The Challenges of Decentralization Fiscal Regulations: Experience from the Philippines

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ABSTRACT

This research aims to understand, analyze, and detail the experience of fiscal decentralization in Indonesia and the Philippines. It explores the main challenges faced in implementing fiscal decentralization policies and valuable lessons that can guide other third countries planning to expand their local entities’ fiscal authority. By comparing the experiences of the two, we can explore the similarities and differences in approaches and analyze their impact on economic development and local empowerment. The results show that decentralization in the Philippines is comprehensive and has one of Southeast Asia’s most substantial legal bases. Moreover, each tier or each type of local government has a rather direct relation to the central government, especially in fiscal relationships, and is relatively independent compared to other countries in the region.

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1. Introduction

Fiscal decentralization is a deep and relevant concept in the context of government financial management in many countries, including Indonesia and the Philippines. This concept refers to the delegation of authority and responsibility in revenue collection and budget allocation to regional or local governments. The principles of fiscal decentralization encourage greater fiscal autonomy for local entities, which in turn is expected to increase the efficiency of resource use, promote economic equality, and provide better decision-making capabilities in accordance with the needs of local communities.1

Fiscal decentralization is a reform that is not easy to implement, and faces a number of challenges that must be overcome. In Indonesia and the Philippines, there are several main

challenges that must be faced in implementing fiscal reform: First, the administrative capacity of local governments is often one of the biggest challenges in managing their own revenues and budgets. The inability to manage local finances well can lead to inefficient use of resources. Second, Corruption and Abuse of Power, where fiscal decentralization can increase the risk of corruption and abuse of power if good governance is not maintained. This creates serious obstacles in achieving reform goals. Third, the existence of Income Potential Gaps means that not all regions have the same income potential. This can result in inequality in tax revenues, so there needs to be an effective redistribution mechanism to overcome this gap.

The selection of Indonesia and the Philippines as the subjects of this research was based on several important considerations, namely: First, there is Geographical and Cultural Diversity where Indonesia and the Philippines are two countries that are very diverse geographically and culturally. Both reflect the diversity that exists in Southeast Asia and provide different views on the implementation of fiscal decentralization. Second, long experience in decentralization where Indonesia and the Philippines have a long history of implementing fiscal decentralization. They are countries that are quite advanced on this reform journey, which provides an opportunity to evaluate the long-term impact of decentralization policies. Third, Comparison and Contrast Selecting these two countries allows us to compare and contrast their approaches to fiscal decentralization. This provides deeper insight into the challenges and benefits associated with various decentralization models.

Even though Indonesia and the Philippines are two different countries, they have several similarities and differences that are relevant in the context of this research, namely on the side of the equation where both countries are in the Southeast Asia region and face similar challenges related to fiscal decentralization, such as institutional capacity that needs to be improved and issues related to income inequality. This provides a basis for comparing their experiences. In terms of differences, there are significant differences between Indonesia and the Philippines, both in terms of size, economic structure and demographics. These differences make it possible to examine how country characteristics may influence the implementation of decentralization.

This research aims to understand, analyze and detail the experience of fiscal decentralization in Indonesia and the Philippines as third countries. We will explore the main challenges faced in implementing fiscal decentralization policies, as well as explore

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valuable lessons that can be used as guidance for other third countries that are or are planning to expand the fiscal authority of their local entities. By comparing the experiences of the two, we can explore similarities and differences in approaches, and analyze their impact on economic development and local empowerment.\textsuperscript{8}

By understanding Indonesia's and the Philippines' fiscal decentralization journeys, we hope to provide better insight into the challenges faced by third countries in their efforts to increase fiscal autonomy and promote sustainable economic development. Thus, this article provides a basis for discussing best practices and policy recommendations in the context of fiscal decentralization that many countries around the world can benefit from. This research has several innovative aspects that make it unique, namely: \textit{First}, in the Third Country Context This research focuses on the experience of fiscal decentralization in Indonesia and the Philippines as "third countries" that fall between developed countries with established decentralization experience and developing countries that are just starting their decentralization journey. This provides a different perspective that has not been widely explored in the literature. \textit{Second}, in an integrated theoretical perspective, this research combines two strong theoretical frameworks, namely agency theory and public choice theory, to understand the dynamics of fiscal decentralization. This approach allows research to dig deeper into decision-making and monitoring mechanisms in decentralization. \textit{Third}, In Implications for Third Countries This research aims to provide lessons that can be taken by third countries that are considering fiscal decentralization. Thus, this research has strong practical implications for policy makers in countries with similar contexts.\textsuperscript{9}

This research aims to understand, analyze and detail the experience of fiscal decentralization in Indonesia and the Philippines. We will explore the main challenges faced in implementing fiscal decentralization policies, as well as explore valuable lessons that can be used as guidance for other third countries that are or are planning to expand the fiscal authority of their local entities. By comparing the experiences of the two, we can explore the similarities and differences in approaches, and analyze their impact on economic development and local empowerment.

\textbf{2. Research Method}

This research uses a case approach method for the Philippines in implementing fiscal decentralization. To further explore, comparisons are also presented with developed countries, namely Germany and Canada. This case study also provides a basis for comparing the experiences of Indonesia and the Philippines with developed countries such as Canada to gain a deeper understanding of the challenges and opportunities that exist. The German experience provides insights into good governance and fair distribution of resources within a fiscal decentralization framework. Theoretical Framework and Methods This research will utilize theoretical frameworks that have been developed in literature related to fiscal decentralization, such as agency theory or public choice theory, and research methods such as comparative analysis to analyze the experiences of Indonesia and


the Philippines. Agency theory is used to understand the relationship between the central government (agent) and local government (principal) in the context of fiscal decentralization. This theory will help in analyzing the dynamics of control and supervision involved in fiscal decentralization. Public choice theory helps in understanding the policy-making process at the local and national level. This will help explain how fiscal decentralization policies are formed, how resource allocation decisions are made, and how public and private interests play a role in this process.11

3. Results and Discussion

3.1. Experience of Fiscal Decentralization Regulations in Indonesia and the Philippines

Indonesia and the Philippines will continue to grapple with complex issues related to fiscal decentralization.12 The success of this process depends on a variety of factors, including effective governance, capacity building, and fair distribution of resources. Fiscal decentralized governance in Indonesia refers to the way the central government and regional governments work together in managing public finances. Fiscal decentralization is part of the Indonesian government’s efforts to give local governments more authority to manage their own finances, while maintaining a coordinated framework.13 Several aspects of fiscal decentralization governance in Indonesia include: First, Inter-Governmental Fund Distribution (DAK) where the central government provides funds to regional governments through the General Allocation Fund (DAU) and Special Allocation Fund (DAK). DAU is used by local governments for general purposes, while DAK is given for special programs or projects.14

Second, Supervision and Accountability where the central government continues to play an important role in overseeing the use of funds by regional governments. This includes financial audits and performance evaluations to ensure the funds are used in accordance with applicable regulations.15 Third, Policy Coordination where the central and regional governments must coordinate in formulating fiscal policy to avoid conflicts of interest and ensure consistent policies throughout the country.16 Fourth, Strengthening Regional Capacity where the central government is also involved in training programs and technical assistance to strengthen the capacity of regional governments in planning,

15 Zeng and others.
budgeting and implementing development programs. Fifth, regular policy evaluations are carried out to measure the impact of fiscal policy on regional development and social progress. This allows for necessary policy refinements and adjustments. Sixth, Transparency and Participation where the Indonesian Government has encouraged transparency in fiscal decentralized governance by requiring local governments to upload their financial data online. In addition, community participation in the planning and decision-making process is also increased.

Fiscal decentralization governance in Indonesia is an evolving process and has undergone several changes over the years. The aim is to increase the efficiency, effectiveness and accountability of public financial management at the regional level while encouraging inclusive and sustainable development throughout Indonesia. The decentralized fiscal governance system in the Philippines is similar to a number of other countries that implement decentralization in public financial management. However, it is important to note that details regarding the governance of fiscal decentralization in the Philippines may change over time, depending on government policies and recent developments.

The following is an overview of fiscal decentralized governance in the Philippines: First, the Philippine central government provides funds to local governments through the General Allocation Fund (DAU) and Special Allocation Fund (DAK). DAU is used by local governments to finance general expenses, while DAK is allocated for special projects or certain programs. Second, the Division of Authority where the central government has decentralized some authority to regional governments in various fields, including education, health and infrastructure. Regional governments have greater responsibility in planning and implementing programs at the local level. Third, Supervision and Accountability where the central government still has a role in supervising and controlling the use of funds by regional governments. Financial audits and performance evaluations

are used to ensure that the funds are used in accordance with applicable regulations.23

Fourth, Policy Coordination, where coordination between the central government and regional governments is important to ensure policy consistency and avoid conflicts of interest.24 Fifth, Strengthening Regional Capacity where the central government also provides training and technical assistance to strengthen the capacity of regional governments in planning, budgeting and implementing development programs. Sixth, periodic policy evaluations are carried out to measure the impact of fiscal policy on regional development and social progress.25

Fiscal decentralized governance in the Philippines also encourages transparency and public participation in the decision-making process. The Philippine government continues to strive to improve the efficiency and effectiveness of public financial management at the regional level while promoting inclusive economic growth and development. Comparison of decentralization between Indonesia and the Philippines with Canada and Germany can be seen from several aspects, including the level of regional government autonomy, division of powers, and government structure. The following is a comparison between the two countries. Viewed from the Level of Regional Government Autonomy: Indonesia has a high level of decentralization, with provincial and district/city regional governments having significant authority in terms of resource management and public services. Regional autonomy is regulated in Law Number 23 of 2014 concerning Regional Government. The Philippines also has a significant degree of autonomy for local governments. The regional autonomy system in the Philippines is governed by the Regional Autonomy Act of 1991 and grants many powers to local governments.

Comparison with Canada and Germany: Canada is a federal country with a highly decentralized government system. Canada’s provinces have broad powers over education, health and infrastructure, and they can make independent decisions on some issues. The federal government has authority in matters of foreign policy, defense, and immigration.26 Germany is also a federal country that has a very decentralized government system. The German states (Länder) have broad powers in various fields, including education, police and administration. The German federal government has authority in foreign policy, defense and several other areas.27 Viewed from the perspective of the Division of Power: In Indonesia, the division of power between the central and regional governments is regulated by the 1945 Constitution of the Republic of Indonesia. The central government

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23 Z. Zhang and others, ‘The Evolutionary Mechanism of Haze Collaborative Governance: Novel Evidence from a Tripartite Evolutionary Game Model and a Case Study in China’, Humanities and Social Sciences Communications, 10.69 (2023), 1–14 https://doi.org/10.1057/s41599-023-01555-8
27 B. Blumenau, ‘Breaking with Convention? Zeitenwende and the Traditional Pillars of German Foreign Policy’, International Affairs, 98.6 (2022), 1895–1913 https://doi.org/10.1093/ia/iiac166
has control over certain areas, such as defense, foreign affairs and monetary, while most services public and regional development is in the hands of local governments. The Philippines also has a division of power between the central and regional governments. The 1991 Regional Autonomy Law gives local governments broad authority in managing budgets, taxes and certain public services.

Meanwhile, comparison with Canada and Germany: In Canada, the division of powers between the federal and provincial governments is regulated in the Canadian Constitution. The constitution provides a clear list of federal and provincial powers, so there is little uncertainty about the limits of authority. In Germany, the division of powers between the federal government and the states is regulated in the German Basic Law (Grundgesetz). This Basic Law establishes exclusive and joint powers as well as a list of express federal powers. A comparison of decentralization between Indonesia and the Philippines with Canada and Germany shows that Canada and Germany have a higher level of decentralization than Indonesia and the Philippines. Local governments in Canada and Germany have more authority in many aspects of public services and local decision making.

3.2. Fiscal Decentralisation Regulation in Philippines

Fiscal decentralization is conceived to achieve economic growth by distributing revenue collection and expenditure management to subnational governments. However, there is a deep-rooted debate on whether the system can apply to all countries or only to countries at a certain level of economic growth. The facts are the current status of fiscal decentralization in developing countries is significantly lower than that of developed ones. The argument in most cases lies in whether the economic status or the level of fiscal decentralization is seen as a cause or a result of the other – are the less developed countries not suited for this system, or are they less developed because they did not practice the system to a good level.

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Decentralization in the Philippines is deemed to be comprehensive and has one of the most substantial legal bases in Southeast Asia. Moreover, each tier or each type of local government has a rather direct relation to the central government, especially in the context of fiscal relationships, and are relatively independent compared to other countries in the region.\textsuperscript{35} Many years after the law granting local government units (LGUs) more resources through unconditional grants and taxing powers was first enacted, it appears that there has been no significant improvement in local public service delivery, and LGUs are observed to have become more dependent on internal revenue allotments. Among the main reasons cited for the seemingly lack of success in decentralization is that there is a lack of proper cooperation among local governments in addressing interjurisdictional problems, as well as the inability to efficiently perform all the responsibilities devolved to them by the central government. In 2019, the Supreme Court granted the Mandanas-Garcia petition, which effectively increased the tax base on which the share of LGUs is computed from in the Internal Revenue Allotment. The fiscal implication of the Supreme Court ruling is equivalent to a 38 percent increase from the FY2021 IRA shares of LGUs, thereby granting more fiscal resources to LGUs from the national budget.

Considered as among the earliest to adopt decentralization in East Asia,\textsuperscript{36} the Philippines bases its current local government structure on the Local Government Code, Republic Act 7160, enacted in 1991 (hereafter referred to as the 1991 Code).\textsuperscript{37} Currently, the country is organized into four sub-national units or local government units (LGUs): provinces, cities, municipalities, and village-level barangays (Refer to Appendix A for the Philippine provincial map). The 1991 Code devolved to the LGUs the national government’s responsibility for the delivery of basic services, as well as the enforcement of certain regulatory powers. Devolved services include health such as hospital services, social welfare services, environment and natural resources, agriculture, and public works. Devolved regulatory powers include: the reclassification of agricultural lands, the enforcement of environmental laws, the inspection of food products, the enforcement of the national building code, and the processing and approval of subdivision plans, among others.\textsuperscript{38} Municipalities and cities are the LGUs that directly provide and implement basic services regularly needed by the residents in the community, such as: primary health care, collection and disposal of waste, and construction of roads. Provinces assist with these devolved services and perform developmental and coordinative functions for their cities and municipalities. When the Code was enacted in 1991, the Philippines had 73 provinces,


61 cities, and 1,496 municipalities. By 2020, there were 81 provinces, 146 cities, and 1,488 municipalities.\textsuperscript{39}

The 1991 Code increased the financial resources available to LGUs by increasing their taxation powers and automatic fiscal transfers. Revenues of local governments come from two sources: local sources that are composed of local tax revenues and non-tax revenues, and external sources that mainly consist of intergovernmental transfers.\textsuperscript{40} As more responsibilities are devolved to sub-national governments under fiscal decentralization, local capacity to cover the increased expenditures using local own revenues may be insufficient. Hence, intergovernmental transfers are used to bridge the fiscal gap between a local government’s own revenues and its expenditures. In the Philippines, transfers from the central government to local governments can be one of the following:\textsuperscript{41} (1) Internal Revenue Allotments (IRA), which are formula-based unconditional fiscal transfers directly distributed from the national government to each local government unit; (2) Congressional allocation, which is allocated to devolved functions in the form of programs and projects; (3) Government-funded programs and projects which government agencies support 9 devolved functions from internally generated revenues as part of the regular agency budget; (4) ODA loans and grants-funded transfers from national government agencies; and (5) off-budget budgeting. Among the five, IRAs comprise the bulk of government transfers. The Philippines’ transfer system is formulated to automatically allocate 40 percent of national internal revenues to local governments.\textsuperscript{42}

3.3. Implications for Countries Considering Fiscal Decentralization Towards Regional Economic Growth

Countries consider fiscal decentralization, there are several implications and considerations that need to be taken into account. Fiscal decentralization is a complex process and its impacts can vary, depending on decisions and existing factors. Here are some implications that third countries need to consider, \textsuperscript{43} First, there are policy objectives. The countries must clearly determine the objectives of fiscal decentralization policies. It is important to determine whether the objective is to increase economic growth, improve service delivery, strengthen local governance, or achieve another specific objective.\textsuperscript{44} Second, the Legal and Institutional Framework by establishing a legal and institutional framework that regulates the roles and responsibilities of the central government and regional governments is key. This framework should outline mechanisms

\textsuperscript{39} G. B. Ramos and others, ‘Composition and Distribution of Free-Living Nematodes in Lake Apo, Bukidnon, Philippines’, 1–21 https://doi.org/10.2139/ssrn.4606169
\textsuperscript{40} Panao.
\textsuperscript{42} Go.
for revenue sharing, expenditure allocation, and decision-making processes.\textsuperscript{45} Third, determine sources of income for local governments. This could include local taxes, grants from the central government, or a combination of both. This choice of revenue source can have a major impact on fiscal sustainability.\textsuperscript{46}

Fourth, building local government capacity is important. This involves providing training and technical assistance to local officials so that they are able to manage finances, plan, and implement projects effectively.\textsuperscript{47} Fifth, third countries must prioritize transparency and accountability in fiscal decentralization. Implement mechanisms to ensure that local governments are accountable for the use of funds and report their activities to the public.\textsuperscript{48} Sixth, consider the potential impact on economic inequality. Fiscal decentralization can exacerbate or mitigate economic inequality, depending on how resources are distributed and used.\textsuperscript{49} Seventh, evaluate how fiscal decentralization will affect the provision of essential public services. Ensure that this leads to the provision of better services, especially in areas such as education, healthcare and infrastructure.\textsuperscript{50} Eighth, determine the extent of local autonomy and authority. Finding the right balance between local autonomy and maintaining national unity is an important consideration.\textsuperscript{51}

Ninth, knowing the potential impact on macroeconomic stability. Ensure that fiscal decentralization does not lead to unsustainable fiscal deficits or economic instability.\textsuperscript{52} Tenth, establish effective mechanisms for coordination and cooperation between various levels of government to avoid conflict and ensure efficient resource allocation.\textsuperscript{53} Eleventh, encourage public participation in the decision-making process. Involving local communities and civil society organizations can help ensure that fiscal decentralization meets people's needs and preferences.\textsuperscript{54} Twelfth, implement a monitoring and evaluation


\textsuperscript{49} V. Oluuyo and others, ‘Fiscal Decentralization Practices in Developing Countries’, \textit{Cuestiones Politicas}, 40.73 (2022), 128–50 \url{https://doi.org/10.46398/cuestpol.4073.06}

\textsuperscript{50} A. M. Kesale, C. Mahonga, and M. Muhanga, ‘The Quest for Accountability of Health Facility Governing Committees Implementing Direct Health Facility Financing in Tanzania: A Supply-Side Experience’, \textit{PLOS ONE}, 17.4 (2022), e0267708 \url{https://doi.org/10.1371/journal.pone.0267708}

\textsuperscript{51} T. J. Mohapi, V. T. Sambo, and G. M. Ferreira, ‘Fiscal Decentralisation’, \textit{Administratio Publica}, 31.2 (2023), 113–35 \url{https://doi.org/10.10520/ejc-adminpub_v31_n2_a7}


\textsuperscript{54} Michael, Dick, and Peersit.
system to measure the results of fiscal decentralization. Regular evaluation can help make necessary adjustments and improvements. Thirteenth, learning from the experiences of other countries that have implemented fiscal decentralization can provide valuable insights and best practices.

In order to realize the vision of fiscal decentralization, four missions must be achieved, namely, developing a relationship between central and regional finance that reduces vertical and horizontal gaps, maximizing the development of the local tax system to support a more efficient national resource allocation system, carry out the development of discretionary regional spending to be responsible in order to achieve minimum public service standards and harmonization of central and regional spending for optimal public service delivery. Efforts to minimize the vertical gap are carried out by giving attention and appreciation to the regions as resource producers in order to create harmonization between central and regional finances. Furthermore, by minimizing horizontal gaps, this is done by forming a pattern of financial relations that creates a relatively balanced fiscal capacity between regions in order to achieve minimum public service standards in the regions. Even though the current fiscal decentralization design in Indonesia relies heavily on the financial expenditure side which is funded by transfer funds for the most part, efforts to strengthen regional taxes (local taxing power) need to be continued without undermining the principle of national efficiency. Minimum Service Standards (SPM) will be a measurable and objective indicator to assess regional success in implementing sustainable development-oriented discretionary spending. The existence of national programs and regional programs in the implementation of development in Indonesia has the potential for overlapping, over supply and under supply, so that central and regional expenditure harmonization is needed to achieve optimal public services. The key to harmonization of expenditures is that each expenditure must begin with clarity of duties and authorities at each level of government.

The implementation of fiscal decentralization is still faced with various challenges, namely: the utilization of TKD is not optimal most of the DAU is used for personnel spending, regional dependence on DAK as a source of capital expenditure, the local tax ratio is still quite low, even though PDRD revenue has increased but the local tax ratio is depressed at 1.2% in 2020 due to the co-19 pandemic, central-regional fiscal synergy is not yet optimal due to mismatch between central and regional programs. The regional spending structure is not satisfactory, among other things, programs and activities are not focused and domination of personnel spending. The five challenges mentioned above have an impact on the uneven distribution of public services between regions.

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Legal reforms undertaken by the government to increase fiscal decentralization and support regional economic growth could involve several important steps. The following are steps that countries can implement to strengthen fiscal decentralization and encourage regional economic growth: First, by giving greater fiscal authority to regional governments: The central government needs to give greater authority to regional governments in managing revenue, expenditure and fiscal planning. This will allow regions to play a greater role in local economic development. Second, it is important to adopt a fair revenue sharing mechanism between the central and regional governments, so that regions have incentives to increase tax revenues and local resources. Third, local governments must be encouraged to develop local sources of revenue through taxes and levies that are appropriate to the economic characteristics of their region. Fourth, the central government must provide support in the form of training, education and technical matters to strengthen the capacity of local governments in fiscal planning and management. Fifth, local governments need to be encouraged to identify strategic infrastructure projects that can increase competitiveness and economic growth in their regions. Sixth, monitoring and accountability mechanisms must be strengthened to ensure efficient and transparent use of public funds at the regional level. Seventh, Policy Evaluation and Correction: It is important to carry out regular evaluations of fiscal decentralization policies and make corrections if necessary so that they are in line with regional economic growth goals. Ninth, Inclusion and Empowerment: Legal reform must ensure that all communities and social groups, including the less fortunate, benefit from regional economic growth.

4. Conclusion
Fiscal decentralization can be a useful policy strategy for many countries, but it requires careful planning and implementation. Each country has a unique situation, so third countries should consider their specific circumstances and objectives when implementing fiscal decentralization, taking into account the implications. Decentralization in the

61 Önder and Zengin.
62 Liu, Xin, and Li.
63 L. Zhao, K. Shao, and J. Ye, ‘The Impact of Fiscal Decentralization on Environmental Pollution and the Transmission Mechanism Based on Promotion Incentive Perspective’, Environmental Science and Pollution Research, 29.57 (2022), 86634–50 https://doi.org/10.1007/s11356-022-21762-1
Philippines is deemed to be comprehensive and has one of the most substantial legal bases in Southeast Asia. Moreover, each tier or each type of local government has a rather direct relation to the central government, especially in the context of fiscal relationships, and are relatively independent compared to other countries in the region. Fiscal decentralization is a policy strategy that can be beneficial for many countries, especially for improving the efficiency of public financial management and providing autonomy to local entities. However, implementing fiscal decentralization requires careful planning and implementation, as each country has unique situations that need to be taken into account.

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