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A New Vision and Credit Policy Framework for Financing LGUs' Basic Services and Development Projects*

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This paper presents a new vision and the proposed policy framework for financing local governments' basic services and development projects. The new vision intends to wean away the LGUs from their dependence on the national government and to promote a more effective private sector participation in developing and funding local projects. The credit policy framework aims to direct and make LGUs creditworthy to the private sources of capital.

The proposed policy framework will enable the LGUs to better deliver the devolved services and activities such as municipal infrastructure (public markets, bus terminals, slaughter houses, roads, etc.), water supply and sanitation, solid waste management, school building construction, basic health services, social welfare, environmental protection and agricultural extension.

Toward Self-Reliant LGUs

The Local Government Code of 1991 provides LGUs with various financing sources. These include the internal revenue allotment (IRA), official development assistance (ODA), loans from government and private banks,

*This paper draws from the study conducted by the PIDS and from the Investment Coordination Committee (ICC) Policy Resolution on National Government Grants.

It also benefited from the seminars and workshops on "LGU Access to the Private Capital Markets" conducted by the PIDS and the workshops on "National Government Financing of Environment/Social Projects of LGU" conducted by the UPECON during the latter part of 1995 and the first half of 1996.

PIDS Policy Notes are observations/analyses written by PIDS researchers on certain policy issues. The treatise is wholistic in approach, and like the PIDS Executive Memo, it aims to provide useful inputs for decisionmaking.

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bonds, local taxes and enterprise revenues, and build-operate-transfer (BOT) arrangements. The objective is to enable LGUs to rely less on transfers from the national government and ODAs, to use more locally-generated funds, and to encourage private sector participation through loans, bonds and BOT arrangements. The passage of the 1991 Code paved the way for many positive steps in this direction.

However, despite the Code's many positive features, heavy involvement of certain national government agencies in devolved activities continued. Despite the strong IRA growth, some LGUs claim that their financial burden has increased. What compounded the problem was the lack of clear policies, programs and mechanisms to properly channel IRA funds and ODAs to the local governments.

ICC Policy Resolution on National Government Grants

The Investment Coordination Committee (ICC) Policy Resolution on National Government Grants is basically a guideline for channelling grants to LGUs. Under the ICC Policy Resolution, national government grants to LGUs will be given selectively on the basis of equity, externalities, and economies of scale. Such government funds will complement the provision of IRA, and will support local accountability, autonomy, needs and preferences. The government recognizes that LGUs are better implementors of devolved functions because they are closer to the people, can target programs better, and have greater accountability for public funds. Under this ICC guideline, community involvement and equity contributions, and LGU counterpart funding are essential. This arrangement ensures that there will be increased ownership of local projects, better maintenance, and better chances of cost recovery through user charges.

Under the ICC Policy Resolution, an LGU will match the national government's grant through a 50-50% cost-sharing scheme, depending on the type of project and the LGU's income class. The national government grant will be *closed-ended (*i.e., limited and temporary), and *specific* (i.e., performance-based for specific projects), and targeted at specific groups. To ensure goal congruence, national government assistance will be implemented through a formal cost-sharing arrangement between a national government agency and the recipient LGU.[1]

Expanding LGU Access to Private Capital Markets

It is widely recognized that government resources are insufficient to meet LGU demand for funds. This is the rationale for expanding LGUs' access to private capital. However, at present, there is no credit policy and institutional framework that will ensure LGUs' access to adequate financing, both from government and private sources of capital. As pointed out in the PIDS study,[2] the roles of the key players in the LGU credit markets such as the Municipal Development Fund (MDF), the government financial institutions (GFIs) and the private sector are not well delineated. This has resulted in a "free-for-all" approach, leading to inconsistencies and duplications in LGU credit programs. There is, thus, a need to define the "catalytic" role of the government, the GFIs and the MDF, especially the latter which has been the LGUs' only source of long-term credits. Also, there is a need to harmonize the policy framework for national government grants[3] and those under the GFI/MDF credit programs.

Present Situation of LGU Financing

The LGU credit market is still undeveloped. The GFIs have re-opened LGU loan windows but these are

[1]There are, however, some unresolved issues such as (i) the sponsoring agency for intersectoral projects, (ii) budgetary treatment and channelling mechanism for grants and (iii) a clearer delineation of functions between national government agencies and LGUs at national, regional, provincial and municipal levels.

[2]Llanto, Gilberto, Mario Lamberte, Rosario Manasan, Jaime Laya and Antonio Avila. "Local Government Units' Access to Private Capital Markets." Unpublished PIDS study, 1996.

[3]The ICC Policy Resolution on National Government to LGUs.

mostly for medium-term, revenue-generating projects. The BOT projects are being actively explored although, so far, only a handful are being developed.[4] Private banks have adopted a "wait-and-see" attitude because of insufficient information on LGUs, their short-term orientation, the perception that LGUs are high credit risk, and the banks' limited if not total lack of expertise in financing social/development projects. While some LGUs have floated bonds, the bond market is yet to be developed.[5] Thus, only the GFIs and the MDF are there to provide financing to the LGUs, with the latter serving as the main conduit for ODA loans/grants.

Toward Realizing the New Vision

As earlier cited, the new vision intends to wean away the LGUs from their dependence on the national government and to promote a more effective private sector participation in developing and funding local projects. This vision is anchored on two premises:

❊ LGUs have varying levels and records of creditworthiness and bankability, and their financing needs are huge.

❊ The private sector (composed of BOT investors, bondholders, commercial banks), the GFIs and MDF all have a role to play in meeting LGU financing needs.

With the objective of increasing creditworthy LGUs' access to private capital, the national government must use the GFIs and the MDF as catalysts to bring them to the mainstream of private capital markets.

[4]For example, Mandaluyong City has a public market constructed under a BOT arrangement. Lucena City has a public market to be operated through a concession. The water supply of Cebu City and Zamboanga City are proposed BOT projects.

[5]The following have floated bonds: Cebu province, the City of Legaspi, and the municipalities of Victoria and Claveria. The last three LGUs floated housing bonds guaranteed by the HIGC and purchased by HDMF. Naga City and the provinces of Pangasinan and Laguna are exploring the issuance of bonds for revenue generating projects.

Operationalizing the Credit Policy Framework

Role of Government Financial Institutions

From the above objectives, the following roles are proposed:

❊ The GFIs will extend loans to creditworthy LGUs that still cannot tap private capital.

❊ The GFIs will develop co-financing arrangements or project referral schemes with commercial banks.

❊ The GFIs will provide limited technical assistance to enhance the creditworthiness of LGUs.

Role of Municipal Development Fund

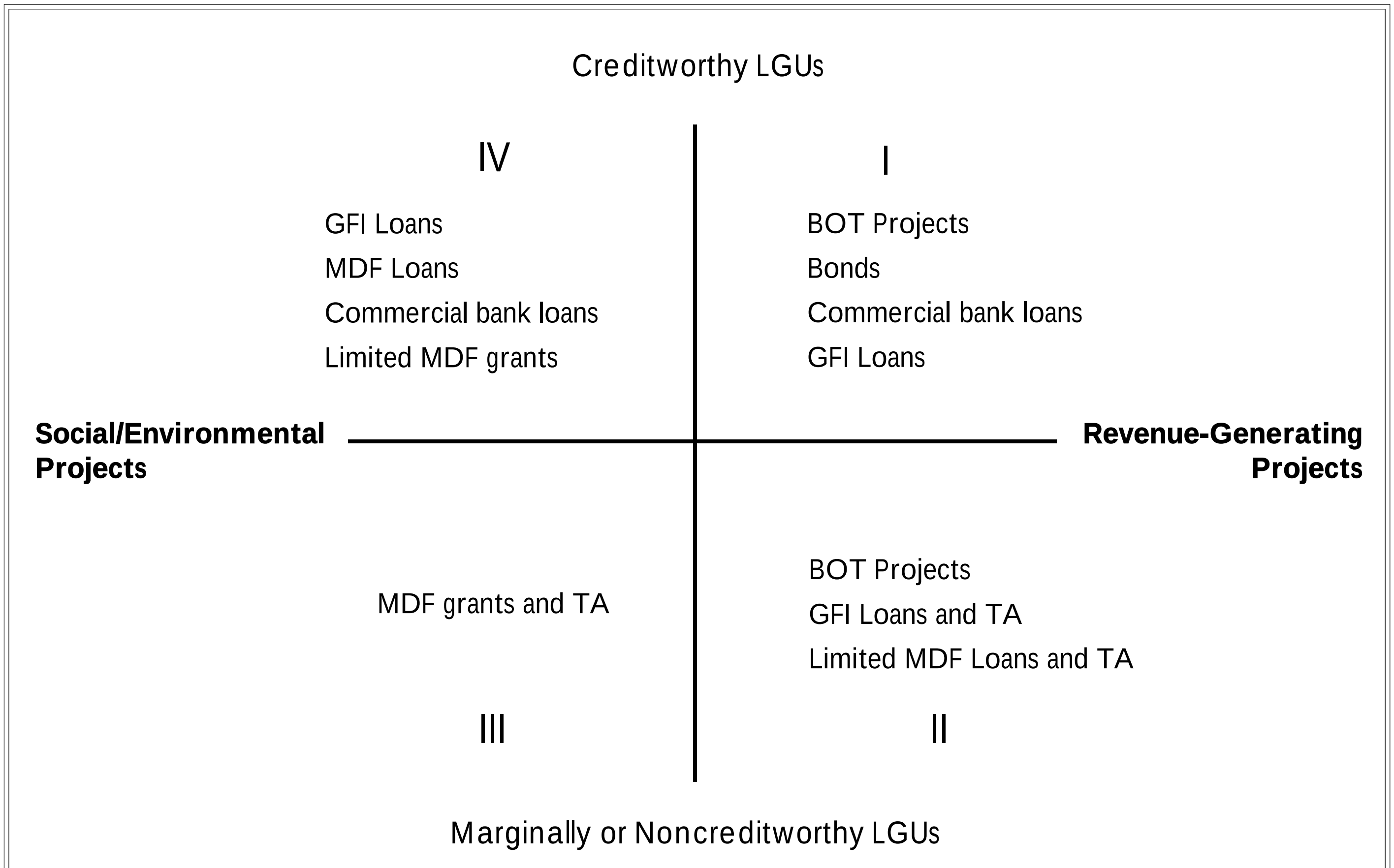
❊ The MDF will target its financing to less creditworthy LGUs and to social/environmental projects.

❊ The MDF will refrain from providing grants and credits to LGUs that are qualified to obtain GFI loans or to those with viable BOT projects.

❊ The MDF will provide technical assistance to improve LGUs' capacity and creditworthiness, enabling them to graduate to GFI credit, and eventually, to private sources of capital.

Figure 1 summarizes the new vision and credit policy and institutional framework for LGUs. The first quadrant shows that ***creditworthy LGUs with revenue-generating projects*** must get financing from commercial banks, GFIs (that can co-finance with commercial banks), BOT arrangements and the bond market. 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 noncreditworthy LGUs with revenue-generating projects*** could have funding from BOT arrangements, GFI loans with technical assistance, and limited

Figure 1
New Vision and Policy/Institutional Framework



MDF loans and technical assistance. The key element here is the revenue-generating nature of LGU projects. With viable and sustainable projects, the LGU could qualify for BOT schemes, and GFI or MDF loans with technical assistance grants from the latter two to improve their creditworthiness. In the third quadrant, ***the marginally or noncreditworthy LGUs with social/environmental projects*** will have to rely on MDF grants and technical assistance. This LGU is not creditworthy and its project does not yield the necessary revenues to repay a loan, hence, the reliance on MDF or on national government grants. In the fourth quadrant, ***the creditworthy LGUs with social/environmental projects*** will tap the GFIs, MDF and if possible, commercial banks and receive limited MDF or national government grants.

Recommended Actions

The following are recommended to fulfill the new vision and the credit policy and institutional framework:

- ***Increase LGUs' use of BOT-like arrangements.*** To do this, there is a need to coordinate and pursue the government's overall efforts through the Coordinating Council for Philippine Assistance Program (CPAP)-BOT Center. Some of the activities under this are: (i) development of market-oriented financing techniques to reduce BOT projects' risks and guarantees, (ii) determining the feasibility of an "equity fund" for infrastructure projects, (iii) promotional and educational campaign for BOT projects, and (iv) assistance in arranging financing for LGU-BOT projects.

- ***Develop the LGU bond market.*** To do this, the following must be done: (i) review the tax treatment of LGU bonds, (ii) streamline the regulations and procedures for LGU bond marketing, and (iii) help set up a credit rating agency and rating mechanics for LGUs/bonds.

- ***Promote LGU access to private banks.*** To do this, the following are necessary: (i) allow LGUs to deposit funds in accredited private commercial banks, (ii) provide IRA intercept provision to GFIs and accredited private commercial banks, and (iii) improve and make available to banks and other private lenders information on the financial condition of LGUs.

- ***Optimize the involvement of GFIs in LGU financing.*** The following must be done: (i) continue the market orientation of interest rate policy, (ii) adopt a built-in scheme so that the most creditworthy LGUs can eventually graduate to access private credit markets, (iii) develop co-financing schemes or adopt a project referral system with private commercial banks, (iv) improve LGUs' creditworthiness through limited technical assistance, and (v) coordinate LGU credit programs with MDF and the private commercial banks.

- ***Restructure and reorient the MDF.*** This calls for the following actions: (i) develop a new policy framework for MDF for its new role of helping build the creditworthiness of LGUs, (ii) delineate the core functions of the new MDF, (iii) develop an implementation plan for the new MDF, and (iv) strengthen the capacity of the new MDF.

- ***Improve the capacity of LGUs to raise own revenues.*** These acticvities must be done: (i) improve the monitoring of LGUs' revenues and expenditures, (ii) intensify training and supervision of local finance officials, (iii) review/revise real property taxation rules and procedures, and (iv) propose amendments to the 1991 Local Government Code to strengthen local treasury operations.

- ***Tap ODA technical assistance and financing.***[6] The following can be undertaken: (i) prepare LGU projects that are eligible for BOT arrangements, (ii) help develop LGU bond market, (iii) strengthen MDF as mechanism to target grants and long-term credits for marginal or noncreditworthy LGUs and/or social/environmental projects, (iv) support training and capacity-building programs for LGUs to enhance their creditworthiness and revenue-generation activities, (v) promote innovative, LGU-implemented projects and encourage greater LGU participation in national government-sponsored projects, and (vi) support activities to gather and disseminate information on LGUs to facilitate lending and targeting of projects. PN 96-03

[6]Some examples are the World Bank's assistance to the Local Government Academy for the LGUs' capacity building, the technical assistance to MDF; the Asian Development Bank's assistance to capital market development, and the creation of regional/national credit rating agency; and USAID's funding and technical assistance to the BOT Center.

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