Comparative practices in fiscal management between governments
Experiences for the Philippines

POLICY BRIEF

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ABSTRACT

This policy brief provides an overview of the theory and practice of fiscal federalism and draws some implications for the evolution of decentralization in the Philippines. This policy brief is organized in two sections. The first section analyzes the design of intergovernmental fiscal arrangements and the nature of horizontal and vertical relations in federal and decentralized systems by exploring three important drivers of intergovernmental conflict: insufficient regional self-rule, high vertical imbalances and prominent regional economic inequalities. The discussion of each dimension includes some takeaway lessons for the case of the BARMM region and, more generally, for the territorial model in the Philippines. The second part of the policy brief analyzes the gap between the theory and practice of fiscal federalism. It describes the distance between some of the normative principles of fiscal federalism in three crucial areas – the allocation of transfers, the correspondence between tax and spending powers and equalization transfers - and the perils associated to a design of fiscal arrangements that deviates from those principles. This section includes a reflection on the implications of the mismatch between theory and practice for the Philippines as well as references to comparative cases to illustrate some of the arguments in the discussion.
1. INTERGOVERNMENTAL FISCAL ARRANGEMENTS AND CONFLICT

The design of subnational financing is usually one of the most controversial issues in decentralized and federal systems. The conflict stems from the fact that the specific design of revenue and expenditure decentralization is the most important defining characteristic of subnational self-rule. Certainly, economic relations between different levels of government reflect the real distribution of power between the center and the subnational units, and this distribution may significantly change when intergovernmental fiscal relations are modified, even in the absence of an amendment of the formal distribution of powers (usually established in the Constitution). The design of territorial financing is, due to its implications in the distribution of power, an essential aspect in the management of intergovernmental conflict.

From a comparative perspective, intergovernmental conflict is more likely to arise when fiscal arrangements between the subnational units and the center limit subnational self-rule, when regional fiscal imbalances result in subnational fiscal irresponsibility or when regional economic inequalities prompt disagreement over the design of equalization transfers. In the next paragraphs, I present some of these potential sources of intergovernmental conflict based on the comparative evidence.

1.1. Lack of regional autonomy

When expenditure powers are decentralized to democratically elected subnational units with legislative powers over specific policy areas (political decentralization), the capacity for self-rule of these subnational authorities is heavily influenced by how expenditures are funded. Regional autonomy will be significantly undermined if subnational governments’ expenditure powers are primarily funded through conditional transfers from the central government (resources over which territories lack decision-making capacity), as compared to a scenario in which subnational expenditures are funded through sources over which they have discretion (unconditional transfers, revenue-sharing with certain normative powers or their own taxes).

When the decentralization of powers to subnational units is not accompanied by adequate resources to fund expenditures, the exercise of subnational authority is also undermined. When the central government imposes expenditure requirements on subnational governments without adequate funding, this frequently leads to vertical intergovernmental conflict.

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1 For example, in the case of Argentina, the strength of the presidency has usually determined the power of the provinces and states against the federal administration. Thus, in Argentina, during the time of Raúl Alfonsín, there was a weak federal government that faced powerful governors in the provinces, who obtained important economic advantages in exchange for giving support to the President. This changed radically with the arrival of Menem and the beginning of a strong presidency that balanced the balance of power between levels of government in favor of the federal government (León 2015).

2 Demands for greater fiscal decentralization in Italy promoted by the Northern League during the 2000s, the “devo-plus” proposal in Scotland as an alternative to secession (full fiscal decentralization towards the Scottish government) or the Agreement of Lambermont in Belgium in 2011 (which launched greater fiscal decentralization to the regions, as advocated by the Wallonia region) illustrate that the management of intergovernmental conflicts often goes through proposals to reform the financing system and, in specifically, for a greater transfer of fiscal autonomy when the conflict leads to secessionist tensions.
conflicts (between the center and the subnational jurisdictions). This scenario of finance not following function is known as “unfunded mandates”, and complaints by subnational governments about this type of mandates can be found in many federations, including Canada, Spain or Russia. When the responsibilities are decentralized to subnational governments but revenues are not decentralized, the quality of services provided by subnational governments may decrease significantly. This causes complaints from subnational authorities as they bear the electoral costs of poor service provision.

1.2. Vertical fiscal imbalances

Vertical fiscal imbalances stem from the mismatch between regional governments’ spending and taxing powers. Alternatively, in other words, it measures the extent to which regional governments’ own expenditures are financed through sources other than regional own revenues (Beramendi, Garmendia Madariaga, and León 2020). There is empirical evidence showing that high levels of regional dependence on transfers from the central/federal government might incentivize regional governments to engage in fiscal indiscipline, resulting in higher spending, deficits, and excessive borrowing (Rodden, Eskeland, and Litvack 2003).

When subnational revenues are funded by “common pool” resources (such as grants and/or tax sharing), subnational authorities receive the benefits associated with the provision of goods and services. Still they do not internalize their total cost because the transfers that are used to fund those services are funded from a common national pool of tax revenues (León-Alfonso 2007). This may generate soft budget constraints for subnational governments, leading to overspending and deficits.

Intergovernmental conflict arises when fiscal irresponsibility in one jurisdiction has negative externalities on the national economy and the central government must raise revenues to bailout indebted regions. Following these considerations, we may expect the central administration to be willing to delegate tax powers to subnational governments to prevent them from incurring deficits or excessive borrowing.

Lessons for the Philippines: A difficult equilibrium

Section 1.1 and 1.2 above illustrate the delicate balance of powers in which the stability of a federation is grounded: a balance between a powerful federal government that ensures macroeconomic stability and redistribution, but not too powerful to void subnational authority (as illustrated in Section 1.1); and a set of subnational units that have sufficient authority to accrue the benefits of decentralization and prevent the free-riding on common goods (such as the national pool of tax revenues illustrated in Section 1.2). Federal dynamics represent a never-ending search for this equilibrium, for the design of intergovernmental fiscal arrangements that can maximize the benefits of fiscal decentralization (and prevent its greatest perils).

A lesson from the comparative evidence for the Philippines case is that the balance between centrifugal and centripetal forces in federal systems is not
stable. Although devolution processes are conceived as the way to appease political conflict, they may alter political dynamics in a way that may ultimately reinforce or open new demands for greater authority. So political conflict might not necessarily disappear. In addition, changes in the balance of powers between the center and the subnational units do occur and can be caused by a variety of different events, such as the appearance of new political movements (for example, the secessionist movement of the Lega Nord in Italy in the early 1990s) or external shocks. For instance, the Great Depression in the US during the 1930s changed the degree of government intervention in society and the economy and enhanced the role of the federal government in social security programs. Another example is the Covid-19 pandemic, which prompted a centralized response in some countries that may outlast the end of the pandemic (León and Garmendia Madariaga 2020).

In the Philippines, intergovernmental fiscal arrangements must therefore be designed with surgical precision. This means that the regulations on expenditure and revenue decentralization must establish the right incentives for federalism to be “self-sustaining” (Filippov, Ordeshook, and Shvetsova 2004), that is, capable of finding a good balance between an excessively powerful federal government that ruins subnational autonomy and a system where opportunistic behavior by subnational elites ends up undermining national common goods.

1.3. Regional economic inequalities

Regional economic inequalities represent an additional challenge for the stability of intergovernmental relations. Economic endowments are usually unevenly distributed across regions, and different levels of economic development across jurisdictions might deepen intergovernmental conflict. Certainly, in order to guarantee a minimum common level of quality in the provision of services, it is necessary to implement a sound system of leveling transfers (in the form of equalization transfers or solidarity transfers). However, richer regions may perceive such redistribution as an excessive “burden” that exceeds the benefits of remaining in the union (and that may contribute to fuel secessionist pressures). If a modification of the design of transfers from the central government has a zero-sum nature (an increase in transfers in some regions leads to a loss of resources in others) then intergovernmental conflict might be hard to avoid. In Spain, for instance, past disagreements during the negotiation of a new model regional financing have traditionally been resolved by turning a zero-sum bargaining into a positive-sum decision where all subnational governments gain new resources under the new system of financing (León 2015).

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3 In the European context, for instance, there are significant economic regional inequalities between the North and the South of Italy, between Flanders and Wallonia in Belgium or between the Spanish peripheral northern regions (Basque Country and Catalonia) and the southern regions (Andalusia and Extremadura).
Lessons for the Philippines: a latent political divide fueled by asymmetries

The economic asymmetries between territories represent one of the most important sources of horizontal (across regions) intergovernmental bickering. This type of intergovernmental conflict is hard to avoid, as economic endowments are usually distributed unevenly across territories, as the case of the Philippines illustrates. It is important to note that conflict over economic inequalities might remain latent in the political debate until they are activated by political entrepreneurs as a strategy of electoral competition, particularly when economic grievances are linked to demands for cultural or identity recognition.

Power asymmetries may also represent a source of intergovernmental conflict. Regional grievances are also more likely to emerge when powers have been asymmetrically distributed, as asymmetric self-rule may reinforce inter-regional comparisons, competitive and confrontational relations and, ultimately, trigger an escalation of demands for self-government from the under-empowered regions in order to “catch up” with the more empowered ones (Hombrado 2011).

In the case of Spain, for instance, two regions, the Basque Country and Navarre, were granted full autonomy over taxes. This prompted rich regions that were financed under the Common system of financing to periodically claim reforms of the regional system of financing oriented towards an increase of tax decentralization (León-Alfonso 2007). In Italy, federal reforms during the 1990s were prompted by the rich and industrialized northern ordinary regions, which pressured the central government to develop their potential for self-rule. Accordingly, in 1999 and 2001, two major constitutional amendments were approved in Italy that considerably increased the autonomy of ordinary regions (Palermo 2021).

In the Philippines, one possible scenario is that devolution in the BARMM region is followed by increased demands for self-rule in other territories. These demands might be more likely to arise when existing divisions - ethnic, linguistic or economic - are used by opportunistic political leaders to build regional electoral platforms grounded on territorial and group grievances. In other countries, an integrated party system with strong statewide parties competing in regional elections may curb the emergence of this type of leader. However, the highly fragmented party system in the Philippines based on clans and personalities might weaken the capacity of the system to contain the emergence of centrifugal dynamics.

4 However, the economic conflict is not always associated with ethnolinguistic demands or claims for greater political autonomy. This is the case, for example, in Germany, where the weight of the nationalist parties is practically non-existent, but this has not prevented the richest states (Hesse, Bavaria and Baden-Württemberg) from challenging the system of interterritorial transfers before the Court Constitutional for considering it excessively redistributive (León 2015).
2. THE DESIGN OF FISCAL DECENTRALIZATION: FROM THEORY TO PRACTICE

Fiscal federalism studies the normative allocation of revenue and expenditure powers in a decentralized system in order to guarantee efficiency in the provision of public goods. Next, I provide a brief overview of the most important principles of fiscal federalism, compare them to how fiscal relations are designed in the real world and discuss some of the implications of the mismatch between theory and practice.

2.1 The allocation of competences

Fiscal federalism theory establishes that the allocation of competences to subnational levels of government must be done considering the costs associated to the provision of goods and services and the area of potential beneficiaries of the specific service or good. More specifically, the “decentralization theorem” by Wallace Oates establishes that “each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision” (Oates 1972:55).

Competences must also be allocated in a clear way and, to the extent that it is possible, clarify the nature of the responsibilities that are being transferred and the limits of the powers associated to each specific competence (León 2015). Finally, according to the principle of subsidiarity, competences must be assigned to the lowest order of government (the government closest to the people) “unless a convincing case can be made for assigning these to higher orders of government” (Shah 2007:7).

The allocation of competences to local governments for the provision of local public goods and services is theoretically associated to two forms of efficiency: allocative efficiency and productive efficiency. On the one hand, allocative efficiency means that a decentralized provision of goods and services allows for a better match with citizens’ preferences over the production of those services and goods than a centralized provision. On the other hand, productive efficiency in a decentralized scenario results from expenditure decisions being better tailored to the real costs of the production of the service or local good. In addition, the economic efficiency gained through the diversification of public goods might be enhanced by consumer mobility and the so-called “voting with their feet” mechanism (Tiebout 1956). Finally, decentralization can promote innovation and experimentation in the provision of public goods.

The allocation of competences and its impact for accountability. Lessons for the Philippines

The most prevailing form of decentralization is that of shared competences (Rodden 2002). The distribution of competences in federal entities is therefore a far cry from the form of decentralization envisaged in the fiscal federalism literature, which conceptualizes the division of powers as a clean transfer of authority and/or resources from central to subnational governments in the form of watertight compartments, that is, with no interference between local and federal spheres of authority.
Decentralization usually implies a fragmentation of responsibilities within public policy areas and resources between different levels of government, resulting in an intertwined and complex state. Health care, education or social services are the policy areas that face particular challenges with respect to overlap and fragmentation, as the management of the Covid-19 crisis has clearly illustrated (Allain-Dupré et al. 2020).

This complex distribution of authority has implications for accountability, as clarity of responsibilities is one of the crucial conditions for citizens to hold politicians accountable (León and Jurado 2021; Hobolt and Tilley 2014). Accountability in multilevel systems of governance cannot work if there is no clear understanding of who does what. This is because the most basic form of accountability happens in elections: citizens evaluate economic and policy outcomes and punish or reward the incumbent accordingly. However, this mechanism can only work if citizens are able to associate outcomes with the responsible level of government: They must be able to identify and then evaluate the specific regional package of services and taxes offered by the regional government.

The vertical distribution of powers complicates responsibility attribution in federal countries. Particularly relevant for the Philippines case is that it takes time for citizens to learn on new devolved responsibilities at the regional level. This means that for a certain period of time a mismatch in responsibility assignments will emerge: citizens will continue to hold the central government accountable for public services in policy areas that have been already devolved to the BARMM administration, as other similar cases of “holding-together” devolution very well illustrates (León 2012). This mismatch undermines the incentives of regional politicians to be responsive to the preferences of the regional population and provide an efficient provision of services because the benefits (or potential costs) associated to good (or alternatively poor) governance at the regional level might eventually be borne by central, not regional, authorities.

2.2 The alignment between tax and spending powers

The fiscal equivalence principle establishes that those who bear the costs associated to the provision of a local public good or service must be the ones who benefit from it. This correspondence between the marginal benefit and the marginal cost of production assures an optimal provision of the public services, that local authorities are responsive to the preferences of the people who benefit and bear the costs of the service and increases fiscal responsibility, particularly if the financing of the services is decentralized. Fiscal responsibility is enhanced when the local decision on public goods or services expenditures are accompanied by the local governments’ capacity to raise the necessary revenues to finance them. However, the constitutional assignment of taxes and expenditures to regional governments in federations shows an imbalance between subnational revenue means and their expenditure needs and this mismatch has consequences both on fiscal responsibility and accountability. In all OECD countries, for instance, spending is more decentralized than revenue (OECD 2021:20).
Vertical fiscal imbalances in practice. Lessons for the Philippines

In practice, the basic idea in fiscal federalism that subnational control of expenditures and taxation should be aligned. As was stated above, in most countries have a vertical gap since the spending needs of regional governments are usually greater than what they earn through the taxes assigned to them. This happens because in the design of tax assignment the principle of revenue adequacy - that revenue means should be matched to expenditure needs - cohabitates with the principles of economic efficiency, national equity and administrative feasibility (and the latter may result in certain taxes being assigned to the central government, see Shah 2007: 20).

The fact that the design of regional financing in federal and decentralized countries does not conform to what the theory predicts is one of the factors that explains why many of the associated the economic benefits associated to decentralization (such as greater economic efficiency) do not occur. Different case studies and cross-country empirical evidence show that large vertical fiscal imbalances and a high degree of fiscal dependence are related to less fiscal discipline (OECD 2021: 197).

In order to prevent regional fiscal irresponsibility regional tax autonomy should be combined with hard budget constraints. Regional governments should have their own tax instruments and strong tax collection powers, coupled with hard budget constraints imposed by the central government. It is vital to articulate that there will be no bailouts, explicit or implicit, or cost-free handouts from the central government.

In addition, regional tax and expenditure autonomy can enhance regional governments’ responsibilities and, in turn, strengthen accountability. Regional political responsibility and accountability to the voter cannot be enforced if subnational governments lack fiscal autonomy. Voters must be aware of the costs associated with public goods and services provided by subnational governments to hold them accountable in elections. However, as stated above, it takes time for citizens to learn about the distribution of tax responsibilities between different levels of government. For instance, the case of Spain shows that a significant proportion of the electorate continue to ignore the fact that regional governments have significant responsibilities over the income tax (León 2015; León-Alfonso 2007).

2.3 Equalization and solidarity

According to fiscal federalism theory, a necessary check upon regional fiscal autonomy is the need to compensate for the unequal distribution of fiscal capacity across territories. Two mechanisms should be put in place to guarantee horizontal equity (equal treatment of citizens nationwide): equalization and solidarity transfers.

The main goal of equalization transfers is to assure that all territories can provide services of similar quality, provided that they make a similar fiscal effort. The “fiscal effort” is
determined by how regional governments use or manage their normative capacity over taxes. In other words, equalization transfers are meant to reduce the gap between the expenditure needs of a territory and its capacity to generate revenues through its own taxes.

The second mechanism consists of solidarity transfers to regions with lower per capita GDP in order to increase regional economic convergence. Central governments can also use public investment to increase the economic capacity of poorer regions.

**Equalization transfers in practice. Lessons for the Philippines.**

The degree of equalization of an equalization system is not a technical decision but a political one. Different types of equalization systems (based on costs, revenues or gap-filling) have different consequences on fiscal redistribution (OECD 2022: 46). As the decision on the level of interpersonal redistribution belongs principally to the realm of political choice, the same logic applies to interregional redistribution. Comparative evidence shows that the nature and degree of equalization vary significantly across federal systems. For instance, in Australia or Spain, the gap-filling equalization system consists of a single transfer designed to fill the gap between assessed costs and revenues. On the contrary, in Germany, there is limited revenue equalization because although Länder with above-average fiscal capacity partially reallocate a portion of their revenue to Länder with below-average fiscal capacity, they can also appropriate their own-source revenues above a certain level of redistribution (OECD 2021:55; Bosch and Durán 2008:142).

We know from different country cases that one of the most conflictive issues in designing regional financing is to determine the degree of equalization of the system. In Spain, the last round of bargaining of the regional model of financing in 2009 was particularly controversial regarding the design of equalization transfers, as richer regions demanded the reduction of the degree of equalization of the system and poorer regions were opposed to any modification.

It is important and good practice to keep equalization formulas simple and transparent while designing them. As these formulas usually include indicators such as surface area, geography or poverty rates to estimate costs of expenditures (and each indicator may have a specific weight in the formula), a complex design may end up trumping the transparency of the results of the formula. In Spain, the equalization formula is highly complex, although the last reform of the regional financing system introduced better indicators to estimate the costs associated with the provision of services (León 2009). In Italy, the equalization formula that measures the costs associated with local government competencies is equally complex (OECD 2022: 51).

A lesson to be drawn for the Philippines case is to design an allocation formula that is based on objective indicators that cannot be directly affected by policy choices so that policy neutrality of equalization is enhanced (OECD 2022: 64). Otherwise, perceptions of unfairness in the system may fuel continuous demands for its reform and reforms may in turn result in more unstable or unpredictable subnational finances.
REFERENCES


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