DRAFT FOR DISCUSSION
17 October 2005

LOCAL GOVERNMENT FINANCING AND FISCAL MANAGEMENT

A Position Paper of Local Governments on the Rationalization Program of the National Government in Support of Local Government Financing and Fiscal Management

1. RATIONALE

1.1 Relevant Provisions of the 1991 Local Government Code (LGC)

The Local Government Code (LGC) of 1991 introduced a paradigm shift in relations between the national government and local government units by declaring it the policy of the State "that the territorial and political subdivisions of the State shall enjoy genuine and meaningful local autonomy to enable them to attain their fullest development as self-reliant communities and make them more effective partners in the attainment of national goals. Toward this end, the State shall provide for a more responsive and accountable local government structure instituted through a system of decentralization whereby local government units shall be given more powers, authority, responsibilities, and resources. The process of decentralization shall proceed from the national government to the local government units". [Book I, Title One, Chapter 1, Section 2(a)]

The local government units (LGUs) were given responsibility for the provision of basic services such as health care, social welfare, and agricultural extension. They were also tasked to provide or maintain infrastructure facilities intended primarily to serve the needs of their residents. For barangays, these include services and facilities related to general hygiene, sanitation and solid waste collection, multi-purpose halls and pavements, day care centers, and maintenance of barangay roads, bridges and water supply systems. For municipalities and cities, these include solid waste disposal systems, municipal roads and bridges, school buildings, health centers, public markets, slaughterhouses and other municipal enterprises and infrastructure. Also devolved to municipalities were communal irrigation systems, water and soil resources utilization and conservation projects; enforcement of fishery laws in municipal waters including the conservation of mangroves; seawalls, dikes, drainage and sewerage, and flood control; and tourism facilities and other tourist attractions. Municipalities were also tasked with the implementation of community-based forestry projects which include integrated social forestry programs, pursuant to national policies and subject to supervision, control and review of the Department of the Environment and Natural Resources (DENR). Subject to the same conditions, provinces were given the responsibility for enforcement of forestry laws limited to community-based forestry projects, pollution control law, small-scale mining law, and other laws on the protection of the environment. For provinces and cities, devolved activities include inter-municipal waterworks, drainage and sewerage, flood control and irrigation systems; low-cost housing and tourism development and promotion programs. In addition, cities were given responsibility for providing adequate communication and transportation facilities and support for education, police and fire services and facilities. [Per Section 17 (b) of the LGC]

However, “public works and infrastructure projects and other facilities, programs and services funded by the National Government (NG) under the annual General Appropriations Act, other special laws, pertinent executive orders, and those wholly or partially funded from foreign sources, are not covered, except in those cases where the LGU concerned is duly designated as the implementing agency for such projects, facilities, programs and services”. [Section 17 (c)] Furthermore, “the NG or the next higher level of local government unit may provide or augment the basic services and facilities assigned to a lower level of local government unit when such services or facilities are not made available or, if made available, are inadequate to meet the requirements of its inhabitants”. [Section 17 (f)]

To operationalize the principle of decentralization, the national government was to provide funding support and technical assistance to LGUs so that they may carry out their newly devolved duties and responsibilities and participate more actively in national development. “The vesting of duty, responsibility, and accountability in local government units shall be accompanied with provision for reasonably adequate resources to discharge their powers and effectively carry out their functions; hence, they shall have the power to create and broaden their own sources of revenues and the right to a just share in national taxes and equitable share in the proceeds of the utilization and development of the national wealth within their respective areas." [Section 3(d)] “The capabilities of local government units, especially the municipalities and barangays, shall be enhanced by providing them with opportunities to participate actively in the implementation of national programs and projects.” [Section 3 (g)]

Furthermore, "the realization of local autonomy shall be facilitated through improved coordination of national government policies and programs and extension of adequate technical and material assistance to less developed and deserving local government units". [Section 3(k)]

Also, “the participation of the private sector in local governance, particularly in the delivery of basic services, shall be encouraged to ensure the viability of local autonomy as an alternative strategy for sustainable development”. [Section 3(l)] Finally, “the national government shall ensure that decentralization contributes to the continuing improvement of the performance of local government units and the quality of community life. [Section 3 (m)]

1.1.1. Internal Revenue Allotment (IRA)

To carry out their new responsibilities, the LGUs were given an increased share of NG revenues. Through the Internal Revenue Allotment (IRA), the LGUs were to receive 40 percent of the internal revenue taxes collected by the NG. The IRA is to be released automatically and directly to the LGUs. The LGUs are mandated by the LGC to spend no less than 20 percent of the IRA for development projects. LGUs are enjoined to submit their local development plans to the DILG. [Per Book II, Title Three, Chapter 1, Sections 284 to 288 of the LGC]

SECTION 284. *Allotment of Internal Revenue Taxes.* – Local government units shall have a share in the national internal revenue taxes based on the collection of the third fiscal year preceding the current fiscal year as follows:

(a) On the first year of the effectivity of this Code, thirty percent (30%);
(b) On the second year, thirty-five percent (35%); and
(c) On the third year and thereafter, forty percent (40%).

Provided, that in the event that the national government incurs an unmanageable public sector deficit, the President of the Philippines is herby authorized, upon the recommendation of Secretary of Finance, Secretary of Interior and Local Government and Secretary of Budget and Management, and subject to consultation with the presiding officers of both Houses of Congress and the presidents of the liga, to make the necessary adjustments in the internal revenue allotment of local government units but in no case shall the allotment be less than thirty percent (30%) of the collection of national internal revenue taxes of the third fiscal year preceding the current fiscal year: Provided, further, that in the first year of the effectivity of this Code, the local government units shall, in addition to the thirty percent (30%) internal revenue allotment which shall include the cost of devolved functions for essential public services, be entitled to receive the amount equivalent to the cost of devolved personal services.

SECTION 285. *Allocation to Local Government Units.* – The share of local government units in the internal revenue allotment shall be allocated in the following manner:

(a) Provinces – Twenty-three percent (23%);
(b) Cities – Twenty-three percent (23%);
(c) Municipalities – Thirty-four percent (34%); and
(d) Barangays – Twenty percent (20%).

Provided, however, that the share of each province, city and municipality shall be determined on the basis of the following formula:

(a) Population – Fifty percent (50%);
(b) Land Area – Twenty-five percent (25%); and
(c) Equal Sharing – Twenty-five percent (25%).

SECTION 286. *Automatic Release of Shares.* – (a) The share of each local government unit shall be released, without need of any further action, directly to the provincial, city, municipal or barangay treasurer, as the case may be, on a quarterly basis within five (5) days after the end of each quarter, and which shall not be subject to any lien or holdback that may be imposed by the national government for whatever purpose.

(b) Nothing in this Chapter be understood to diminish the share of local government units under existing laws.

SECTION 287. *Local Development Projects.* – Each local government unit shall appropriate in its annual budget no less than twenty percent (20%) of its annual internal revenue allotment for development projects. Copies of the development plans of local government units shall be furnished the Department of Interior and Local Government.

> **SECTION 288.** *Rules and Regulations.* – The Secretary of Finance, in consultation with the Secretary of Budget and Management, shall promulgate the necessary rules and regulations for a simplified disbursement scheme designed for the speedy and effective enforcement of the provisions of this Chapter.

1.1.2. LGU Shares in National Wealth and Other Taxes

In addition to the IRA, LGUs were to have an equitable share in the proceeds derived by the NG and any of its agencies and corporations from the utilization and development of the national wealth within their locality including those from mining taxes, royalties, forestry and fishery charges. [Per Book II, Title Three, Chapter 2, Sections 289 to 294 of the LGC]

> **SECTION 289.** *Share in the Proceeds from the Development and Utilization of the National Wealth.* – Local government units shall have an equitable share in the proceeds derived from the utilization and development of the national wealth within their respective areas, including sharing the same with the inhabitants by way of direct benefits.
>
> **SECTION 290.** *Amount of Share of Local Government Units.* – Local government units shall, in addition to the internal revenue allotment, have a share of forty percent (40%) of the gross collection derived by the national government from the preceding fiscal year from mining taxes, royalties, forestry and fishery charges, and such other taxes, fees, or charges, including related surcharges, interests, or fines, and from its share in any co-production, joint venture or production sharing agreement in the utilization and development of the national wealth within their territorial jurisdiction.
>
> **SECTION 291.** *Share of the Local Governments from any Government Agency or-Owned and-Controlled Corporation.* – Local government units shall have a share based on the preceding fiscal year from the proceeds derived by any government agency or government-owned or-controlled corporation engaged in the utilization and development of the national wealth based on the following formula whichever will produced a higher share for the local government unit:
>
> (a) One percent (1%) of the gross sales or receipts of the preceding calendar year; or
> (b) Forty percent (40%) of the mining taxes, royalties, forestry and fishery charges and such other taxes, fees or charges, including related surcharges, interests, or fines the government agency or government-owned or controlled corporation would have paid if it were not otherwise exempt.
>
> **SECTION 293.** *Remittance of the Share of Local Government Units.* – The share of local government units from the utilization and development of national wealth shall be remitted in accordance with Section 286 of this Code: Provided, however, that in the case of any government agency or government-owned or controlled corporation engaged in the utilization and development of the national wealth, such share shall be directly remitted to the provincial, city, municipal or barangay treasurer concerned within five (5) days after the end of each quarter.
>
> **SECTION 294.** *Development and Livelihood Projects.* – the proceeds from the share be appropriated by their respective to this chapter shall be appropriated by their respective sanggunian to finance local development and livelihood projects: Provided, however, that

at least eight percent (80%) of the proceeds derived from the development and utilization of hydrothermal, geothermal, and other sources of energy shall be applied solely to lower the cost of electricity in the local government unit where such a source of energy is located.

1.1.3. Local Tax and Non-Tax Revenues

LGUs were also given enhanced authority to collect local taxes. Provinces and cities are allowed to impose taxes on transfer of real property ownership; the business of printing and publication; sand, gravel and other quarry resources; delivery trucks of manufacturers and dealers; and the franchise tax, professional tax, and amusement tax. Municipalities and cities may impose taxes on businesses; fees for sealing and licensing of weights and measures; and fishery rentals, fees or charges. Barangays may impose taxes on small businesses; application fees for barangay clearance; user fees for barangay-owned properties or service facilities; and fees and charges on cockfighting-related activities, recreation facilities which charge admission fees, and billboards, signboards and other outdoor advertisements. [Per Book II, Title One, Chapters 1 and 2, Sections 128 to 152 of the LGC]

Real property taxes have traditionally been the biggest source of LGU tax revenues. While the province has the power to levy the annual ad valorem tax on real property such as land, buildings, machineries and other improvements, collection of the tax is the responsibility of the municipal treasurers. A province or city may also levy and collect an annual tax of one percent on the assessed value of real property, which shall be in addition to the basic real property tax, for the Special Education Fund. A province or city may also impose an additional five percent tax on idle lands. A province, city or municipality may also impose a special levy on lands inside its area of jurisdiction that are benefited by public works projects or improvements funded by it. [Per Book II, Title Two, Chapters 1 to 8, Sections 197 to 283 of the LGC.]

LGUs were also given the power to raise non-tax revenues. They may collect reasonable fees and charges for services that they render. They may fix tariff rates for the public utilities that they own and operate within their jurisdiction. They may charge toll fees for the use of public roads, bridges, waterways, piers or telecommunication systems funded and constructed by them. Cities and municipalities may also levy a community tax. [Per Sections 153 to 164 of the LGC]

1.1.4. Loans and Grants

LGUs were also allowed to accept donations directly from donors, without prior approval of the National Government. They are required only to report this to both houses of Congress and the President. [Per Section 23 of the LGC]

The LGC also gave LGUs the power to create indebtedness and to avail of credit facilities to finance local infrastructure and other socio-economic development projects in accordance with the approved local development plan and public investment program. LGUs may contract loans from any government or domestic private bank and other lending institutions to finance the construction, expansion, operation or maintenance of public facilities, infrastructure facilities, housing projects, acquisition of real property and implementation of other capital investment projects as well as agricultural, industrial, commercial, livelihood projects, and other economic enterprises. Subject to the rules and regulations of the central bank and Securities and Exchange Commission, provinces, cities and municipalities are authorized to issue bonds, debentures, notes and other obligations to finance self-liquidating, income-producing development or livelihood projects. The proceeds of loans contracted or grants secured by the National Government with foreign financial institutions or other international funding agencies may be relent to any LGU for the construction, expansion, operation or maintenance of public utilities and facilities, infrastructure facilities, housing projects, acquisition of real property, and implementation of other capital investment projects. LGUs may also enter into contracts with private individual contractors for the financing, construction, operation, and maintenance of any financially viable infrastructure facilities under the build-operate-transfer (BOT) scheme subject to the provisions of R.A. 6957. [Per Book II, Title Four, Sections 295 to 303 of the LGC]

Provinces, cities and municipalities may extend loans, grants or subsidies to other LGUs in amounts not exceeding their surplus funds. LGUs may also jointly or severally contract loans, credits, and other forms of indebtedness for purposes mutually beneficial to them. LGUs may, through appropriate ordinances, group themselves, consolidate, or coordinate their efforts, services and resources for purposes commonly beneficial to them. In support of such undertakings, the LGUs involved may contribute funds, real estate, equipment and other kinds of property and appoint or assign personnel as may be agreed upon by the concerned LGUs through Memoranda of Agreement. [Per Sections 300 and 33 of the LGC]

1.2. 1996 LGU Financing Framework

The LGU Financing Framework was formulated by the Department of Finance (DOF), in consultation with various stakeholders, in response to the 1991 Local Government Code which mandated the devolution to LGUs of many functions previously carried out by national government agencies. Although the LGUs were given an increased share of national government revenues and were receiving increasing amounts of official development assistance, all these would eventually not be enough for the LGUs to deliver all the services that would be expected by their constituents. LGUs would have to improve their ability to generate their own revenues and to gain access to private capital.

The basic objective of the Framework is to wean away the LGUs from dependence on the national government and promote effective partnership with the private sector. This vision is anchored on two premises:

> First, LGUs have varying level and records of creditworthiness and bankability.
> Second, their financing needs are huge.
>
> Therefore, the private sector (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 the more creditworthy LGUs to private sources of capital which are vast and promising, but remain largely untapped.

The LGU Financing Framework provided a conceptual framework by which LGU projects requiring financing could be clustered into four groups based on the creditworthiness of the LGU and the type of project to be undertaken. Each group would have access to a different set of credit and grant facilities. The Credit Policy Framework for LGUs is presented as Annex 1.

A seven-point program of action was recommended to implement the Framework, namely:

1) Increase LGU use of BOT arrangements;
2) Develop the LGU bond market;
3) Promote LGU access to private banks;
4) Optimize the involvement of GFIs in LGU financing;
5) Restructure and reorient the Municipal Development Fund;
6) Improve the capacity of LGUs to raise own revenues; and
7) Tap ODA technical assistance and financing.

The GFIs and MDF were envisioned to act as catalysts to bring LGUs into the mainstream of the private capital markets. The GFIs and MDF were given guidelines on how to provide their financial and technical assistance to LGUs. GFIs were asked to do the following:

1) Lend to creditworthy LGUs that cannot yet tap private capital;
2) Develop co-financing arrangements or project referral schemes with commercial banks; and
3) Provide limited technical assistance to enhance LGU creditworthiness, particularly in the areas of financial and project management.

The MDF was tasked to do the following:

1) Target its financing to less creditworthy LGUs and to social/environmental projects;
2) Refrain from providing grants and credits to LGUs that are qualified to obtain GFI loans or have viable BOT projects;
3) Link its funding to technical assistance to improve LGU capacity and creditworthiness for graduation to other sources of credit; and
4) Promote more direct access of LGUs to ODA sources.

To help realize the objectives of the LGU Financing Framework, new directions for ODA support were outlined, namely:

a. Participate in building up the LGUs' infrastructure pipeline by providing technical assistance to finance project feasibility studies;
b. Support an LGU capacity building fund to promote LGU institutional development in the areas of revenue mobilization, budget administration, development planning, capital budgeting and investment programming, project preparation, contract management and construction supervision;
c. Participate in establishing market-based credit enhancement mechanisms for LGU BOT infrastructure projects; and

d. Provide grants and long-term credits for poorer LGUs and for social/environmental projects through the MDF, GFIs and other facilities and promote innovative LGU-implemented projects and/or greater LGU participation in NGA-sponsored projects

In line with the framework, various ODA-supported projects were developed and are still being implemented in which the LGUs play a central role. The so-called demand-driven approach was adopted in many cases, wherein financing facilities are put in place, and LGUs are free to make their proposal or application, depending on their own needs and priorities.

2. STATE OF LGU FINANCING

2.1. BOT Projects of LGUs

BOT projects of LGUs that have been completed include the Mandaluyong City Marketplace (US$23 M), Dapitan Public Market (US$1.3 M) in Quezon City, and the Talisay City Hall (US$4 M). Joint ventures between the Bohol Provincial Government and Salcon Consortium operate the Bohol Provincial Electric System (US$5 M) and Bohol Water Supply System (US$14.4 M). Five BOT projects were under construction as of 30 June 2004, per report of the BOT Center under the Department of Trade and Industry (DTI): Binirayan Administrative and Commercial Center (US$3.8 M) of the Antique Provincial Government; Bocaue Public Market and Commercial Center (US$5.0 M) in Bulacan; Tarlac City Public Market (US$3.88 M); Roxas Commercial Center (US$1.0 M)in Isabela; and Matnog Integrated Bus Terminal (US$4.4 M) in Sorsogon.

Six LGU projects are in the pipeline, namely: the Information and Communication Technology Projects of Koronadal City, Kidapawan City and Cavite City (US$0.5 M each); General Santos City Integrated Transport Terminal and Commercial Complex (US$2.7 M); Davao del Norte Integrated Water Resource Development Project (US$76.36 M); and Upgrading and Rehabilitation of Olongapo City's Electric Power Distribution System (US$6.4 M).

2.2. Bond Issuances of LGUs

With the assistance and guarantee of the Local Government Unit Guarantee Corporation (LGUGC), fourteen bonds have been issued by twelve LGUs since the LGUGC was incorporated in March 1998. Prior to the creation of the LGUGC, only four LGU bonds had been floated. One was floated by the Province of Cebu while the three others, including one for Legazpi City, were housing bonds guaranteed by the Housing Insurance and Guarantee Corporation (HIGC).

The LGUGC-guaranteed bonds have maturities of five to seven years. Interest cost is the 182-day Treasury Bill rate plus 2 or 3%, depending on the credit rating of the LGU. Operating performance, financial condition and management risk are the factors considered in determining credit rating. Most of the LGU bonds are purchased by private banks.

2.3. Private Bank Loans to LGUs

Aside from the Philippine Veterans Bank, which is technically a private bank, but which has strong links with the government given the nature of its shareholders, no private banks have given direct loans to LGUs. The Philippine Veterans Bank has approved a total of P723.7 million for loans to LGUs as of end-December 2004.

2.4. GFI Loans to LGUs

As of end-December 2004, the Land Bank of the Philippines has approved a total of P45.3 billion in loans to LGUs, of which P34 billion has been availed of. As of June 2004, the Development Bank of the Philippines has released a total of P5.8 billion in loans to LGUs. The Philippine National Bank, which is in the process of being privatized again, had approved P5.1 billion and released P4.4 billion in loans to LGUs.

2.5. Restructuring the Municipal Development Fund

As of September 2004, the MDFO had released P4.2 billion in loans to LGUs.

2.6. Improving the Revenue Generation Capacity of LGUs

2.7. Tapping ODA Technical Assistance and Financing

3. ISSUES AND CONCERNS [pls fix margins]

3.1. Internal Revenue Allotment

The transfer of responsibilities from the National Government (NG) to LGUs was accompanied by a substantial transfer of resources primarily through the Internal Revenue Allotment (IRA) whereby LGUs get 40% of the internal taxes collected by the NG. In the mid-1990's, these were growing substantially every year as the NG posted budget surpluses. In recent years, as the NG experienced large budget deficits, portions of the IRA were sometimes not given automatically to the LGUs. In the years that the General Appropriations Act was reenacted, the IRA allocation was frozen at the previous year's level. Based on the slowdown in the growth of internal revenue collections since 1998, the slowdown in the growth of the IRA can also be expected to continue. While the LGC provides for the automatic release of the IRA and the Supreme Court has disapproved of various steps that the NG had taken in the past to reduce or delay IRA releases, there is still a provision in the LGC that in the event of an unmanageable public sector deficit, the President, following certain procedures, may still reduce the IRA allocation to as little as 30%. With the continuing uncertainties regarding the NG's medium term fiscal position, LGUs should try to reduce their reliance on the IRA more proactively.

Data for 2003 from the DOF's Bureau of Local Government Finance (BLGF) show that LGUs were dependent on the IRA for about 69% of their total revenues and 73% of their expenditures. Provinces are the most dependent, with their IRA accounting for around 83% of revenues and over 90% of their expenditures. Municipalities have slightly lower ratios, 77% of revenues and 85% of expenditures. Cities are the least dependent, with IRA accounting for around 45% of revenues and just over 50% of expenditures.

Issue: While it is up to the LGUs to exercise their political will to increase their own revenues, the concerned national government agencies should still provide the necessary policy guidance, technical assistance and financial incentives to the LGUs. This requires coordination among the concerned government agencies, as mandated by the LGC, so that the LGUs can be properly guided and not confused by different reporting systems and guidelines on what they can and cannot do in terms of resource mobilization.

Proposed Actions: The DOF, through the MDFO and BLGF, and in coordination with the DILG and the Local Government Academy could develop and implement effective capacity building activities that will help LGUs improve their ability to mobilize financial resources from internal and external sources. The training and capacity building programs should cover the following areas: revenue generation, financial management, financing options and municipal enterprise management

The BLGF could also take the lead in resolving issues related to the collection of real property and business taxes that have been identified by LGUs.

3.2. Regular and Automatic Release of LGU Shares in National Wealth and Other Taxes

In addition to the IRA, the LGC also provides that LGUs shall have an equitable share in the proceeds from the development and utilization of natural resources within their areas. The National Government (NG) and government-owned or controlled corporations (GOCCs) are mandated to give a forty percent share from mining taxes, royalties, forestry and fishery charges, earnings from joint ventures or production sharing agreements to the provinces, cities or municipalities, and barangays where the natural resources are located. In the case of the NG, shares in collections from the preceding fiscal year are to be remitted automatically like the IRA. In the case of GOCCs, remittances shall be made directly to the local treasurers within five days after the end of each quarter.

Aside from the IRA in which all LGUs have a share of internal revenue taxes, some LGUs also have a share in taxes collected from enterprises or utilities operating in their locality, pursuant to laws other than the LGC. These include the Tobacco Excise Tax per R.A. No. 7171, Value Added Tax per R.A. No. 7643, Gross Income Tax paid by all enterprises within the Economic Zones per R.A. No. 7227, Franchise Tax per R.A. Nos. 8407 and 7963, and Special Privilege Tax for hydroelectric plants per R.A. No. 7156.

Issue: The LGUs' share in national wealth from NG collections are not fully and regularly included in the annual General Appropriations Act (GAA) leading to postponement, usually indefinitely, of their release to the LGUs, contrary to the provisions of the LGC. In most cases, this is because the concerned government agencies do not give the necessary collection reports to the Department of Budget and Management (DBM), possibly because they have no incentive to do so.

Proposed Actions: The DBM will require, as part of the annual Budget Call, the concerned agencies including the Department of the Environment and Natural Resources (DENR) and the Bureau of Internal Revenue (BIR) to submit the necessary collection reports together with their proposed budgets. If they do not do so, their proposed budgets will not be given due course. The DBM, in turn, will include the full amount of the LGUs' shares in the proposed budget submitted to the Cabinet and to Congress. The Development Budget Coordination Committee (DBCC) of the NEDA Board will exercise oversight function to ensure that this process is implemented in accordance with the LGC and other relevant laws. If possible, the above steps could still be applied to the proposed budget for 2006.

3.3. Reactivation of the NG-LGU Cost Sharing Arrangement Adopted by the NEDA Board in March 2003

In December 1997, the Investment Coordination Committee (ICC) approved a cost-sharing scheme between the NG and LGUs for LGU projects with social and/or environmental objectives. The guidelines specified the percentage of project cost that could be given by the national government as capital grants and the types of projects and income classes of LGUs that would be eligible for the grants. Revised guidelines were approved by the NEDA Board in March 2003 upon recommendation of the ICC and based on a study prepared for the Policy Governing Board (PGB) of the Municipal Development Fund Office (MDFO) of the Department of Finance (DOF) which had been implementing the existing policy. Revenue-generating sub-projects such as public markets, slaughterhouses, bus and jeepney terminals, and Level 3 water supply facilities were made eligible for grants if implemented by 3rd and 4th class provinces and municipalities (20 percent grant) and 5th and 6th class provinces and municipalities (50 percent). For social sub-projects and green and blue environmental projects, 5th and 6th class cities and 1st and 2nd class municipalities and provinces can avail of 30 percent grants, 3rd and 4th class municipalities and provinces can avail of 40 percent grants, and 5th and 6th class municipalities can receive 50 percent grants. For brown environmental projects, 5th and 6th class cities and 1st and 2nd class municipalities and provinces can avail of 20 percent grants, 3rd and 4th class municipalities and provinces can avail of 40 percent grants, and 5th and 6th class municipalities can receive 50 percent grants. Please see Annex 2 for more details. Counterpart equity required were 10, 15 and 20 percent respectively. The rest could be borrowed from the `MDFO at market-based interest rates (currently at 12 percent) that were fixed for the life of the loan. Maturity is 15 years inclusive of three years grace on the principal.

In August 2004, a joint memorandum by the DOF and DBM Secretaries informed all heads of national government agencies and GOCCs that the NG would no longer provide grants/subsidy to LGU-devolved programs, activities and projects (PAPs), in line with the full implementation of its decentralization policy. The policy was to be applied to all proposed PAPs with no signed project/program agreement yet, irrespective of financing source (i.e. foreign or local), and which will have budgetary implications starting in 2005. The new policy superseded the NG-LGU cost sharing arrangement adopted on 29 November 2002. In cases, however, where the LGUs may need additional or supplemental resources in implementing the devolved PAPs, such LGUs were directed to avail of loans through the Municipal Finance Corporation (MFC) or other government financial institutions (GFIs).

Issue: Lower-income LGUs including 5th and 6th class cities are presently unable to avail of NG grants for projects with social and environmental objectives including solid waste management projects which are mandated by the Ecological Solid Waste Management Act of 2000 (Republic Act No. 9003). Many LGU projects that were being prepared were withdrawn from the pipeline of foreign-assisted projects because of the sudden suspension of the cost-sharing policy. LGUs continue to have great difficulty in undertaking projects which are also in the priority of the national government because of the zero grant policy.

Proposed Actions: The ICC Cabinet Committee could consider the reactivation of the NG-LGU cost sharing policy in line with present government policy as shown by the Kilos Asenso counterparting fund included in the proposed 2006 budget. The ICC Technical Board could be instructed to form a working group to consider possible modifications in the policy to make beneficiaries more targeted and to reward good performance particularly in revenue generation. The MDFO could be requested to prepare the working paper since it had prepared the earlier study on which the March 2003 guidelines had been based. The MDFO-PGB is also considering the introduction of performance-based grants.

3.4. Limited private sector participation in LGU projects and limited access of LGUs to private capital

As shown in Section 2.1, private sector participation in LGU projects through Build-Operate-Transfer (BOT) and other similar schemes is still quite limited, even after many years since the passage and revision of the BOT Law. Sections 2.2 and 2.3 show that while private banks have been investing in LGU projects indirectly by purchasing LGU bonds guaranteed by the LGUGC, they are not yet ready to take a direct credit risk by lending directly to LGUs.

Issue: The concerned national government agencies will have to take immediate concrete action if the objectives of the LGU Financing Policy Framework are to be realized in the near future.

Proposed Actions: With regards to BOT projects, the BOT Center could review actual LGU experiences with BOT projects and identify measures to make BOT or similar arrangements more attractive for both LGUs and private sector proponents. The recent revision of rules and procedures in the BOT project approval process could be more widely disseminated to spark fresh interest in the BOT mode of private sector participation in LGU projects and activities. Where necessary, the regulatory regimes in particular sectors for which BOT projects would be appropriate should be strengthened so as to avoid the need for national government guarantees.

With regards to private banks, steps could be taken to allow those who meet certain criteria to be accredited as depository banks for LGUs. If and when they decide to give direct loans to LGUs, the private banks should also be allowed to have the same arrangement as GFIs in having access to the IRA of the LGUs who fail to service their debts promptly.

To facilitate LGU access to the private capital market, steps should be taken to establish a mechanism for LGU bond pooling or securitization through specialized revolving funds. A credit rating system for all LGUs supported by a performance-based evaluation system should be established. Efforts to ensure the timely preparation and disclosure of uniform and accurate financial reports of LGUs should be strengthened.

The DOF should take the lead in pushing and implementing the above reforms, through the MDFO Policy Governing Board which is chaired by DOF, operationalization of the Municipal Finance Corporation (MFC) and the re-engineering of the Bureau of Local Government Finance (BLGF).

3.5. Utilize Official Development Assistance (ODA) and Government Financial Institutions (GFIs) to catalyze private-LGU partnership and more effectively assist lower income class LGUs

Issue: There are a lot of funds in GFIs from ODA sources for LGU projects but these are not being utilized quickly or effectively enough to catalyze private sector-LGU partnership and assist lower income class LGUs.

Proposed Actions: ODA resources could be leveraged to secure LGU access to private capital rather than used only for direct on-lending. For example, a reserve fund for a specialized revolving fund for LGUs could be partly sourced from ODA funds. Or private financial institutions (PFIs) could be included in programs to provide two step loans with long maturity for projects with long gestation. GFIs' on-lending terms of funds sourced from official development assistance (ODA) could be harmonized so that they do not have undue advantage over PFIs.

With regards to ODA-sourced lending facilities in GFIs, the approval process for LGU projects could be streamlined by giving GFIs a free hand to approve sub-projects for which they take the credit risk anyway. Project eligibility requirements could also be kept to a minimum so that LGUs have more flexibility to finance projects of their choice. Documentary requirements could also be reduced to fast-track the approval and implementation of sub-projects.

ODA could also be used to help finance project preparation activities of LGUs and to help develop a credit rating system for all LGUs supported by a performance-based evaluation system.

Again, the DOF should take the lead in pushing and implementing the above reforms.

3.6. Facilitate dialogue between LGUs and the Commission on Audit on issues of mutual concern, particularly the implementation of the New Government Accounting System (NGAS) and proposed LGU innovations in remittance procedures for tax payments.

4. RECOMMENDATIONS FOR THE NG RATIONALIZATION PLAN

4.1. Immediately within the next 12 months:

a. **BLGF of the DOF**. Implement DOF Department Order 1-05 dated January 20, 2005 "Directing the Reengineering of the BLGF and Clarifying its Functions and Responsibilities" in line with Executive Order No. 366.

b. **Amend E.O. 127 Reorganizing the Ministry of Finance**, dated July 22, 1987, to include the various roles of the DOF and its constituent units in strengthening the financial capacity of LGUs. This would include the BIR's accounting for all revenues collected to include the LGUs' shares in national wealth and value added taxes. (Section 28) Relevant offices such as the Municipal Development Fund Office, International Finance Group, Bureau of the Treasury, Insurance Commission, Securities and Exchange Commission, to collaborate on the development of the domestic capital market with a view to facilitating the access of LGUs and other sub-national entities to long term peso funds.

c. **MDFO thru its Policy Governing Board (PGB)** to exercise oversight function over the implementation of the LGU Financing Framework. This will entail close collaboration among the oversight agencies represented in the PGB to move forward the various policy reforms and institutional changes needed to implement the Framework.

d. **MDFO to work closely with the BLGF, DILG and LGA** in developing a capacity building program and performance-based incentive system that will enhance the financial capacity of LGUs and improve their overall performance and service delivery.

e. **The DILG** to rationalize the operations of the following offices and bureaus with responsibilities for LGU development: Office of Project Development Service, Bureau of Local Government Supervision, Bureau of Local Government Development and Local Government Academy.

f. **The Department of Trade and Industry (DTI) thru the BOT Center and its regional offices** to work more closely with the DILG, NEDA and DOF in promoting local prosperity and economic development programs among the LGUs.

4.2. Within the next 2-3 years:

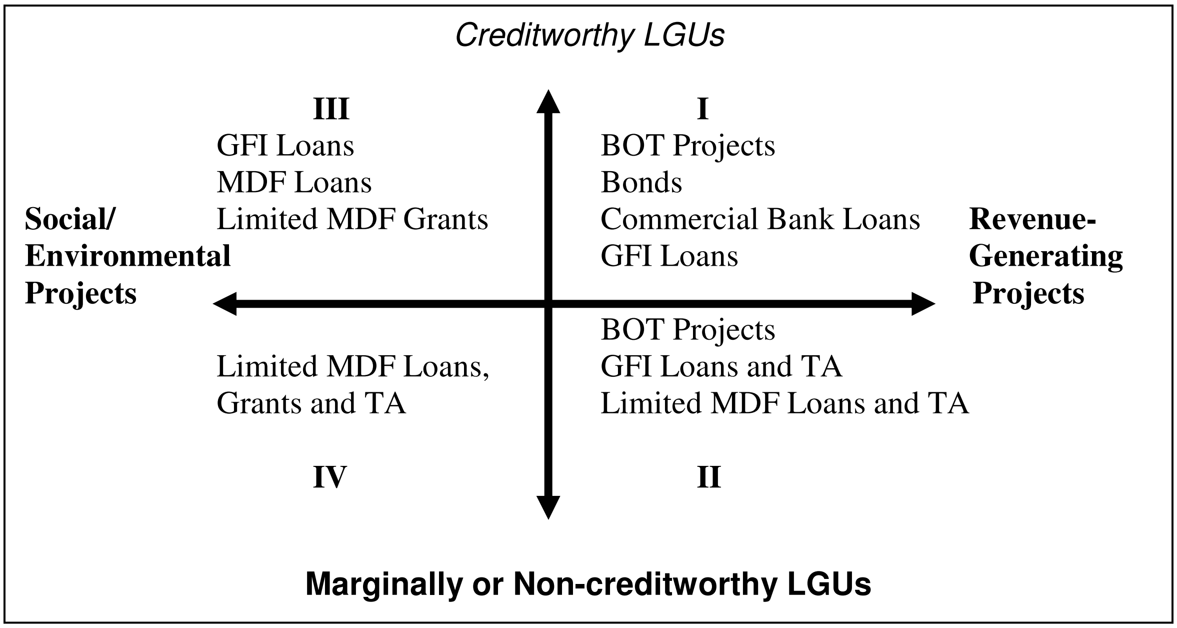
a. Establishment of the **Municipal Finance Corporation** with an original charter.

b. **Consider merger of the NEDA and DBM** to better align the national government budget with the Medium-Term Philippine Development Plan (MTPDP) and Investment Plan (MTPIP) including national government support for LGU projects and other foreign assisted projects.

Annex 1

Credit Policy Framework for LGUs

The LGU Financing Framework clusters LGUs into four groups based on their creditworthiness and the types of projects to be undertaken. In so doing, the Framework seeks to rationalize the use of credit and grant facilities for the financing of different types of LGU projects.



On the vertical axis, LGUs are classified according to creditworthiness, with the most creditworthy on the top and the marginally or non-creditworthy at the lower end. On the horizontal axis, revenue-generating projects are on the right side and projects with social and/or environmental objectives, usually with long gestation, are on the left side.

The first quadrant shows that *creditworthy LGUs with revenue-generating projects* can get financing from GFIs (from their own funds), private commercial banks, the bond market or enter into BOT arrangements. The rationale is clear: revenue-generating projects of creditworthy LGUs can be funded mostly from private sources of capital.

The second quadrant shows that *marginally or non-creditworthy LGUs with revenue-generating projects* could have funding from BOT arrangements, GFI loans with technical assistance, and limited MDF loans and technical assistance. The key element here is the revenue-generating nature of the project. With viable and sustainable projects, the LGU could enter into BOT arrangements or obtain GFI or MDF loans with supplementary technical assistance grants to improve creditworthiness. The LGUs may have the financial resources but lack the project management capability to be truly creditworthy.

In the third quadrant, *creditworthy LGUs undertaking social/environment projects* whose returns are low or long in coming could be allowed to tap long-term, lower-cost ODA funds through loans from the GFIs or MDF. They may also be eligible for limited grants from MDF.

In the fourth quadrant, the *marginally or non-creditworthy LGUs with social-environmental projects* could be assisted by loans and grants from the MDF, in accordance with the approved policy of the NEDA-ICC, and technical assistance.

Source: LGU Financing of Basic Services and Infrastructure Projects: A New Vision and Policy Framework, Department of Finance, December 1996.

Annex 2

GUIDING PRINCIPLES AND NG-LGU COST-SHARING POLICY IN THE EVALUATION AND PROCESSING OF PROJECTS INVOLVING DEVOLVED ACTIVITIES

[Approved by the Investment Coordinating Committee-Cabinet Committee (ICC-CC) on December 12, 2002 and by the NEDA Board in March 2003]

Guiding Principles of the NG-LGU Cost Sharing Scheme:

1. The new financing mix shall adopt a separate Loan-Grant-Equity mix for Provinces/Municipalities and for Cities.

2. Expanded the activities that NG could cost share with LGUs to include revenue generating subprojects (under Cluster 1) and brown sub-projects (under Cluster 3)

3. Maintain ICC policy that the maximum allowable grant should not be more than 50% of the total sub-project cost for the 5th and 6th income class LGUs.

4. Of the total LGU equity requirement, the minimum cash component should be 10% of the total sub-project cost.

5. Maintenance and operating expenses are not part of the sub-project cost.

6. For multi-sectoral projects, the Loan-Grant-Equity mix will be based on the component unit with the largest investment share.

7. The ICC approved mix shall apply only to devolved activities of LGUs.

EFFECTIVITY:

The NG-LGU Cost Sharing Policy shall apply to prospective projects to be submitted to and approved by the ICC effective 01 January 2003.

NG-LGU Cost Sharing Policy

Cluster 1 – Sub-projects that are generally considered as public economic enterprises which include but are not limited to the following:

Public Markets, Slaughterhouses, Bus and Jeepney Terminals, Municipal Wharves and Fish Ports, Post Harvest Facilities, Cold Storage Facilities, Ice Plants, Water Supply Level III, Public Memorial Parks

LGU Income Class	Municipalities and Province			Cities		
	Loan	Grant	Equity	Loan	Grant	Equity
1st and 2nd	0	0	0	0	0	0
3rd and 4th	70	20	10	0	0	0
5th and 6th	40	50	10	0	0	0

Cluster 2 – Sub-projects that are generally social and green/blue environment-related which include but are not limited to the following:

a. ***Social Sub-projects*** *– Health Centers, Lying-in Clinics and Hospitals, School Buildings, Water Supply Levels I & II, Communal Irrigation, Farm-to-Market Roads, Rural Roads or Local Roads, Bridges.*
b. ***Green/Blue Sub-projects*** *– Reforestation, Forest-Related Activities, Soil Conservation, Mangrove and Watershed Protection, River and Seashore Protection.*

LGU Income Class	Municipalities and Province			Cities		
	Loan	Grant	Equity	Loan	Grant	Equity
1st and 2nd	50	30	20	80	0	20
3rd and 4th	45	40	15	80	0	20
5th and 6th	40	50	10	50	30	20

Cluster 3 – Consists of brown environment-related sub-projects which include but are not limited to the following:

Solid Waste Management Project, Sewerage, Sanitary Support Facilities

LGU Income Class	Municipalities and Province			Cities		
	Loan	Grant	Equity	Loan	Grant	Equity
1st and 2nd	60	20	20	80	0	20
3rd and 4th	45	40	15	80	0	20
5th and 6th	40	50	10	60	20	20