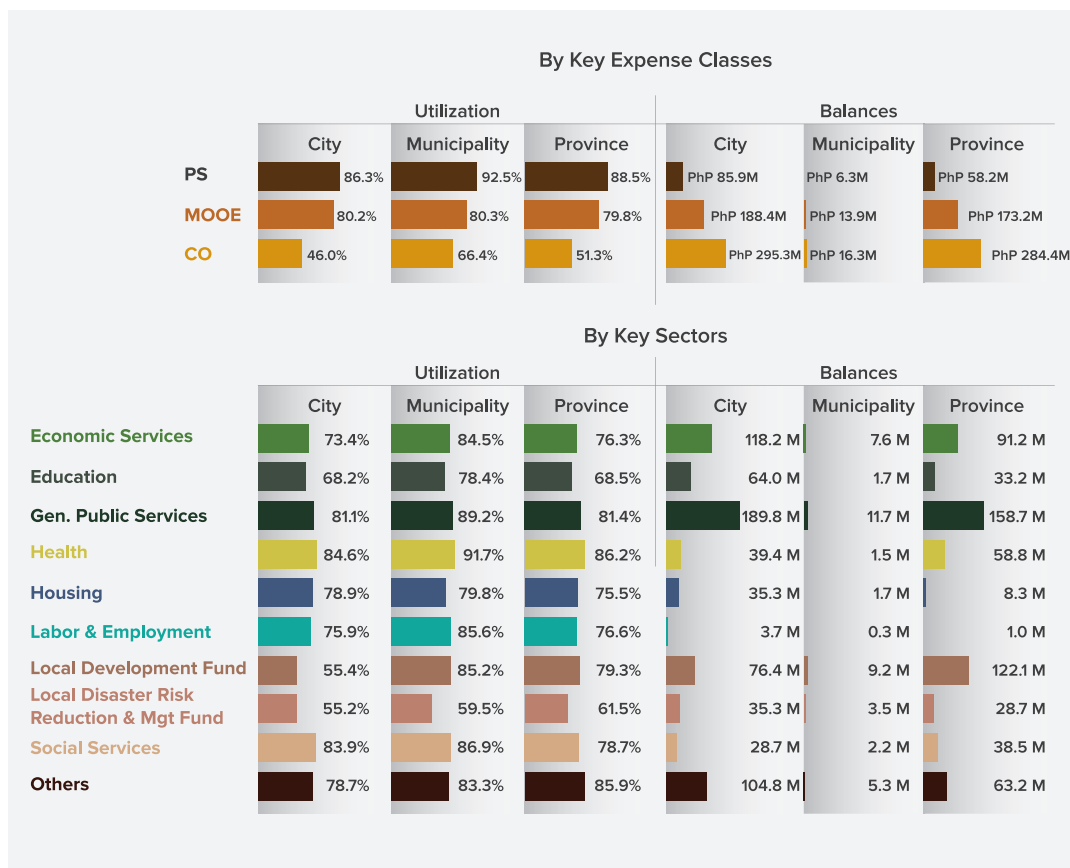
FIGURE 2.3. Average Budget Utilization Rates (2015-2018), and Distribution



As reported by the World Bank (2021), the BUR for capital outlays is much lower than the other expenditure classes. It averages 64 percent among all LGUs, with cities having the lowest BUR at 46 percent. Among functional classes or sectors, BURs are lowest for Local Disaster Risk Reduction and Management Funds (LDRRMFs, 59 percent), Education (77 percent), Housing (79 percent), and Local Development Funds (LDFs, 82 percent). Cities, in particular, are on average able to utilize only a little over half of what

they had budgeted for their LDFs and LDRRMFs. Budget balances in General Public Services, Economic Services, and LDFs, are the largest, indicating the magnitude of resources that could be utilized for priority endeavors (see *Figure 2.4.*). The large balances for General Public Services reflect the share of the sector in the total budget of LGUs, which ranges from 33 percent to 45 percent. This is followed by Economic Services and the Local Development Fund (See *Figure 2.5.*).

FIGURE 2.4. Budget Utilization Rates and Balances by Expense Class and Sector

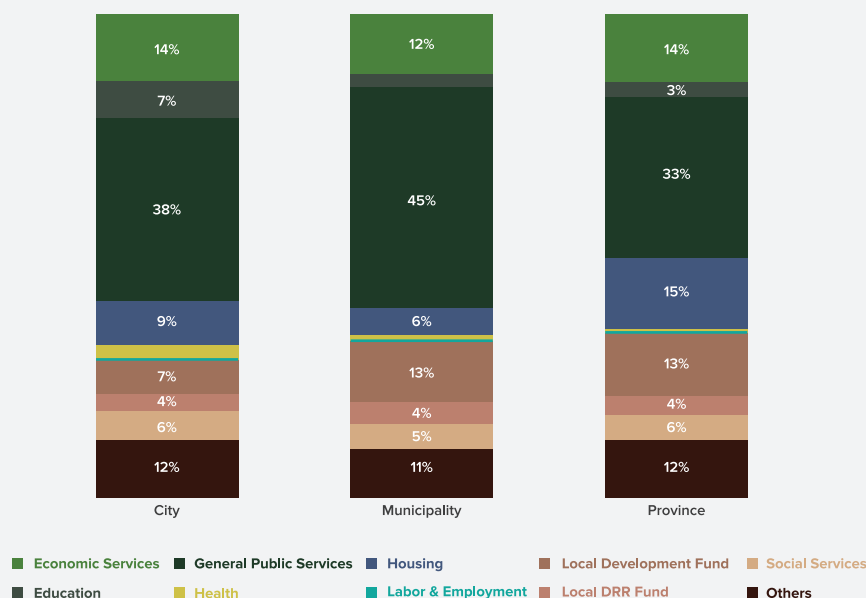


“...from 2015 to 2018, cities and provinces have PhP604 million (USD 11.5 million) and PhP527 million (USD 10 million) of average unspent budget, respectively... In 2018, Top 10 underspenders among cities and provinces had a total unspent amount of PhP43.3 billion (USD 819.8 million) and PhP19.2 billion (USD 363.4 million), respectively.”

Given these budget utilization rates, from 2015 to 2018, cities and provinces have PhP604.0 million (USD 11.5 million) and PhP527.0 million (USD 10.0 million) of average unspent budget, respectively.⁵ In particular, cities on average, for the same period, have average unspent budgets amounting to PhP82.7 million (USD 1.6 million), PhP118 million (USD 2.2 million) for Economic Services, and PhP35.9 million (USD 680.3 thousand) for Local Disaster Risk Reduction and Management, among others. Meanwhile, provinces on average, have average unspent budgets amounting

to PhP124.0 million for Local Development Fund (USD 2.3 million), PhP81.6 million (USD 1.5 million) for Economic Services, and PhP28.3 million (USD 536.3 thousand) for Local Disaster Risk Reduction and Management. Lastly, cities and provinces, have an average unspent budget for 2015 to 2018 on capital outlays of PhP295.0 million (USD 5.6) and PhP283.0 million (USD 5.4 million), respectively. In 2018 alone, Top 10 under spenders among cities and provinces had a total unspent budget of PhP43.3 billion (USD 819.8 million) and PhP19.2 billion (USD 363.4 million), respectively.

FIGURE 2.5. Budget Breakdown of LGUs (2015-2018)



With respect to financial performance of the LGUs, municipalities are 83 percent dependent on IRA, while cities are 63 percent dependent and provinces are 80 percent dependent. The growth rate of local resources per capita, or the tax effort of LGUs, was also considered. This is at 17 percent for municipalities while cities and provinces are at 3 percent and 19 percent respectively.

Good Governance

The regression analyses include the Financial Administration and Sustainability Score of the SGLG, which looks at the recent audit opinion of the COA, compliance with full disclosure policy of local budget and finances, bids and public offerings, at least 5 percent increase in average local revenue growth for three consecutive years, utilization of the development fund with benchmark of at least 66 percent utilization, utilization of the SGLG Incentive Fund⁶ and the approval of the annual budget. About 52 percent of municipalities are compliant; while 64 percent are for cities and 65 percent for provinces.

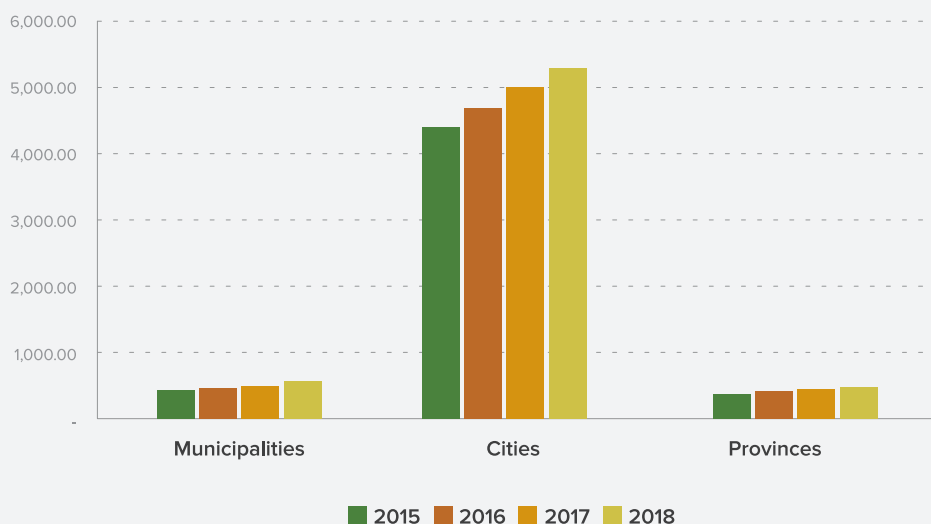
The analysis also includes the percentage of NGOs participating in the local development councils (LDCs) as a measure of the extent of participation of civil society in local governance. The participation rate is 32 percent in municipalities, 30 percent in cities and 31 percent in provinces. Other SGLG scores were also included to mea-

sure governance and institutional capacity. The peace and order score accounts for the performance of the LGU on peace and order performance audit, Anti-Drug Abuse Council performance audit, and provision of logistical support to the police. For the peace and order score, 57 percent of municipalities, 71 percent of cities and 82 percent of provinces are compliant.

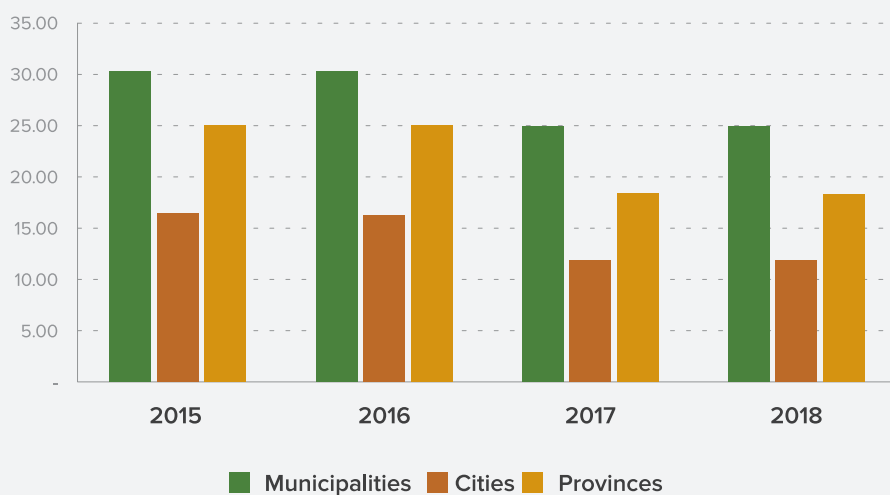
Business friendliness accounts for the establishment of the economic and investment promotion office, updated citizens charter, simplified business processing and licensing system, computerized tracking of economic data, and updated investment incentives codes. For provinces, they are also required to prove the utilization of grants for road repair and improvement (DILG, 2021). On business friendliness, 64 percent of municipalities, 77 percent of cities, and 78 percent of provinces met the requirement.

Social Development

Population density was also included in the analysis. The rate of population growth is highest in cities compared to municipalities and provinces. The following graph summarizes the population density (per sq. km.) in municipalities, cities, and provinces. On average, the population density in municipalities is at 460 individuals per sq. km. The population density in cities is at 4,854 individuals per sq. km. and in provinces it is at 388 individuals per sq. km. (see *Figure 2.6.*)

FIGURE 2.6. Population Density in LGUs (2015-2018)

Meanwhile, poverty incidence is highest in municipalities at 27.50 percent, on average, from 2015-2018. This is 14 percent in cities and 21.73 percent in provinces. As shown below, poverty was decreasing before the COVID-19 pandemic (see *Figure 2.7*).

FIGURE 2.7. Poverty Incidence in LGUs (2015-2018)



Conduct of Disaster Risk Management and Institutional Strengthening (DRMIS) Visayas Cluster's training on Climate Disaster Risk Assessment (CDRA) in March 2020. Photo by: BLGS

Disaster Risk Reduction

This study hypothesizes that the LGUs' budget utilization and implementation are affected by their exposure to disaster risks, i.e., LGUs that are more prone to disasters encounter more challenges. To measure disaster risk at the LGU level, the housing vulnerability index is used as a proxy variable (Healey et al., 2022). On the average, municipalities have moderate vulnerability at 0.22 and cities have very low vulnerability at -1.94.

Other variables that were used to measure vulnerability comes from SGLG scores on disaster preparedness, environmental management and early warning systems. Disaster preparedness accounts for establishment of structure and human resource complement with respect to disaster risk reduction and management, availability of plans and utilization of funds, availability of early warning system, evacuation management, and systems and structures with respect to search and rescue, emergency response,

functioning DRRM center, and established preemptive and forced evacuation policies (DILG, 2021). On these parameters, 34 percent of municipalities, 49 percent of the cities, and 62 percent of provinces are compliant with the SGLG requirements. On the early warning score, 78 percent of municipalities, 91 percent of cities, and 89 percent of provinces are compliant.

Environmental management accounts for the presence of a local solid waste management board, non-operation of open and/or controlled dumpsites, an approved 10-year solid waste management plan or presence of a materials recovery facility, and access to sanitary landfill (DILG, 2021). On environmental management score, 78 percent of municipalities, 87 percent of cities, and 89 percent of provinces are compliant. *For the detailed overall descriptive statistics, and the descriptive statistics per LGU type, you may refer to Tables 2.4.1. to 2.4.4. in Annex 2.4.*

6. Results and Key Findings

“LGUs with audit disclaimers from COA are more likely to have higher BURs than LGUs with unqualified audit reports.”

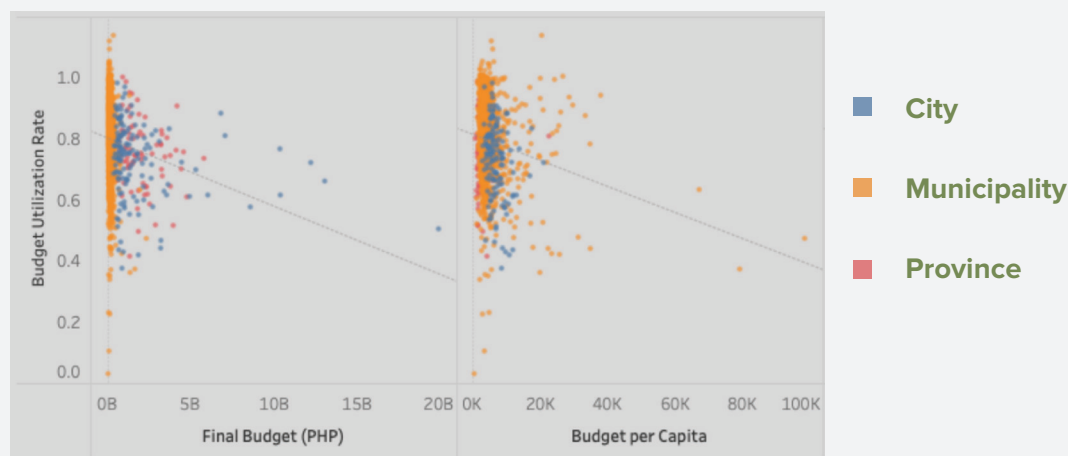
This section discusses the key results of the panel data regression analyses using the model described in Section 4 above. Three variants of the said model were used: 1) includes only of the current and lag values of functional LGU budgets on BUR as covariates; 2) excludes housing and labor budgets to improve the sample size⁷; and 3) controls for variables on socioeconomic development, good governance, and disaster risk. Several regression analyses were run conducted to examine the relationships between the overall BUR and BUR per budget type for all LGUs and for each type of LGU. This resulted in 48 regression analyses, which are described and shown in tables in Annex 2.5. Described below are the key findings that are consistent across the regression analyses as well as other notable observations.

Finding 1: Increased budget size dampens spending performance

The World Bank (2021) already posited that increased LGU budget sizes, particularly for capital outlays, are associated with lower BUR. This study largely affirms this relationship. Furthermore, the regression analyses show consistently that budget per capita, where statistically significant, is negatively correlated with the BUR. The

effect size of budget per capita on BUR, however, is quite muted: a PhP10,000 increase in budget per capita results in a decrease of a measly 0.17-0.19 percentage points in the BUR of municipalities, 0.23-0.26 points for cities, and around 0.51 points for provinces. For comparison, the mean budget per capita is PhP 5,205.

FIGURE 2.8. Comparison of Budget Size and BUR



Furthermore, reduced BUR is associated with increases in some of the functional budgets. In the overall model, the budgets for general public services (GPS), education, economic services, and the LDF have negative effects on the budget utilization rate of LGUs. Additionally, for cities, increases in the DRRM budget tend to negatively affect the BUR. Furthermore, an increase in the budget for a functional category is, with some exceptions⁸, associated with a lower utilization rate for that category.

Another notable observation is the positive effect of the previous year's budget—overall and per function—on spending performance. In most of the observations, the previous year's functional budget is seen to have positive effects on budget utilization rates. This is true for the effects of the increase in the one-year lag of the health budget on the budget utilization rate in the overall model; the increase one-year lag of the budget for GPS, education, economic services, and development fund for municipalities; and the development

fund, and social services and welfare budget on the budget utilization rates of cities. These results suggest that the implementations of programs and projects under these functional budgets accelerate in the second year.

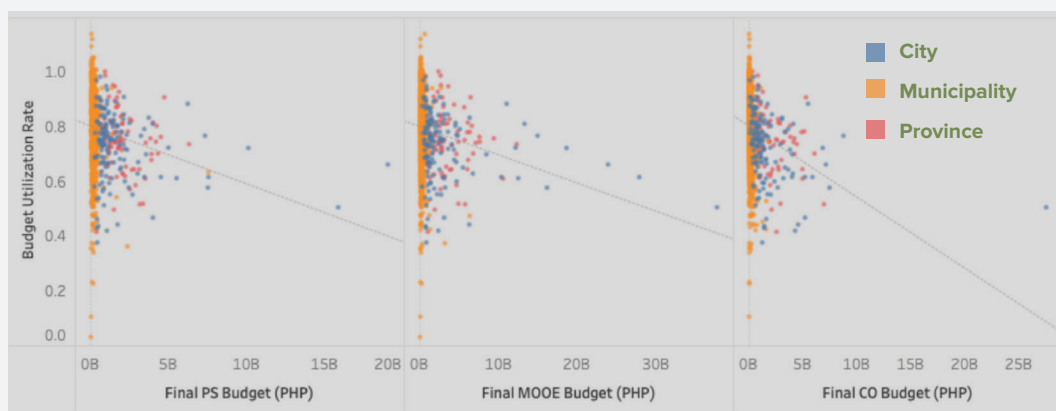
The behavior of BUR vis-à-vis the health sector budget is interesting. The relationship is positive and statistically significant for the overall model and for municipalities and negative for cities (i.e., higher health budget increases BUR) and provinces. The observation for cities, however, is statistically not significant. Meanwhile, the previous year's health budget has a negative effect on the budget utilization rate of the overall model, municipalities, cities, and provinces. But only the observations for the overall model and municipalities are statistically significant. These are indicative, first, of the assignment of healthcare services functions across LGU types and, second, the narrow fiscal space for healthcare spending at the municipal level.

Finding 2: LGUs struggle to implement capital outlays

The size of the capital outlay budgets is negatively correlated with the BUR of LGUs, particularly for cities and municipalities, indicating that LGUs struggle to implement infrastructure projects and other capital investments. The size of capital outlay budgets is also negatively correlated with the BURs for key functional budgets: general public services, economic services, and the LDF of both cities and municipalities, social services of municipalities, and health services of cities. These budgets tend to have sizeable capital outlays

components (e.g., government facilities under general public services and roads under economic services). After all, capital outlays, particularly infrastructure, require more time and technical capability to be undertaken. Weaknesses in planning and design, procurement, and contract management have constrained LGUs' capital outlays spending. Due to delay in implementation of capital outlays, the national government has assisted LGUs in implementing basic infrastructures (Sicat et al., 2019).

FIGURE 2.9. Comparison of Budgets by Expense Class and BUR



This contrasts with the consistent observation that MOOE and PS generally have positive effects on BUR. The MOOE typically consists of consumable items and other recurring expenditures to support day-to-day operations of LGUs (BLGF, 2008). Except for consulting services, MOOE takes a shorter time to be procured, delivered, and translated into expenditure. Thus, the positive relationship between MOOE and BUR can be seen in the main regression model and the analyses for provinces. For the functional budgets, statistically significant and positive relationships can be seen between MOOE and the budget utilization rates of the LDRRMF, education, economic services, and LDF of municipalities; health, and the GPS of cities; and with education and the LDF of provinces.

Similarly, the same effect can be seen for PS, which is statistically significant and positively correlated with the overall BUR and those of GPS, economic services, and social services of municipalities; and LDRRM, GPS, and education of cities. This is not

a surprise as PS includes salaries, wages, and other compensation of permanent, temporary, contractual, and casual employees of the government (Bureau of Local Government Finance, 2008). Interestingly, the PS budget is statistically significant and negatively correlated for the budget utilization rate of social services of cities and health and GPS of provinces, both of which are dependent on manpower.

Finding 3: LGUs vulnerable to disasters tend to have lower budget utilization rates

Another important observation is the relationship between disaster preparedness, vulnerability, and budget utilization rate. A positive correlation can be clearly seen between disaster preparedness, as measured by the early warning score of the SGLG, and budget utilization rate. Meanwhile, disaster vulnerability—as proxied by the housing vulnerability index—is inversely related to the BUR. These are statistically significant in the overall model, and the regression models for municipalities, and cities. This is also seen in the budget utilization rates of LDRRM, health, GPS, economic services, development fund, and social services, CO, MOOE and PS

of municipalities; budget utilization rates of LDRRM, education and PS of cities; and the development fund utilization rate of provinces. This is important because it affirms that greater risks to disaster and greater vulnerability of LGUs affect service delivery as reflected by low budget utilization rate.

In contrast, population density and poverty incidence are not statistically significant in the overall, and the regression models for each LGU type. These are statistically significant in the functional budgets' regression models, but there seems to be no clear trend in terms of direction of effect.





Conduct of DILG Southern Leyte Audit Orientation and Provincial Team Conference (2021). Photo by: DILG Region VIII

Finding 4: LGUs with good financial performance tend to have lower BUR

This study also tested the relationship of key good financial administration indicators with LGUs' BUR and found a generally inverse relationship. First, financial administration scores under the SGLG are generally inversely related to budget utilization, but statistically significant only in the overall model and the models for municipalities. Second, tax effort—or the growth of local resources per capita—also has a negative and statistically significant relationship with the BUR but only for provinces. Because an increase in local resources leads to an increase in the budget, it is consistent with the observation of a negative relationship between the budget per capita and BUR. It must be noted, however, that IRA dependence does not have a clear relationship with the BUR when the other factors are held constant as per this study's model. Other notable good governance indicators—including civil society membership in LDCs—also did not make a statistically significant dent to the BUR.

Meanwhile, LGUs with audit disclaimers from COA are more likely to have higher BURs than LGUs with unqualified audit reports. This observation is seen to be statistically significant in the overall model and the regression model for municipalities. This can also be seen in the regression model for the MOOE of municipalities. Cities with adverse findings and disclaimer in their COA reports are also more likely to have higher budget utilization compared to LGUs with unqualified audit reports. COA observations are not statistically significant in the regression models for provinces. This observation suggests that the more cautious the municipalities are in their fund utilization, the lower their budget utilization rates are. It supports the findings of the report by the Union of Local Authorities of the Philippines (ULAP) that LGUs face problems with respect to COA audit. The report noted that COA auditors have different interpretations of the rules and regulations, leading to audit observations for the LGUs (ULAP, 2016).



Improvement of the Gaddang road in Aparri, Cagayan (2021). Photo by: DILG Region II

7. Conclusion and Recommendations

The findings above validate the hypothesis that the implementation of the *Mandanas-Garcia* decision will have a negative effect on their spending rate. The LGUs will not be able to keep up with the increase in their current year budget and will tend to keep pushing balances to the following year unless necessary measures are taken to address the institutional and structural constraints to fiscal performance which previous studies have identified. Furthermore, disaster risk exposure and good governance requirements have been found to be key constraints to timely budget utilization: the former hampers governmental operations, while the latter seem to put up roadblocks for LGU spending and delivery.

Given the socioeconomic and environmental situation of the Philippines, the country needs to heavily invest in crisis resilience, recovery, and development at the grassroots level if it is to stand a chance of meeting the SDGs in 2030. However, given the LGUs current fiscal performance, these are precisely the areas which tend to see poor budget utilization rates. With the *Mandanas-Garcia* transition now underway, the level of underspending could increase further, particularly in these crucial areas.

In this regard, the following measures are being recommended:

Recommendation 1: Review fiscal transfers and assignment of functions to LGUs

Long-term reform requires the review of the formula for the allocation of NTA. This measure echoes the recommendations already expressed in previous studies to, among others, rebalance the distribution of resources from cities (which are able to, by default, generate more local income) to provinces and municipalities, inject development considerations like poverty incidence and crisis risk exposure in the distribution formula, and incentivize fiscal and governance performance, among others.

Measures have been taken by the government to include these reform elements in the fiscal transfers to LGUs. This includes the Seal of Good Local Governance (SGLG) Incentive Fund that has been institutionalized under the SGLG Law (R.A. No. 11292) and provided with PhP 1 billion under the 2022 Budget of DILG (DBM, 2021). Other related programs such as the Conditional Matching Grant for Provinces⁹ and the Financial Assistance to Local Government Units¹⁰ provide additional capital outlays budgets to LGUs which meet good governance conditions. These have a total of about PhP11 -billion in the 2022 budget.

The government had also proposed a PhP10-billion Growth Equity Fund to assist LGUs which belong to the poorest half of LGUs and have below-median per capita NTA (DBM, 2021b). The enacted budget for 2022, however, only allocates PhP1.25billion to the Growth Equity Fund (DBM, 2021), severely limiting the capability of such fund to equalize horizontal disparities. In the end, these allocations for performance- and equity-based transfers—around PhP13-billion in total—are dwarfed by the nearly PhP1-trillion in NTAs for 2022.

Recommendation 2: Review procurement policies particularly around capital outlay.

Review and reform of government procurement policies need to be undertaken to facilitate the implementation of infrastructure and capital outlays projects. While principle-based procurement and processes that emphasize transparency, fairness, and competition are paramount to ensuring value-for-money, delays caused by unclear policies, hard-to-understand processes, and unnecessary technicalities hamper timely, cost-effective, and quality infrastructure projects.

Steps towards process rationalization have started to be taken by the Government Procurement Policy Board (GPPB) through, among others, simplifying the public bidding documents for infrastructure (reducing the number of pages from 113 to 35); and modernizing the Philippine Government Electronic Procurement System (to, among others, enable electronic bidding) (GPPB, n.d.). Fundamental aspects of the procurement law, however, may need to be revisited, such as; the composition and size of bids, awards committees, the thresholds for requiring formal competitive bidding, and allowing alternative (though still competitive) methods, among others.

Furthermore, conducting pre-procurement processes, which may include the frontloading of procurement requirements, may be necessary to help make the overall procurement process more effective and efficient. This may help indicate in advance the eligibility or quality of performance of LGUs to help assess the appropriateness of the release of their budgets. Moreover, these have to be supported with a more mindful and strategic planning and implementation of Programs, Projects, and

Activities (PPAs) to ensure good timing of procurement and prioritization of items and services in the Annual Procurement Plan (APP). The use of monitoring dashboards must be maximized to ensure that delivery is on track and that high-risk procurements get flagged.

Such policy review and reform must be aided by the following measures: First, continued strengthening and capacity building of procurement units, and their creation if these do not yet exist in certain LGUs; Second, continued strengthening of civil society participation in the observation of bids and monitoring of contract implementation; and, Third, improvement in the capacity of the national government to monitor procurement performance, including the digitalization of procurement monitoring and reporting.

Recommendation 3: Boost oversight as enabler of good governance and delivery.

Two of the findings from the analysis are quite perplexing: 1.) that having a clean audit sheet is associated with slower spending; and, 2.) that civil society participation does not make a dent in either side of the BUR. Before these statements are taken out of context in favor of corruption and impunity, some caveats must be provided to these findings and offer some recommendations to boost budget oversight in the right way.

First, on audit. An independent assurance of the propriety of financial transactions is an indispensable element to the proper functioning of any public financial management system. Audit, when done correctly, is not a fault-finding exercise, but one of advising, even guiding, public managers on how to implement public services more efficiently and effectively. Audit, when oriented to be an enabler, provides opportunities for government entities to rectify their practices, strengthen their systems and capabilities, and

even provide bases for the pursuit of policy reforms. Audit is an exercise of integrity - it goes beyond compliance, and importantly - it promotes accountability and performance.

Second, on participation. It must be emphasized that the mere membership of civil society organization (CSOs) in the development bodies of LGUs is a necessary but insufficient metric of public participation and does little justice to the hard work and substantive contribution that CSOs have brought into local governance and public financial management. For future versions of the SGLG, it is recommended that more substantive measurements of the quantity, quality, and impact of CSO participation be included. Global models like the Open Budget Survey and the E-Participation Index may be considered.

Instead of merely involving CSOs for accountability, CSOs that are highly capable can likewise be considered as partners to deliver services in partnership with the government, while still ensuring that proper checks and balances are in place.

Recommendation 4: Capacity Augmentation Support Hand in Hand with Capacity Building.

By putting a Php185-billion (DBM, 2021b) windfall in LGUs' collective coffers, the *Mandanas-Garcia* transition necessitates a massive scaling-up of the capacity of local governments to manage public funds and deliver services. Section 9 of E.O. no. 138 mandates the DILG to oversee the provision of capacity development interventions for LGUs, develop other capacity development strategies, and performance incentive mechanisms, among others, in a bid to boost delivery capacity. Subsequent issuances by DILG, DBM, and other bodies required LGUs to formulate capacity development agendas alongside their devolution transition plans (DTPs). Furthermore, one of the

components included in the DTPs is the Local Revenue Forecast and Resource Mobilization Strategy to help address needs on capacity building, improve local revenue generation, and make resource mobilization more targeted to make LGUs less NTA-dependent.

It must be said at this point that training is insufficient for building capacity: what is needed is a holistic yet tailored capacity support for LGUs. The DILG has already adopted a Capacity Development Framework (DILG, 2021a) and the agency has issued guidelines to apply such framework to the DTPs (DILG, 2021b) towards this effect. These guidelines seek to prioritize the provision of capacity development interventions based on the level of capacity and performance, i.e., those LGUs which are assessed to have scored poorly in both capacity and performance rubrics will be prioritized.

To truly address the unique capacity needs and performance contexts of LGUs, the following steps are being recommended: 1.) to complement the assessment of LGU capacity and performance using the SGLG and other available data, rigorous analysis and identification of pain points and weak areas must be undertaken; 2.) Use the results from Public Financial Management Assessments conducted over the years as a starting point; and 3.) Focus must be given to provinces and cities that tend to have the lowest BURs and largest budget balances considering that it will be logistically difficult to do individualized deep dives per LGU. Cluster analyses may then be employed within these LGUs, (i.e., grouping LGUs according to characteristics, such as level of poverty and disaster risk exposure).

These targeted assessments should then be useful in identifying capacity augmentation in the near-term for problematic areas. Such “surge” of capacities may be a pool of technical specialists who, working

with the regional knowledge centers of DILG and the Local Government Academy, can coach and mentor LGU officials in addressing delivery bottlenecks. This assistance may include finalizing terms of references of preferred design specifications, developing and finalizing actual designs and cost estimates, strategic management of the PPAs, data analysis, and knowledge management. In addition, local contractors may also be given technical advice or support to secure the quality of implementation of the PPAs. Inter-LGU exchange of experience and innovations can likewise be facilitated by these specialists. These technical specialists could come not only from the private sector but also from local academe, civil society, and professional organizations. In key regions and provinces, Governance Hubs composed of these multisectoral specialists, have already been established and can be easily tapped for both short-term capacity augmentation and long-term capacity development.

At the start of 2022, LGUs have an estimated beginning fiscal balance of Php761.5-billion from the previous year (DBM, 2021c): a number that may yet be expected to grow as it had in the past decade. While the *Mandanas-Garcia* ruling may have corrected the computation of LGUs’ share in national revenue, it does not guarantee that sufficient resources are mobilized and utilized for social development.

This study supports the argument that the increased funds of the LGUs due to the *Mandanas* ruling, without any institutional or structural improvements, will result in a decrease in budget utilization and delay in service delivery and program implementation. Else, the Php761.5-billion in fiscal balances may continue to be parked resources. There is a need to implement structural, institutional and policies reforms for decentralization to work effectively to attain sustainable development.

End notes

- 1 These calculations excluded outlier LGUs which incurred a budget utilization rate beyond 150%.
- 2 The Statements of Revenue and Expenditure (SRE) accounts for the LGU's sources of income including locally generated revenues, grants, transfers from foreign or domestic sources, internal revenue allotment, and shares from national wealth. The BLGF also reports the total expenditure and the expenditure of the LGUs by function. These include General Public Services, Education, Health, Nutrition and Population Control, Labor and Employment; Housing and Community Development; Social Security; Social Services and Welfare; Economic Services; Debt Service; and Other Purposes. Local treasurers are required to prepare a Statement of Income and Expenditures (SIE) on a cash and modified accrual accounting basis. The statement serves as an input to the monitoring tools of the national government with regard to financial performance and to assist LGUs with financial operations.
- 3 Same sectors as in the SRE, i.e., General Public Services, Education, Health, Nutrition and Population Control, Labor and Employment; Housing and Community Development; Social Security; Social Services and Welfare; Economic Services; Debt Service; and Other Purposes. COA however reports the LDF and LDRRMF as distinct sectors or functions (compared to SRE where spending from such funds are distributed across sectors).
- 4 In the summary analysis, eight (8) LGUs which are outliers—those which have a budget utilization rate of more than 150%—have been excluded as these could distort the analysis. It is nevertheless possible for an LGU to incur a BUR above 100 percent when, for instance, it utilizes its prior year's budgets for MOOE and CO in the current year. The estimates here are close but not identical to the summary statistics presented by the World Bank (2021).
- 5 Computed based on COA records on Actual and Final budgets based on current accounts.
- 6 Formerly known as the Performance Challenge Fund.

- 7 Because of missing or NULL entries for the housing and labor budgets in many LGUs particularly municipalities, bulk of observations (LGUs) were dropped in the first variant of the panel regression. By excluding these functional budgets, most of the observations were kept intact.
- 8 These are the housing budget of cities (positively correlated); and labor budget of municipalities, LDRRMF and LDF of cities, and LDRRMF, labor, and housing budgets of provinces (not statistically significant).
- 9 Refers to Conditional Matching Grant to Provinces for Road and Bridge Rehabilitation, Upgrading and Improvement
- 10 Refers to the Financial Assistance to Local Government Units and Support for Capital Outlays and Social Programs