Financing Local Infrastructure Through a Municipal Development Fund

The Case of the Philippines

Infrastructure Finance Regional Workshop
Sponsored by USAID Indonesia
Project No.: 940-1008

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for the
Research Triangle Institute
(RTI Task No.: 6598-03)

November 1997

Environmental and Urban Programs Support Project
Contract No.: PCE-1008-I-00-6005-00
Project No.: 940-1008
Contract Task Order No. 02
Sponsored by the Office of Environment and Urban Programs (G/ENV/UP)
U.S. Agency for International Development
Washington, DC 20523

FINANCING LOCAL INFRASTRUCTURE THROUGH A MUNICIPAL DEVELOPMENT FUND: THE CASE OF THE PHILIPPINES[1]

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I. WHY A MUNICIPAL DEVELOPMENT FUND?

The paper has two objectives: (a) to discuss briefly the operation of a municipal development fund (MDF) which has been used by the Philippine government to provide long-term credits to local government units (LGUs) and (b) to present the policy, regulatory and institutional reforms needed to improve the MDF's performance to increase the flow of funds to local infrastructure. It has three parts. Section 1 discusses the rationale of the MDF and its projected role in the future. Section 2 describes the implementation of the MDF. Based on the experience with this financing option, the last section enumerates the next steps toward greater LGU access to long term finance.

In more developed countries, LGUs have access to the private capital markets for local infrastructure financing. In contrast, in a developing country like the Philippines, the LGUs have not successfully tapped the private capital markets. This is explained by the relatively undeveloped state of the Philippine capital markets and a number of reasons, among which are the following:

- The market has no information on the creditworthiness of LGUs.
- LGUs have uneven management and executive ability.
- Banks prefer to finance short-term, revenue generating projects.
- There is a mismatch between LGUs' demand for long term financing for infrastructure and the supply of financing available in the private markets.

Thus, LGUs have traditionally only two major sources of infrastructure finance: (a) the *government financial institutions (GFIs)* and (b) the *municipal development fund (MDF)*. See *Table 1.*

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[1]Presented at the USAID\UMP Regional Conference on "Local Government Infrastructure: Implementing Financing Options," Jakarta, Indonesia, 10-12 November 1996.

The author acknowledges the assistance of Mary Ann Dizon in the preparation of this paper.

Table 1. LGU Loans from Traditional Sources

Loans approved	In million pesos	No. of LGU borrowers
Municipal development fund (as of June 1995)	1,827.8	87
Government financial institutions		
Development Bank of Philippines (as of September 1995)	180.3	21
Land Bank of Philippines (as of November 1995)	4,693.2	108
Government Service Insurance System (as of March 1995)	120.8	9
Local Water Utilities Administration (As of June 1995)	9,401.6	409
Philippine National Bank* (As of October 1995)	5,921.7	88

* PNB is now a private commercial bank.
Source: Llanto et al. (1996).

Before the MDF's creation, only the government financial institutions (GFIs) lent to LGUs upon the review and recommendation of the Department of Finance. In 1984, the government created a Revolving Fund known as the MDF which is capitalized and funded by the proceeds of foreign loans, assistance and grants and is used to provide loans to LGUs. The motivation is to have an effective system for channelling long term (up to a maturity of 20 years) financing to LGUs. It has also been used to monitor the disbursement and utilization of foreign loans and assistance to LGUs. The GFIs provide mostly medium term loans, with a maximum maturity of 12 years.

With the 1991 Local Government Code's liberal credit policy framework, LGUs are now considering commercial bank loans, bond flotation and Build-Operate-Transfer (BOT) arrangements with the private sector for financing local infrastructure. They are now actively undertaking various private financing options without having to secure prior authority from the Department of Finance. Because of the LGUs' varying levels and record of creditworthiness and bankability, only the higher income LGUs will be able to access the private capital markets. The majority will continue to depend on the GFIs and MDF for long term financing until the capital markets are developed and the LGUs in general attain investment grade status.

Nevertheless, the Philippine authorities are currently taking concrete steps to address the LGUs inability to access the private capital markets[2]. More specifically, the long term objective is to graduate the LGUs to the private capital markets. In the interim period, the government will use the MDF and GFIs as LGU financing mechanisms, but more importantly as catalysts to bring them to the mainstream of private capital markets.

A related issue is the grant system for LGUs. Interfiscal transfers are an important source of LGU revenues. There are two broad types of transfers: (a) the internal revenue allotment (IRA) which represents the LGUs' share in national taxes and (b) grants/donations which are sourced from external donors. The government has recently adopted a policy framework for the grant system for LGUs which generally states that grants will be made available to LGUs on the basis of equity, externalities and economies of scale[3]. Community involvement, equity contribution and LGU counterpart funding are essential. An LGU will match the central government's grant through a 50-50% cost sharing scheme, depending on the type of local project and the LGU's income class. In this respect, the MDF is envisioned to play an important role in channelling grants to LG

II. IMPLEMENTATION OF THE MDF

Institutional change. The presidential decree creating MDF put it under the administration of the Department of Finance. It is presently administered through the Bureau of Local Government Finance (BLGF) under the Department of Finance. Figure 1 shows the organizational structure of the MDF. A Policy Governing Board composed of representatives of the Departments of Finance, Budget and Management, Public Works and Highways, Interior and Local Government and the National Economic and Development Authority oversees the MDF and lays down policy directions.

The MDF is implemented through two distinct units: (a) project budgeting, accounting and loan collection under the MDF/BLGF (*the financial unit*) and (b) project identification, packaging and approval under the CPO (*the implementing unit*) of each MDF (foreign-sourced) loan.

The *financial unit* of MDF/BLGF acts as a funding conduit for projects approved by the CPO's Project Steering Committee. and acts as project monitor and accountant. It consolidates the fund requirements of individual projects under an MDF budget, releases funds, undertakes financial reporting and replenishment through special accounts, and recovers the loans from the LGUs. Thus, the MDF *per se* does not function as a real credit intermediary but as a loan disbursing, monitoring and collecting unit.

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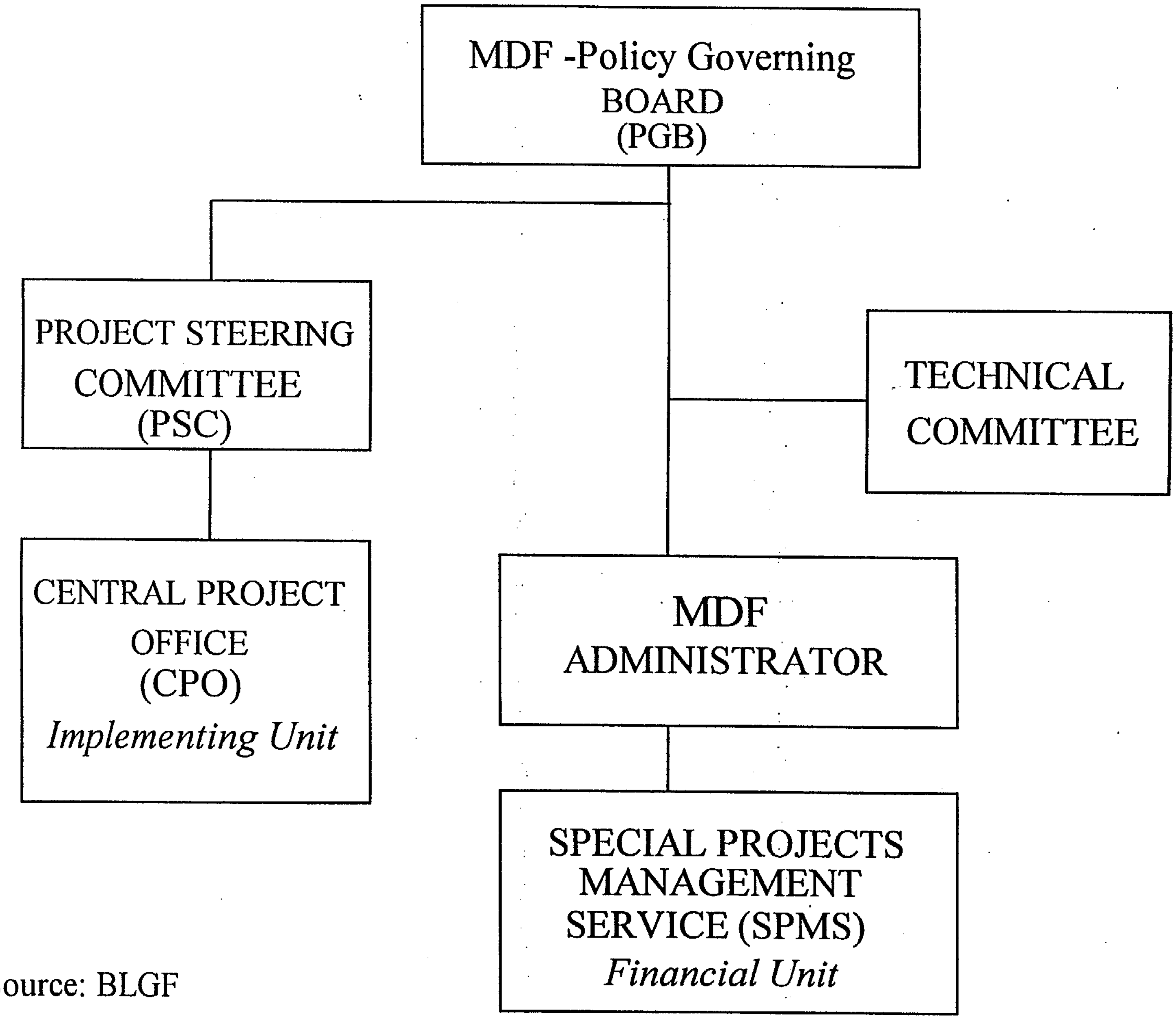
[2]See Soriano and Llanto (1996) for a statement of the new vision and policy framework for LGU financing. A more thorough discussion is in Llanto et al. (1996).

[3]NEDA ICC Policy Framework for National Government Assistance for the Financing of Local Government Projects with Environmental and/or Social Objectives.

Figure 1: MDF ORGANIZATIONAL STRUCTURE



Source: BLGF

Each project under the MDF has an *implementing unit* known as the Central Project Office (CPO) normally located in the lead agency for the given project. Thus, there will be a CPO at Public Works and Highways if the project is undertaken under that department. The CPO appraises the technical merits of a project and submits its recommendations to an inter-agency Project Steering Committee which approves or disapproves the proposed project. The CPOs and the MDF staff maintain close coordination through meetings, workshops, consultations and direct phone calls.

The Land Bank of the Philippines act as depository and servicing bank to MDF.

Regulatory change. The Departments of Finance and Budget and Management, and the Commission on Audit issue joint circulars on the accounting, auditing and budgeting procedures for the MDF together with the necessary information and guidance on fund releases, withdrawals, repayments.

The Policy Governing Board lays down policy directions and issues financial and credit policies which guide the operations of the MDF and the evaluation and control of local government transactions with it. Among the salient policies are the following:

- Any LGU will be eligible to apply for a loan, subject to its passing a creditworthiness test specified by the Policy Governing Board. This will be based on the current financial condition and on the future projection of the financial condition of the applicant LGU.

- The interest rate is currently set at 2% above the weighted average interest rate of 61-90 day time deposit.

- No collateral is required. The internal revenue allotment, representing the LGUs share in national taxes is used to guarantee loan repayment.

- Loan maturity period is from 15 to 20 years, depending on the economic or useful life of the project.

- Appropriate penalties shall be applied in the event of default by LGUs, including a recovery of arrears through offsetting from the internal revenue allotment.

- Subsidies to LGUs with limited borrowing capacity will be provided through explicit capital grant administered through the MDF grant mechanism, rather than through concessional loan terms.

- Debt servicing capacity is based on the provision of the 1991 Local Government Code which is set at 20% of the LGUs' regular income.[4]

[4]This is more liberal. i.e. 3 to 10 times larger than the previously-used formula set by the Commission on Audit.

To make it self-sustaining, loan repayments accrue to the MDF for loan reinvestment or relending to finance approved local projects. Thus, accumulated funds do not revert to the Treasury but are instead retained at the servicing bank of MDF. It is envisaged that the accumulated funds, called "second generation" funds will eventually pave the way for graduation from using foreign loans for relending to LGUs. As of December 1995, the accumulated funds were almost P1 billion pesos.

MDF has recently used the "second generation" funds to partly provide up front financing under the current Municipal Development Project (MDP) 3. Under the previous Municipal Development Projects 1 and 2, the World Bank provided the initial releases. However, under MDP 3, a different approach- reimbursement basis- is being used and thus, the MDF is able to provide LGUs up front financing.

Institutional capacity. The MDF Administrator is assisted by 16 personnel in the Central Fund Management Division under the Special Project Management Service of BLGF. This unit is the financial unit of MDF. The financial unit has personnel devoted exclusively to funds management, monitoring, accounting and loan collection. The CPOs which report to the lead or participating agency, e.g. Department of Public Works and Highways have their own full time personnel. Over the years, the CPOs have gained valuable experience and expertise in identification, development, appraisal and approval of local infrastructure projects.

Through the MDF approach, the government has achieved its objective of establishing an institutional framework to assist LGUs in project preparation, financing and implementation of infrastructure projects. An important element is the cooperation among different key government agencies through regular meetings of the Policy Governing Board and the Project Steering Committees of each CPO. Workshops, seminars and conferences are important venues to clarify policy directions and guidelines, thresh out problems and provide information on MDF operations.

Principal constraints. There are several constraints to the effective and efficient use of MDF as long term financing intermediary. The major ones are as follows:

- Originally conceived as a revolving fund, the MDF has functioned primarily as a fund disbursing mechanism. While loan collection has been generally satisfactory, resulting to a substantial stock of "second generation" funds, the MDF must envision a more catalytic use of those funds. For example, those funds can be used as a leveraging mechanism to draw co-financing schemes with the private sector, or as establishing credit lines to commercial banks for on-lending to LGUs. This means that the MDF's role must be nested within a larger vision of how to bring LGUs to the mainstream capital markets.

- Implementing MDF through two distinct, independent units creates inefficiencies. An immediate disadvantage is the risk of inconsistency between the technical feasibility and the economic and financial feasibility of the project. Under the present organizational arrangement, the financial unit is a mere conduit of loans, monitor and collector of loan repayments. The CPOs are in charge of project identification, appraisal and approval.

- The MDF has provided access to long term credit but the transaction cost for LGUs seems high. The financial unit is centralized and located in Metro Manila. The CPOs are likewise in Metro Manila. This makes the MDF inaccessible to many LGUs. In addition, MDF personnel (financial and implementing units) need considerable exposure and training to project evaluation techniques, financial management and related disciplines to be more effective.

III. MUNICIPAL DEVELOPMENT FUND IN THE FUTURE: NEXT STEPS

Policy and institutional framework for MDF. Today, the MDF is at a critical crossroads. With the policy of deregulation and financial liberalization, the private capital markets are expected to assume a greater financing role for LGUs. An evolving new vision and credit policy framework for LGU financing seek to restructure the MDF into an institution that will target and support the poorer LGUs through a combination of long term finance, grants and technical assistance with a view to eventually graduate them to the private capital markets over time[5]. It will not be an institution that will merely provide long term credits to LGUs, independently and unmindful of its catalytic role in the capital markets. Figure 2 summarizes the new vision and policy and institutional framework for LGU financing. It shows that the MDF in the near future will:

- target its financing to less creditworthy/poorer LGUs and to social/environmental projects;

- refrain from providing grants and credits to LGUs that are qualified to obtain financing from GFIs, commercial banks and to those with viable BOT projects; and

- provide technical assistance to improve the LGUs capacity and creditworthiness, enabling them to graduate to GFI credits, and eventually to private sources of capital.

Concrete steps. The following must be undertaken to vest on MDF a more catalytic role in LGU credit markets:

- ***Restructure MDF.*** The technical and financial units must be integrated into one semi-autonomous organizational unit under the DOF. The Policy Governing Board can be expanded to include representatives from the LGUs, GFIs and commercial banks to ensure that MDF funding goes to LGUs that do not have access to GFIs or the commercial banks.

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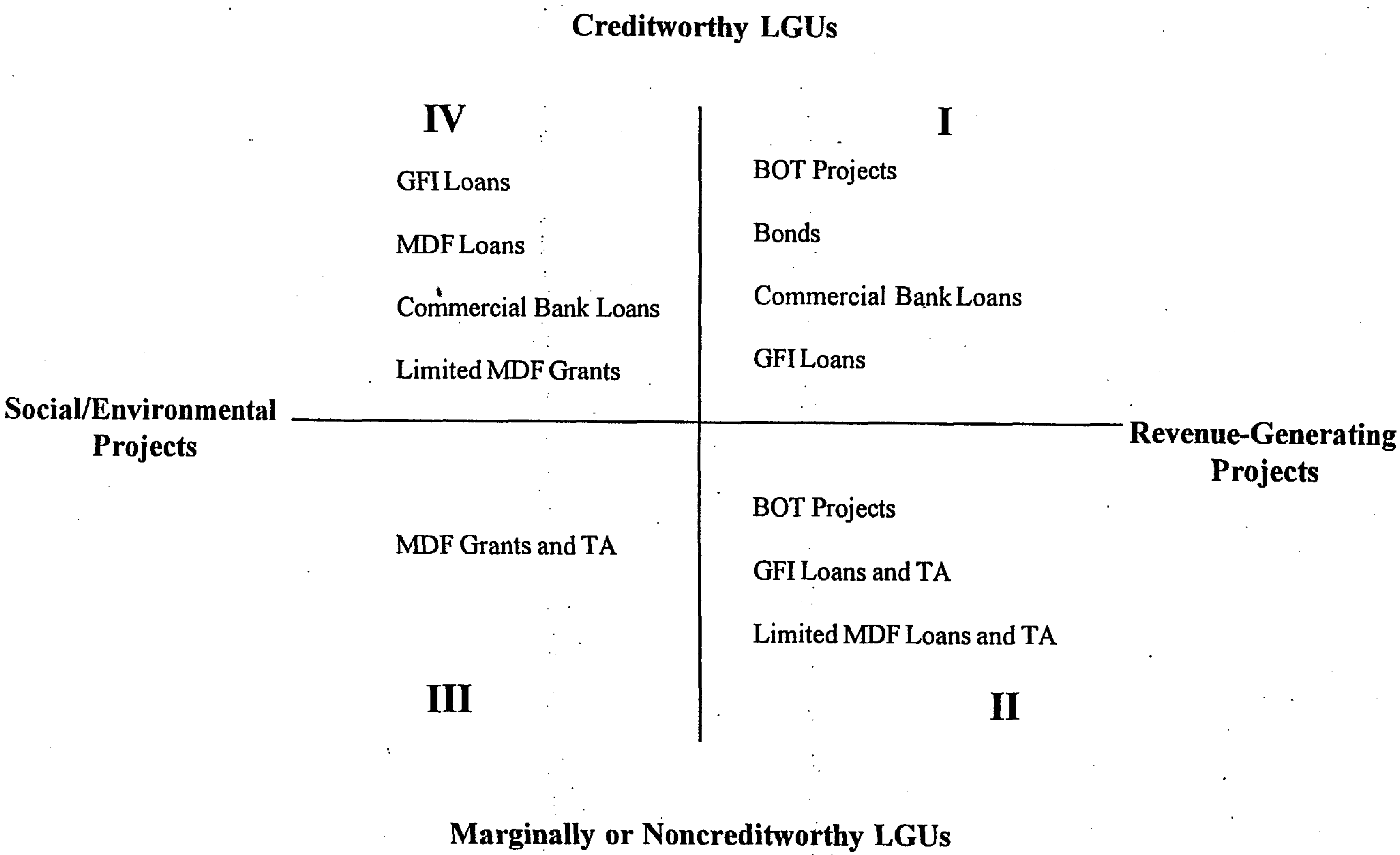
[5]Soriano and Llanto, ibid.

Figure 2: New Vision and Policy/Institutional Framework



- *Strengthen MDF*. As the government's main credit intermediary for the poorer LGUs and for social/environmental projects, the MDF staff must be trained in various aspects of project identification, development, appraisal, funds management, loan monitoring and supervision, loan collection. Automation of the MDF will improve its operational and administrative performance. To be able to provide technical assistance to LGUs, MDF staff will likewise need exposure and training in such areas as fiscal management, including revenue generation, user charges, expenditure control, BOT type arrangements, capital budgeting, budget programming.

- ***Define its role vis-a-vis GFIs and commercial banks***. There is a need to define the specific policies and operating rules that will govern its relationship with GFIs and commercial banks with respect to LGU financing. At present, there is lack of coordination among these financial institutions which results to duplication of programs (in the case of MDF and GFIs) and the lack of LGU access to commercial banks.

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