

## **SUMMARY OF THE DRAFT LCP POSITION PAPER ON LOCAL GOVERNMENT FINANCING AND FISCAL MANAGEMENT** (under EO 444 and in support of EO 366)

(Note: please refer to the attached position paper for details)

### **General position**

The Local Government Code (LGC) of 1991, in its pursuit of decentralization, clearly states the general principle that should govern LGU financing and fiscal management: Local government units, in order to discharge their powers and effectively carry out their functions, “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 (g)]

The Code also states that “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)] The participation of the private sector, particularly in the delivery of basic services, is also encouraged “to ensure the viability of local autonomy as an alternative strategy for sustainable development.” [Section 3 (l)]

### **Sources of revenue and the LGU financing framework**

To carry out their new responsibilities under the Code, LGUs were given an increased share of National Government (NG) revenues. These came in the form of: (1) the Internal Revenue Allotment or IRA with LGUs receiving 40% of the internal revenue taxes collected by the NG; (2) an equitable share of the income from the utilization and development of the national wealth within their locality; (3) local taxes and non-tax revenues such as fees and charges; and (4) loans and grants which the Code allows LGUs to contract or receive.

“Although the LGUs were receiving an increased share of national government revenues and were receiving increasing amounts of official development assistance, all these would eventually not be enough...” (p. 6) It is therefore imperative that “LGUs...improve their ability to generate their own revenues and to gain access to private capital.” (Ibid)

Thus, in 1996, the Department of Finance formulated the LGU Financing Framework. “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.” The ultimate goal of the Framework is “to graduate the more creditworthy LGUs to private sources of capital which are vast and promising, but remain largely untapped.” (Ibid)

“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.” (p. 7) Such facilities include: Build-Operate-Transfer (BOT) arrangements, bonds, loans from private banks, loans from Government Financial Institutions (GFIs), the Municipal Development Fund (MDF), and Official Development Assistance (ODA).

## **Issues, concerns and recommendations**

**Internal Revenue Allotment.** DOF data for 2003 show that LGUs are highly dependent on the IRA for about 69% of 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 about 45% of revenues and just over 50% of expenditures.” (p. 10)

Given the continuing uncertainties regarding the medium term fiscal position of the NG, LGUs should, more proactively, reduce their dependence on the IRA. While increasing revenues is partly a function of political will, LGUs can greatly benefit from capacity building activities that DOF and DILG could undertake to improve their (the LGUs) ability to mobilize financial resources from internal and external sources. Capacity building should cover: “revenue generation, financial management, financing options and municipal enterprise management.” (p. 10)

**LGU shares in national wealth and other taxes.** While the LGC provides that LGUs should have an equitable share in NG and GOCC revenues from the development and utilization of natural resources in their areas, and from taxes on enterprises or utilities in their locality pursuant to laws other than the LGC (e.g., tobacco excise tax), such shares are not fully and regularly included in the national budget (GAA). This has led “to postponement, usually indefinitely, of their release to the LGUs, contrary to the provision of the LGC.” (p. 10)

The DBM should require, as part of the annual Budget Call, concerned agencies (including DENR and BIR) to submit the necessary collection reports together with the proposed agency budgets. The DBM will in turn include the full amount of the LGUs’ shares in the proposed budget, with the Development Budget Coordination Committee of NEDA exercising oversight function to ensure that the requirements of the LGC and other relevant laws are satisfied.

**NG-LGU Cost-Sharing Arrangement.** “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.” (p. 11) However, in August of 2004, the DOF and DBM Secretaries signed a joint memorandum informing all heads of NG agencies and GOCCs that the NG would no longer provide grants/subsidy to devolved programs, activities and projects (PAPs), in line with the full implementation of decentralization.

Low-income LGUs, including 5<sup>th</sup> and 6<sup>th</sup> class cities, are presently unable to fund projects with social and environmental objectives, including solid waste management projects mandated by RA 9003 (Solid Waste Management Act). Also, many projects were withdrawn from the pipeline of foreign-assisted projects due to the sudden suspension of the cost-sharing policy. It should be noted that some of these LGU projects are also in the priority list of the NG.

The ICC Cabinet Committee should consider the reactivation of the NG-LGU cost-sharing policy in line with the present government policy reflected in the Kilos Asenso counterpart 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.” (p. 12)

**Private sector participation and access to private capital.** It is clear that “[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.” Also, “while private banks have been investing in LGU projects indirectly by purchasing LGU bonds..., they are not yet ready to take a direct credit risk by lending directly to LGUs.” (p. 12)

Concerned NG agencies will have to exert more effort to realize the objectives of the LGU Financing Policy Framework. “With regard 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.” Wider dissemination of recently revised rules and procedures on BOT project approval and the strengthening of regulatory regimes to avoid the need for NG guarantees should also be considered.

Steps could be taken to allow private banks that 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.” (p. 12)

“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.” (pp 12-13)

**ODA and GFIs as catalysts in private sector-LGU partnership.** “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 LGUs.” These substantial financial resources could be leveraged to secure LGU access to private capital instead being used 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.” (p. 13) Along this line, the GFIs’ on-lending terms for funds sourced from ODA could be harmonized so that they do not have undue advantage over PFIs.

As regards ODA-sourced 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...” (p. 13) Eligibility requirements could be kept to a minimum so LGUs have more flexibility to finance projects, and documentary requirements could be reduced to fast-track sub-projects. ODA could also be used to help finance project preparation activities of LGUs and to help develop an LGU credit rating system. The DOF can take the lead in all these.

**Dialogue between LGUs and the Commission on Audit (COA).** Finally, dialogue between LGUs and COA should be facilitated. This dialogue can focus “on issues of mutual concern, particularly the implementation of the New Government Accounting System (NGAS) and proposed LGU innovation in remittance procedures for tax payments.” (p. 13)

**Recommendations for NG rationalization.** Immediately, within the next 12 months: (a) Implement DOF Order 1-05 “Directing the Reengineering of the BLGF and Clarifying its Functions and Responsibilities”; (b) amend EO 127 reorganizing the DOF; (c) MDFO to exercise oversight function over the implementation of the LGU Financing Framework; (d) MDFO to work closely with the BLGF, DILG and LGA; (e) DILG to rationalize operations responsible for LGU development; and (f) DTI to work more closely with DILG, NEDA and DOF in promoting development programs among LGUs. (See details in p. 14)

Within the next 2-3 years: (a) Establish the Municipal Finance Corporation with an original charter; and (b) Consider merger of NEDA and DBM to better align the budget with the MTPDP and the medium-term investment plan, including NG support for LGU projects and other foreign assisted projects.