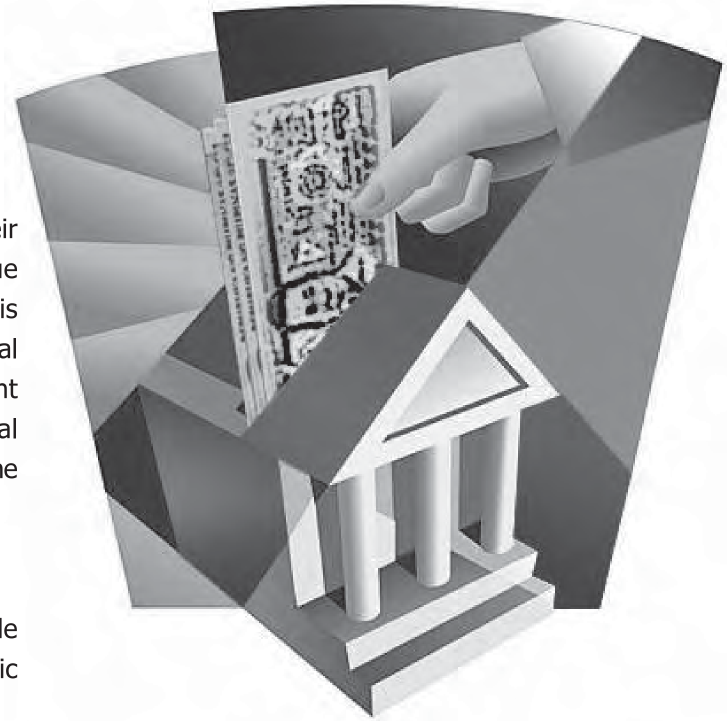
ECONOMIC POLICY
REFORM & ADVOCACY



Local government units (LGUs) need to strengthen their financial capabilities by exploring innovative revenue generation and resource mobilization schemes. This is especially since traditional budget allocation from a central agency and financing from international development agencies have become more and more inadequate. Local governments should vary their financial options and redefine their financing strategies to meet these challenges.

LGU Financing Outcomes

The implementation of the 1991 Local Government Code (LGC), allowed LGUs to borrow from private and public

An Overview of LGU Financing

Who's bankrolling the LGUs?

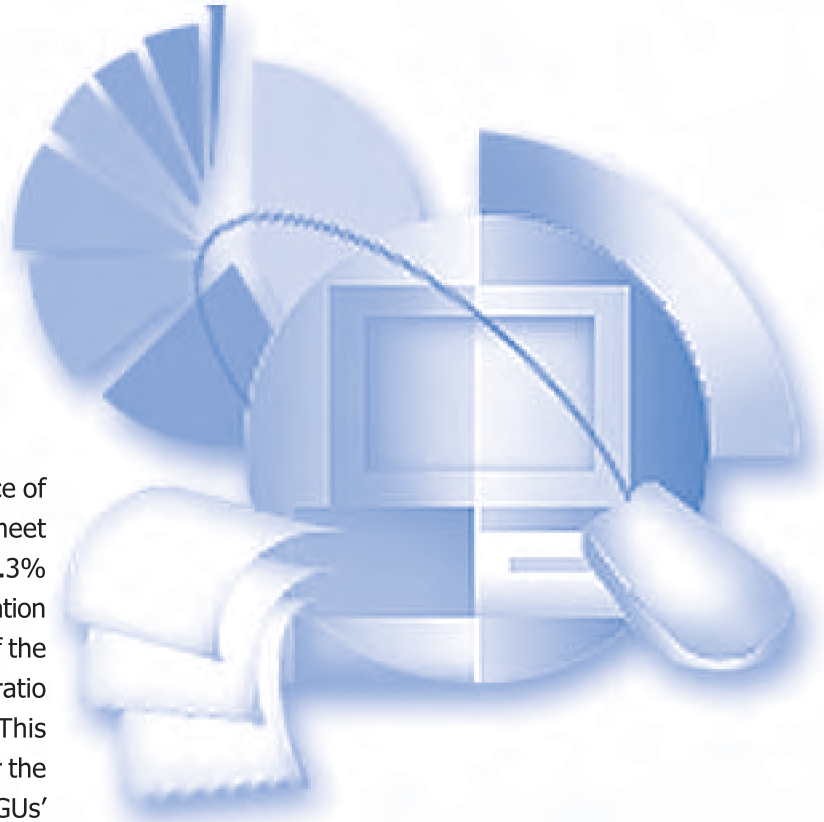
financial institutions without prior approval from the Department of Finance (DOF). Consequently, the degree of fiscal decentralization in the post-LGC period was not only higher but became more intensified as seen in the expenditure decentralization ratio (or EDR, defined as the relative importance of local expenditures to general government expenditures) and the modified decentralization ratio (expenditure decentralization ratio net of debt service from both local and government expenditure). The latter measure increased from 8.1% in 1985-1991 to 16.8% in 1992-1999. The first measure also followed a similar path, going up by about 3 to 6 percentage points higher than EDR.

In fact, in 1995-97, four years after the LGC went into effect, figures for the two measures show that the degree of fiscal decentralization appeared to have deepened, compared to the 1992-1994 figures. The two indicators registered substantial increments between the two post-Code sub-periods.

Still, public sector finance in the Philippines continues to be largely concentrated at the center. The increase in the

Traditional budget allocation from a central agency and financing from international development agencies have become more and more inadequate. Local governments should vary their financial options and redefine their financing strategies to meet these challenges.

Still, public sector finance in the Philippines continues to be largely concentrated at the center.



revenue decentralization ratio (the relative importance of local revenues to general state revenues) didn't meet expectations, rising from 4.9% in 1985-1991 to only 6.3% in 1992-1999. Moreover, the degree of fiscal decentralization appeared to have declined with the implementation of the LGC when measured by the financial autonomy ratio (ratio of locally raised revenues to local expenditures). This measure dropped from 51.6% pre-LGC to 35.0% after the Code. This indicator is important because it shows LGUs' capacity to sustain their operations and thus their ability to remain autonomous. While we view expenditures as signs of stronger decentralization, these are in fact misleading without corresponding improvements in revenues.

More importantly, debt stock has been rising. Records show that LGUs have borrowed heavily from key semi-government banks—the Land Bank (P45 billion [B]), Development Bank of the Philippines (P5.384B), and Philippine National Bank (P5.384B). It seems clear from this that the government needs to take a closer look at the financial situation of LGUs to genuinely decentralize and empower them. The extent to which they are able to deliver and improve their services to their constituents very much depends on the resources available to them.

LGU Financing Policies and their Consequences

The LGC shifted many functions and revenues to the LGUs, including providing LGUs with a formula-based fiscal transfer to support their responsibilities. The Code defines the total Internal Revenue Allotment (IRA) in any one year as 40% of the gross national (internal) government tax revenue averaged over the three years prior to the current year. The IRA provides all LGUs with direct, unrestricted transfers. It is allocated first among subnational levels—23% to provinces and cities, 34% to municipalities, and 20% to barangays—and then within level by a formula based on population (50%), land area (25%) and equal share (25%).

The IRA accounts for 94% of total transfers. Categorical grants to LGUs are relatively small and come from various sources: (1) lump sum allocations under the General Appropriations Act of various years; (2) allocations made by national government sector agencies from their own budgets; and (3) lump sum and/or line item appropriations at the direction of legislators. Notice that the Code does not mention matching grants. Transfers account for more than three-quarters of the provincial and municipal revenues. However, it is the cities that have more financial autonomy, relying on the IRA for about 40% of their income.

Prior to 1991, LGUs were restricted to borrowing from government financial institutions (GFIs)—including government banks and the Municipal Development Fund (MDF)—for their capital financing requirements. While local government borrowing was never a substantial source of

LGU financing compared to revenues from sources such as the IRA, grants, and local taxes, the GFIs nevertheless stopped lending to LGUs in the mid-1980s because of mounting LGU loan arrears and defaults. The national government had to step in with a first debt relief program for LGUs in the 1980s and a second one after the enactment of the Code, giving LGUs a clean slate vis-à-vis government lenders. The 1991 Code allowed local governments to float their own bonds, enter into build-operate-transfer arrangements, and in general, tap various sources of credit financing. LGUs were no longer confined to sourcing credit from GFIs.

What then constituted the major source of loan financing for local governments since the Code's passage is the MDF? Created by Presidential Decree 1914, the MDF serves as a revolving fund for official development assistance-supported projects of local governments. Through programs like the Municipal Development Program, Community-Based Resource Management, and Local Government Finance and Development Program, the MDF provides loans to finance revenue generation, social infrastructure, and environmental projects of local governments.

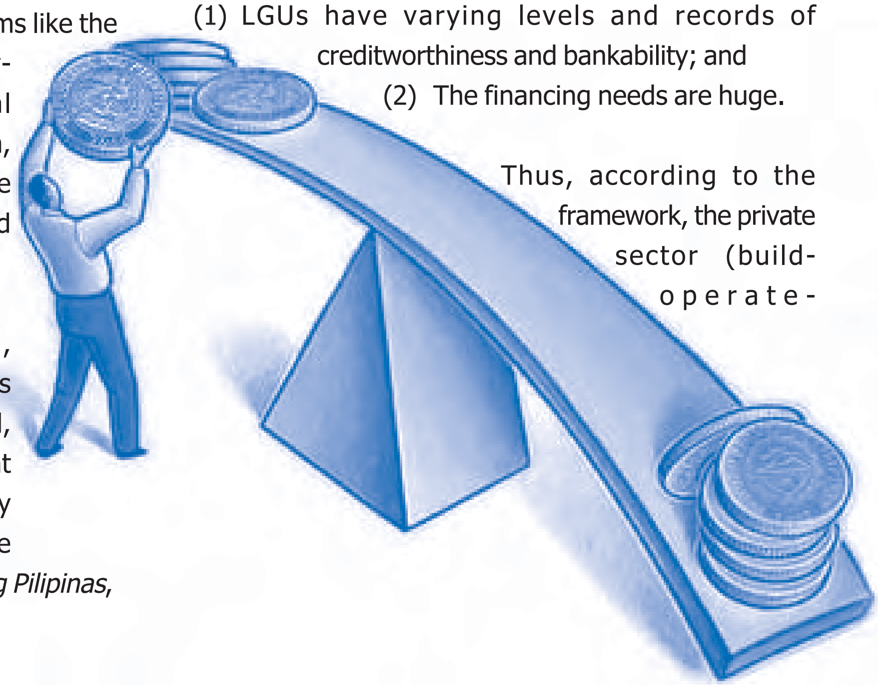
The combined state policy of devolution, liberalization and deregulation however has resulted in the increased spending of LGUs and, with their added responsibilities, the consequent depletion of funds for development. In the early 1980s, the state liberalized and deregulated the financial markets. It asked the *Bangko Sentral ng Pilipinas*, for instance, to stop its involvement in government credit programs and to transfer the Agricultural Loan Fund to the Land Bank of the Philippines. With prodding from foreign donors, the government also started to dismantle the subsidized agricultural credit programs which had been funded at great cost to taxpayers, yet had failed to provide the intended beneficiaries, the small farmers and other small scale borrowers, access to bank credit. Thus, in 1987, the government terminated 42 subsidized credit programs in the agriculture sector and consolidated the remaining fund balances into a loan guarantee scheme for farmers called the Comprehensive Agricultural Loan Fund (CALF). The CALF was to be used to encourage bank lending to small farmers and other small-scale borrowers. The expectation was that by taking as much 85% of the credit risks of small farmer loans, the CALF would encourage private banks to lend to small farmers. However, particularly because the government often imposed unfunded mandates, public credit failed to flow into the rural areas and only made LGU spending on public goods greater.

Government Recommendations

To support the Code's decentralization objectives in 1996, the DOF prepared an LGU Financing Framework. The framework defined a vision and an action program to make financing of LGU capital investments more market-based. The vision was anchored on two premises:

(1) LGUs have varying levels and records of creditworthiness and bankability; and

(2) The financing needs are huge.



Thus, according to the framework, the private sector (build-operate-

The principles and strategy embodied in the framework are still valid and are crucial to the Philippine decentralization process. However, the framework has only been weakly implemented.

transfer [BOT] investors, bondholders, commercial banks), the GFIs, and MDF all have a role to play in meeting LGU financing needs. The ultimate objective is to graduate LGUs to private sources of capital, which are vast and promising but remain largely untapped.

The Framework recommended that steps be taken to achieve seven reform objectives: (1) increase LGU and BOT arrangements; (2) develop the LGU bond market; (3) promote LGU access to private banks; (4) optimize involvement of GFIs in LGU financing; (5) restructure and reorient the MDF to use it for program and policy loans to local governments; (6) improve LGU capacity to raise their own revenues; and (7) tap ODA technical assistance and financing.

Also, as part of this framework, the Inter-government Coordinating Council and the National Economic Development Authority developed a matrix specifying the loan-grant-equity mix that would apply to LGU projects which required loan or grant financing whether the project was supported by multilateral or national funds. The matrix was an attempt to enhance the transparency of subsidies for LGU programs, to clarify the eligibility of certain investments for matching grants, and to specify the matching formula that would be applied to projects of certain types, for LGUs of a given class. However, support for the loan-grant-equity mix formula declined with changes in government administration, and it was used only for projects implemented by the Municipal Development Fund Office, which must adhere to World Bank conditions on the use of its loan funds.

The principles and strategy embodied in the framework are still valid and are crucial to the Philippine decentralization process. However, the framework has only been weakly implemented. As a result, LGU borrowing for critical investments occurs in a non-competitive environment, and funds from multilateral sources are channeled in inefficient ways. For example, the World Bank's own projects do not always assure the same credit conditions, which leads to cases where LGUs invest in certain types of infrastructure because of the more lenient credit terms, rather than because of the soundness of the investment or its contribution to the community.

References

Llanto, G. 2004. "Rural Finance in the Philippines: A Continuing Saga in Policy Challenge," *PIDS Policy Notes*, No. 2004-06.

Llanto, G. 2003. "Policy Lending for LGUs: An Innovative Financing Instrument for Local Governments," *PIDS Policy Notes*, No. 2003-05.

Manasan, R. 2000. Fiscal Decentralization: The Case of the Philippines. Processed paper. Makati: Philippine Institute for Development Studies.

Wiest, D. 2004. *Intergovernmental Loans: Their Fit into a Transfer System*. International Studies Program Working Paper 04-22, Andrew Young School of Policy Studies, Georgia State University.