The Philippines: Recent Developments in the Subnational Government Debt Markets

Lili Liu, Gilberto Llanto, and John Petersen

Introduction

This chapter reviews access of Philippine subnational governments to the credit markets, impediments to such access, and recent developments in Philippine subnational finances. The Local Government Code of 1991 commenced decentralization and defined the structure of subnational government units in a unitary system. In this chapter, the term Local Government Unit (LGU) in the Philippines, used interchangeably with subnational governments, includes all tiers of the government under the central government.¹ Our findings have benefited from several recent reports that bear on the various issues covered in this chapter.²

In the Philippines, LGU borrowing is low compared to borrowing by subnational governments in many other countries. As will be discussed in the chapter, LGUs are carefully monitored by the central government both on their individual debt transactions, which are almost exclusively done with four Government Financial Institutions (GFIs),³ and by regular reporting to the Philippine Department of Finance (DOF). There is no evidence that LGU borrowing has been used to cover operating deficits or to finance unusually large, speculative projects.
The LGUs appear to live under a “hard” budget constraint, and the sector as a whole typically runs a budget surplus. Part of the smaller appetite of LGUs for taking on debt has to do with the assignment of service responsibilities to the various levels of local governments. Most major infrastructure projects are controlled and funded at the national government level. Aside from a few major cities and the nation’s capital region around Manila, there is a diffuse scattering of small and often rural governments that are highly reliant on transfers from the central government. In addition to the small scale and diffusion of local governments, there are also significant institutional and managerial barriers to their planning and managing major building projects.

Subnational governments in the Philippines were largely unaffected by the 2008–09 global financial crisis. LGUs, heavily reliant on national government transfers, felt little impact (they were more affected by two large tropical storms). While future national government payments to them will be slightly affected (the distribution formula has a three-year lag), the LGUs have continued to operate with an annual surplus.

Overall, local governments in the Philippines are light borrowers and appear to restrict lending to relatively small projects or to meeting occasional cash flow needs. By and large, the LGU sector has relatively small-scale and pedestrian (albeit individually important) capital financing needs. The low level of indebtedness is attributed to the limited functions assigned to LGUs that require infrastructure spending, the reluctance of local governments to borrow, and the impact of various financial oversight mechanisms. Some areas are changing, however, such as the use of project financing and restricting the security on loans to specific projects.

Notwithstanding a decade and a half of policy planning and innumerable reports, implementation has been slow in following through on an initial planning framework designed to move LGUs into private financing markets. Earlier, the Local Government Unit Guarantee Corporation (LGUGC) spearheaded the development of the LGU bond market. More recently, it has spurred Private Financial Institution (PFI) direct lending to LGUs, water districts, and electric cooperatives through the use of its guarantees. These efforts, while innovative, have not been mainstreamed in recent years. A main challenge has been the reluctance of GFIs and other government agencies to open the subnational credit market for LGU borrowing.
The basic question that remains is how to construct a financing framework to help LGUs attain “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.” The DOF developed the LGU Financing Framework in 1996, which was later confirmed by the government. The development of clear and consistent government policies to encourage competition in the subnational credit market will in the long term help the implementation of the framework.

Another key aspect in the deferral of implementation of policies lies in the very nature of the LGUs themselves. While there has been innovation in devising programs to foster the use of credit to support development, the local governments have been reluctant to borrow. This appears to be due in large part to a natural conservatism. Local governments appear to have little appetite for credit financing, with the exception of a relatively small number, which have tapped both loans and bonds to finance various local projects.

On the one hand, this attitude has avoided fiscal difficulties that might have occurred as a result of profligacy. On the other hand, the cautiousness has stymied local development initiatives. According to the discussions within the country, next steps include bolstering LGU credit relationships with the private sector. However, the dominant role of GFIs in financing LGUs may limit the extent of the financing opportunities by the private sector.

The remainder of this chapter is structured as follows. Section two examines the structure and finances of subnational governments in the country, including the growth and patterns of local government spending and revenues, and presents a recent history of LGU borrowing and its levels of indebtedness and the regulatory framework for subnational unit borrowing. Section three analyzes a range of factors, including the legal borrowing limitations and the various financial oversight mechanisms that have led to low demand for debt instruments by subnational governments in the country. Section four reviews the development of subnational credit markets, the status of PFI lending, and the composition of debt instruments. Section five reviews recent innovation in the subnational credit market and analyzes prospects. Section six provides conclusions.
Subnational Government Finance and
Borrowing Framework

The Philippines is a unitary state with a hierarchical system of governance. Subnational governments are part of the state and are directly under the control of the national government, though with certain constitutional protections. The subnational government sector consists of three levels: the provinces and major cities, the municipalities, and the barangays (neighborhood organizations). The country, with a population of approximately 90 million, has more than 1,700 local governments (not counting the 42,025 barangays), including 80 provinces, 138 cities, and 1,496 municipalities. The Local Government Code of 1991 was revolutionary in its impact on decentralization. It assigned greater responsibilities for service provision to subnational governments and also entitled them, under the Internal Revenue Allotment (IRA) scheme, to receive 40 percent of the national government’s income and value added tax revenues, which are distributed on a formula basis. The Code also gave local governments expanded powers for setting local tax rates and collecting own-source revenues. The mainstays of local revenues are the property tax, the business tax, and taxes on vehicles.

The implementation of decentralization and the realization of what was envisioned in the Code have been slow. Two decades after enactment of the Code, the size of subnational governments measured by spending remains small. Total LGU spending increased from an average of 1.6 percent of Gross National Product (GNP) during 1985–91 to about 3 percent in the late 2000s.

Local Government Spending and Revenues

Local governments allocate the biggest portion of their budgets to general public services, which are basically the general administration services needed for the daily routine of running a local government. Expenditure for economic services is the second-biggest expense. A review of local public expenditure management is needed to achieve more efficient allocation of resources. There appears to be relatively low investment in human capital (education, health, and nutrition) and in infrastructure relative to other expenditure items. The central
government and government-owned and government-controlled corporations continue to implement major infrastructure projects, but with greater emphasis on public-private partnerships (PPP) in infrastructure. Overall, LGU spending has averaged only around 3 percent of GNP. Table 11.1 presents a distribution of LGU expenditure.

On the revenue side, subnational governments’ own revenues accounted for about 32 percent of total revenues in 2009, and subnational governments are highly dependent on fiscal transfers from the central government. Figure 11.1 illustrates the percentage composition of sources of revenues of all local governments. There were no significant changes in the composition of sources of revenues in the 2000s. The fiscal transfers, principally the IRA, account for almost two-thirds of LGU revenues.

Table 11.1 Distribution of Total Expenditure, All Local Government Units, 2001–09

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
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<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
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<tr>
<td>General public</td>
<td>40.51</td>
<td>41.34</td>
<td>40.41</td>
<td>40.02</td>
<td>39.63</td>
<td>40.36</td>
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<td>44.14</td>
<td>53.91</td>
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<tr>
<td>services</td>
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<td>Education,</td>
<td>7.09</td>
<td>6.53</td>
<td>6.85</td>
<td>6.61</td>
<td>6.95</td>
<td>6.86</td>
<td>6.53</td>
<td>5.94</td>
<td>6.11</td>
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<td>culture, and sports/</td>
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<tr>
<td>Labor and</td>
<td>0.16</td>
<td>0.15</td>
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<td>0.06</td>
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<td>0.07</td>
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<td>0.06</td>
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<td>Housing and</td>
<td>4.38</td>
<td>4.42</td>
<td>2.40</td>
<td>2.05</td>
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<td>2.05</td>
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<td>2.13</td>
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<tr>
<td>Social security/</td>
<td>3.02</td>
<td>2.83</td>
<td>2.57</td>
<td>2.39</td>
<td>2.39</td>
<td>2.35</td>
<td>2.45</td>
<td>2.41</td>
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<tr>
<td>Economic services</td>
<td>18.55</td>
<td>16.74</td>
<td>15.76</td>
<td>15.76</td>
<td>15.75</td>
<td>15.04</td>
<td>15.22</td>
<td>15.09</td>
<td>18.55</td>
</tr>
<tr>
<td>Debt service</td>
<td>2.41</td>
<td>2.39</td>
<td>2.87</td>
<td>2.73</td>
<td>3.27</td>
<td>3.21</td>
<td>3.23</td>
<td>3.29</td>
<td>1.59</td>
</tr>
<tr>
<td>Other purposes</td>
<td>12.37</td>
<td>13.88</td>
<td>18.18</td>
<td>19.42</td>
<td>19.59</td>
<td>20.26</td>
<td>18.97</td>
<td>17.17</td>
<td>0.00</td>
</tr>
<tr>
<td>Expenditures</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: Bureau of Local Government Finance.
Figure 11.1 Distribution of Total Income, All Local Government Units, 2009

Figure 11.2 presents revenue sources across provinces, cities, and municipalities for 2009. As can be seen, the aggregate revenue numbers mask big differences among the categories of local jurisdictions. Cities derived about 40 percent of their revenues from their own revenue sources in 2009 compared with only about 8 percent for municipalities and 10 percent for provinces. The cities have larger tax bases and, consequently, enjoy more buoyant own-source revenue opportunities. However, most LGUs (that is, the provinces and municipalities) have narrower tax bases and thus do not raise proportionately as much own-source revenues. They have remained dependent on fiscal transfers, principally the IRA, for funding local development activities.10

The IRA program of the formula-based revenue sharing led to local governments largely substituting the new revenues from the central government for own-source revenues, especially the local property tax. Between 1990 and 1996, local own-source revenues declined from 50 percent of total local revenue to 30 percent, which is about the same today. The large vertical fiscal gap has been filled by IRA transfers, which comprised around 65 percent of total LGU incomes in 2009. The dependence on the IRA results in lesser local fiscal autonomy, which
creates opportunities for greater control by the central government, contrary to the envisaged situation of local governments able to use own resources to respond to local needs and to match local outputs with local preferences. In other countries, greater reliance on own-revenue generation has given subnational governments more fiscal autonomy. Granting subnational governments more revenue-raising power aims at creating a closer link between expenditure accountability and the use of revenues to finance such expenditure (Bird 2010).

Meanwhile, fueled by IRA payments, local governments’ share of total government spending in the Philippines between 1990 and 1996 grew from 6 to 16 percent. Thus, although their position as the final deliverer of public services grew, the local governments’ relative share of direct spending remained small compared to that of the central government.

One motivation for the decentralized intergovernmental structure as reflected by the Code was to enable subnational governments to assume a greater share of the burden of financing infrastructure. It was thought that this might be accomplished by permitting subnational governments broad powers to borrow without the approval of the national government. To that end, the Philippine DOF, with considerable support from International Financial Institutions (IFIs), led the way on initiatives to
expand local governments’ access to credit, following a policy articulated in 1996.\footnote{Until Debt Do Us Part}

Although the Code grants subnational governments the general power to borrow, there are regulatory restrictions on borrowing activities. These restrictions are specified in the Code itself and also arise from regulations in the banking and financial sector. A brief synopsis of the major components of the regulation of local government borrowing and indebtedness, which is discussed in greater detail below, is provided in table 11.2.

Governments borrow for a variety of reasons. Generally, long-term borrowing for long-lived capital improvements is recognized as a legitimate use of debt as long as the indebtedness incurred aligns with a locality’s ability (and ongoing willingness) to repay during the economic life of the capital investments. Borrowing to fund persistent shortfalls in current revenues (aside from unforeseen emergencies) is frowned upon.\footnote{Consistent application of this behavioral norm is an important element of a “hard” budget constraint.} The Local Government Code allows subnational governments to use credit financing for two purposes: liquidity and capital projects. Meeting liquidity needs involves credit financing of a local government’s current spending in advance of expected releases of intergovernmental (primarily IRA) payments or the receipt of taxes. Borrowing by local

<table>
<thead>
<tr>
<th>Debt service ratio limit</th>
<th>Outstanding debt amount limit</th>
<th>Other restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt service not to exceed 20 percent of “regular income,” which includes intergovernmental payments. Of those payments, not more than 20 percent can be used for debt service. All LGU debt is effectively general obligation. Some water district borrowing (water) is based only on revenues.</td>
<td>None</td>
<td>• Bank loans for current and long-term investment needs; use of intercept of transfer payments as loan security (i.e., the central government fiscal transfers to LGUs can be used or intercepted for loan payments) • Bonds restricted to “self-supporting” (revenue-producing) investments • Bond issues subject to central government review for meeting debt guidelines • Localities must budget for committed debt service payments for their budgets to be valid.</td>
</tr>
</tbody>
</table>


Note: LGU = Local Government Unit.
governments for liquidity has been modest, accounting for only 2 or 3 percent of their total annual receipts. However, subnational governments are not allowed by law to incur operating budget deficits and must appropriate in their annual budgets amounts sufficient to pay debt service for indebtedness incurred.\textsuperscript{15}

The Local Government Code (Section 324) imposes a limit on subnational governments’ borrowing capacity, stipulating that their appropriations for debt service (payments of interest and principal) should not exceed 20 percent of their “regular income” in any given year. Regular income is defined by the Bureau of Local Government Finance (BLGF) under the DOF, which certifies the debt service and debt capacity calculations, as the combined total of the three-year average of Locally Own Sources Income, the IRA payments estimated by the Department of Budget and Management, and the three-year average of national wealth payments. The total gives the “ARI” or “average regular income.”\textsuperscript{16} The \((\text{ARI}) \times (.20)\) equals the maximum allowable debt service ceiling.\textsuperscript{17}

Given the high dependency of subnational governments on central transfers, what portion of revenues that can be pledged as security for debt service becomes important? A tighter definition is used with regard to the amount of IRA payments that can be pledged to debt service because of the widespread use of the IRA “intercept” (or a deposit offset) as a security on subnational loans. Only in the case of large cities does the distinction between “the regular income” and the IRA payment make a difference, since for municipalities and provinces, the IRA payments dominate the revenue stream.

As noted, regulation by the Code requires that a subnational government must budget for all its contractually due debt services; otherwise, its budget is considered void, and it cannot lawfully spend funds. Furthermore, the BLGF provides oversight of subnational government lending by calculating the required debt service.

Regulation of subnational bond issuance was indirectly implied by Section 296 of the Local Government Code, which subjected such debt to regulation by the Securities and Exchange Commission and the Bangko Sentral ng Pilipinas (central bank). However, at the outset of devolution after 1991, these regulatory provisions were not energetically exercised. Early on, the Securities and Exchange Commission held that local government bond issues were exempt from its registration
procedures, but in late 2000, the DOF successfully requested the Commission to “delegate” its approval powers to it for purposes of developing a registration procedure.\(^\text{18}\)

In addition, the New Central Bank Act (Republic Act 7653) requires that, as a condition of borrowing, the monetary board render an opinion on the impact of the borrowing on monetary aggregates, the price level, and the balance of payments. For a sovereign guarantee, there is a more rigorous test, and approval is required from the secretary of finance. No subnational government has borrowed with such a guarantee, nor has any borrowed in foreign currency.\(^\text{19}\)

There is no formal subnational government insolvency system in the Philippines. The prevention of any potential defaults is through the screening (and de facto approval) of borrowings by the BLGF, and the GFI deposit offsets and intercepts fiscal flows to subnational governments. The intercept can be used directly only by the Municipal Development Fund Office (MDFO), which has not invoked it because subnational governments have proven to be good borrowers. The MDFO has worked closely with BLGF in tracking subnational borrowing capacity and debt service capacity, and has made good use of the information in screening subnational loan applicants. Government policy does not allow the direct use of the IRA intercept by government or private banks. However, all central government payments to subnational units are made via the Land Bank of the Philippines, which does employ assignments of IRA and deposit offset agreements to secure loans. Furthermore, subnational governments are required to keep deposits in the Land Bank and the Development Bank of the Philippines—both GFIs—except under special circumstances that require specific exceptions.

The global financial crisis of 2008–09 did not adversely affect the financial sector in the Philippines, much less the subnational governments. In general, domestic banks, investors, and subnational governments had no exposure to sophisticated financial instruments such as derivatives, although a few (domestic) commercial banks had negligible amounts in their investment portfolios. Instead, the Philippine subnational governments have maintained budget surpluses in general, with their revenues unaffected by international conditions (see table 11.3). All three levels of subnational governments have maintained budgetary surpluses. Overall, the Philippine economy runs a trade surplus,
which is helped greatly by the growing level of international remittances from an estimated 8 million Filipino overseas workers. Philippine gross domestic product (GDP) continued to grow during the 2008–09 global recession. Philippine nominal GDP grew annually by 7.1 percent in 2007, 4.1 percent in 2008, and 1.1 percent in 2009. Subsequent growth in GDP was 7.5 percent in 2010 and 4 percent in 2011.\(^{20}\)

Table 11.3, which is based on 2008 data, indicates that, with the exception of the cities, the smaller municipalities and the provinces are highly reliant on intergovernmental transfers (most of which consist of the IRA transfers). The LGU share of national internal revenue taxes was fixed by law at 40 percent of national internal revenues in the third year prior to the allocation year. However, the amount of IRA transfer varies over time, depending on the revenue effort of the central government. In 2009, a year after the financial crisis, the country’s national revenue effort (measured as national revenues as a percentage of GDP) declined to 14.6 percent of GDP from 16.2 percent in 2008. In 2010, revenue effort further deteriorated to 14.1 percent. This means that the current IRA allocation was computed on the basis of central government collection of national internal revenues during the financial crisis year, which was a relatively bad year for revenue effort, with GDP growing at 1.1 percent in 2009. Thus, IRA payments are expected to decline somewhat—but, there has been a considerable lag.

Meanwhile, as discussed next, LGUs have surpluses to buffer the fluctuations in IRA payments. In addition, as seen in table 11.3, the level of LGU borrowing is negligible in proportion to receipts, and

<table>
<thead>
<tr>
<th>Type of Local Government Unit</th>
<th>Surplus as % revenue</th>
<th>Debt service as % revenue</th>
<th>Transfers as % revenue</th>
<th>Borrowings as % revenue</th>
<th>Total revenue (pesos millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cities</td>
<td>13.4</td>
<td>1.3</td>
<td>41.3</td>
<td>5.2</td>
<td>126,763</td>
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<tr>
<td>Municipalities</td>
<td>11.7</td>
<td>0.8</td>
<td>78.4</td>
<td>2.1</td>
<td>99,270</td>
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<tr>
<td>Provinces</td>
<td>16.0</td>
<td>1.6</td>
<td>76.2</td>
<td>3.7</td>
<td>71,596</td>
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<tr>
<td>Overall</td>
<td>13.5</td>
<td>1.2</td>
<td>62.0</td>
<td>3.8</td>
<td>297,629</td>
</tr>
</tbody>
</table>

Source: Bureau of Local Government Finance.

Note: Borrowings = total receipts from loans and borrowings, debt service = debt service (interest expense and other charges), surplus = total revenue – [total current operating expenditure + total nonoperating expenditures], transfers = IRA + other shares from national tax collections, and total revenue = total current operating income + total nonincome receipts.
annual debt service requirements are just as low, equaling less than 3 percent of revenues in the aggregate. It needs to be noted that the actual surpluses are smaller than the reported “surpluses” in table 11.3 because, until 2011 when reforms were implemented, the government reporting systems did not capture expenditures from “continuing appropriations” that LGUs carry over from capital outlays that span more than one fiscal year.\(^{21}\)

Table 11.4 provides a four-year display of the annual budget surpluses of subnational governments by type of unit. These have been steady among the various types of units.\(^ {22}\) As noted, the IRA payments to subnational governments are based on a three-year lag of national government revenues, which delays the impact of any national receipts on the IRA payments.

Central oversight of local unit debt is generally predicated on the nature of the market for such debt. Because there is a limited private market for Philippine LGU debt, there effectively has been de facto supervision of borrowing by the GFIs, which hold the vast majority of LGU debt. More formally, oversight is exercised by the BLGF through its review of the debt service ceiling and represents a de facto approval of borrowing.

LGU debt is monitored by the BLGF under the DOF. An agreement signed in 2002 requires that the GFIs, the central bank, and the LGUGC submit data on LGU debt to the BLGF. LGUs also provide data on debt and debt service through their Statement of Income and Expenditure, which they submit quarterly to the BLGF. The central bank also monitors GFI loans to LGUs and the purchases of LGU bonds.\(^ {23}\)

<table>
<thead>
<tr>
<th>Type of unit</th>
<th>2005</th>
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<th>2007</th>
<th>2008</th>
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<tr>
<td>Provinces</td>
<td>6.2</td>
<td>5.5</td>
<td>4.7</td>
<td>8.8</td>
</tr>
<tr>
<td>Cities</td>
<td>13.5</td>
<td>19.2</td>
<td>14.9</td>
<td>21.2</td>
</tr>
<tr>
<td>Municipalities</td>
<td>7.3</td>
<td>8.2</td>
<td>7.2</td>
<td>10.7</td>
</tr>
<tr>
<td>Total</td>
<td>27.0</td>
<td>32.9</td>
<td>26.8</td>
<td>40.7</td>
</tr>
</tbody>
</table>

Source: BLGF Statement of Income and Expenditure.
Note: After adjusting for the expenditures from “continuing appropriations,” Local Government Unit annual surpluses ranged from half to one-third of the reported surpluses (see note 23).
Subnational Demand for Debt Instruments

The Philippine subnational debt is low compared to many other countries. The best way to make comparisons is to examine the level of debt as a percentage of the nation’s GDP, since this takes into account the varying sizes of the underlying economy. The reported Philippine subnational debt is less than 1 percent of the national GDP. That ratio changes little by adding the indirect debt of subnational water utilities.\(^{24}\) By comparison, the average ratio of subnational debt to GDP for developing and transitioning countries was 5 percent in the mid-2000s.\(^ {25}\) The low percentage suggests that Philippine subnational governments neither do much capital spending nor use much borrowing to finance those needs. Most capital spending appears to be for “development” purposes and is relatively small scale.\(^ {26}\) The contrast is even greater when compared to developed countries (the Organisation for Economic Co-operation and Development [OECD] nations). For the developed countries, the average subnational debt to GDP in 2006 was 6.7 percent.\(^ {27}\)

The disincentives for LGUs to contract debt for public infrastructure investments contribute to what seems to be a low demand by subnational governments for debt instruments in the Philippines.\(^ {28}\) The disincentives are mainly explained by the binding constraints that weaken the capacity of local governments to provide basic devolved services and drive economic growth.\(^ {29}\) The high level of fragmentation in the subnational government structure contributes to the lack of economies of scale in infrastructure provisions. The local government system comprises a large number of small jurisdictions at each level of subnational government. The fragmentation can be overcome by forming interjurisdictional cooperation in infrastructure provision.\(^ {30}\) However, there is a lack of noticeable pressure from local citizens for local governments to invest in better infrastructure and service delivery. The service delivery system is multitracked in almost all sectors. National government agencies continue to play major roles in the delivery and finance of local services, including using discretionary funds.

The current IRA formula does not compensate for the varying degrees of fiscal capacities of LGUs. In fact, the large IRA transfers from the central government have a disincentive effect on local
Local officials have strong incentives to lobby for resources directly from the national government. A recent study shows that a model-based Good Governance Index is not strongly associated with election results.

The poorer LGUs have a low fiscal capacity to leverage borrowing. Real property taxation potentially offers a revenue-rich tax base, but there are challenges to greater use of that source: land titling issues, lack of cadastral surveys, unwillingness of local assessors to update assessment levels, and resistance of the local propertied class to an increase in property taxes. Weak local economies give rise to low local business tax collections. As a result, the weaker, rural LGUs heavily depend on the IRA, the national government’s fiscal transfer, to finance local development activities, and on the “pork barrel” of legislators for livelihood projects and the usual infrastructure projects such as farm-to-market roads, barangay halls, and others.

An ongoing national government project on improving land and property valuation seeks to provide LGUs with the tools for doing proper land valuation and assessment. According to BLGF, many LGUs are starting to realize the great revenue potential arising from updated land values and better assessment practices. The project has led to the establishment of Philippine Valuation Standards, patterned after the international best practices on valuation, the development of IT (information technology) systems, and measures to support the formulation of a market-based schedule of property values.

The higher-income LGUs are experiencing pressure for better infrastructure and services, stemming from their transformation into growing urban centers. The growth of global business processing outsourced to Philippine-based companies and call centers, among others, is transforming the bigger LGUs, which are seeing the need for better local infrastructure, including more reliable and competitively priced electricity supply, and public service delivery. These higher-income LGUs borrow mostly from the GFIs, and receive a larger share of the IRA due to their larger population and land areas.

The national government has adopted PPP as its main strategy for infrastructure provision at the national and local levels. The PPP approach is a potential source of demand for more debt financing at the
local level if LGUs are to manage those PPP projects assigned to their mandate and the above-mentioned binding constraints to local service delivery relaxed.

Moreover, on the demand side, using PPP for infrastructure development at both the national and local government levels, encouraged by the government policy, will require the building of local capacities to deal with private sector investors and lenders under this mode of procurement.\textsuperscript{35} LGU demand for borrowing, especially for infrastructure, is expected to increase. PPP for local infrastructure and an increase in LGU demand for borrowed funds for this purpose will require effective coordination with the national government, especially its oversight agencies and infrastructure agencies.\textsuperscript{36} There is also the issue of how effective the PPP approach will be as an alternative for small-scale and non-revenue-producing projects.

**Subnational Credit Market and Composition of Debt Instruments**

The composition of Philippine subnational debt consists mainly of debt owed either to higher levels of government or debt in the form of loans from government-owned banks. Although development of the subnational bond market gained momentum in the late 1990s, subnational bonds have not become a main part of the debt portfolio.

**Public Financial Institution Lending to LGUs**

The Local Government Code of 1991 has the potential to open several avenues for local governments to access credit finance from bank credits and “other similar forms of credits,” and also from bonds and “other securities.” Notwithstanding the potential, lending by the GFIs continues to be almost exclusively the source of loan funds for subnational governments. Subnational governments naturally made initial credit requests to the GFIs, since the GFIs hold the cash accounts of LGUs. The main sources of domestic credit financing are two GFIs, the Land Bank and the Development Bank of the Philippines, and two specialized onlending institutions, the Local Water Utilities Administration (LWUA)\textsuperscript{37} and the Municipal Development Fund (MDF), which is run by MDFO.\textsuperscript{38} The LWUA channels development assistance to local water
supply projects and has offered long-term loans that match those of the underlying development assistance loans.

In the early years after the Local Government Code was implemented, the Philippine National Bank, which was later privatized, and the Land Bank were the largest providers of credit to local governments. In 1995, the Philippine National Bank held about 6 billion pesos in loans to local governments and the Land Bank held about 5 billion pesos. The Development Bank of the Philippines was just starting to lend to local units. The MDF had about 2 billion pesos in loans and the LWUA had about 8 billion pesos in loans to the water sector.39

The GFIs, reopening their lending windows to local governments after the widespread defaults of the 1980s, focused on those with higher incomes, as evidenced by the large average loan size in their local government loan portfolios. Interest rates on these loans were about the same as those on their prime commercial loans, suggesting that they assigned a low-risk premium to local governments. The average tenures were longer than those for commercial loans, at about two to four years.

After 1995, the growth of lending rapidly accelerated for both the Land Bank and the Development Bank of the Philippines, in part because of the rapid withdrawal of the Philippine National Bank from the local government credit market following the bank’s privatization.40 Also, both the Land Bank and the Development Bank of the Philippines got access to foreign loans for relending to LGUs and enhanced their depository relationship with LGUs.

The GFIs have actively used the depository relationship and government reporting to create credit and investment instruments. They base lending decisions for capital projects on the IRA and revenue flows of the LGUs rather than on the revenue flows of the project. They make available short-term credit facilities tied to future budget releases that allow LGUs to draw funds in advance of revenues.41 They also enable LGUs to arbitrage on interest rates and on financial reporting by, for example, granting loans secured on their deposits and allowing the local governments to earn spreads on their investments, while still reporting high deposit balances. These practices help the GFIs manage the risk of lending to LGUs, while enabling the LGUs, to venture into commercial borrowing and financing of capital projects.
The LWUA, which lends to the local water districts, suffered ongoing structural problems that prevented it from expanding its participation in financing local water supply projects. Lending by the MDFO also grew slowly, reaching 2.7 billion pesos in 1999 and 3.7 billion pesos in outstanding loans by the third quarter of 2010. Among other possible sources, the government pension funds, which had shown early interest, were content to invest in high-yield government obligations and made heavy commitments to the commercial property sector and equity investments. These factors impeded their participation in the local government credit market.

Table 11.5 summarizes the present structure of the Philippine local government debt market. Overall, with a relatively small domestic bond market, the provision of credit to LGUs in the Philippines is overwhelmingly done by the GFIs. The Philippines has a largely bank-dominated credit system. Generally, as financial systems mature, they tend to develop alternatives to the reliance on banks for credit. This usually entails the growth of savings-based institutions and various forms of insurance that have longer-term investment horizons. As will be discussed, the Philippines has a formal policy of promoting private sector financing of those LGUs that are higher income and that have self-supporting projects. However, notwithstanding earlier efforts to achieve that goal, the current state of affairs is a continuing dominance by the GFIs over LGU credit access, as shown in table 11.6.

Out of a total outstanding LGU debt of 68.02 billion pesos, as of September 10, 2010, about 86 percent was owed to GFIs, and 9 billion pesos, or 13 percent, was owed to two private banks, which by law

<table>
<thead>
<tr>
<th>Institutions</th>
<th>Cost of borrowing</th>
<th>Debt instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Predominantly loans by government-owned banks. Also, some bond issues in capital market using bond insurance that also relies on transfer aid intercept provisions. Some special onlending funds.</td>
<td>Most interest rates at market levels. Government banks can use intercept/offset on intergovernmental transfers to secure loan repayments. Local governments usually must use government banks for deposits.</td>
<td>Bank loans and bonds of 7-to-10-years’ maturity. Some subsidized onlending using donor funds for special purposes up to 15 years.</td>
</tr>
</tbody>
</table>

Until Debt Do Us Part

Table 11.6 Outstanding Loans and Bonds of LGUs (as of September 10, 2010)

<table>
<thead>
<tr>
<th></th>
<th>Amount (billions pesos)</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans from GFIs</td>
<td>58.29</td>
<td>85.69</td>
</tr>
<tr>
<td>Land Bank of the Philippines</td>
<td>43.25</td>
<td>63.59</td>
</tr>
<tr>
<td>Development Bank of the Philippines</td>
<td>3.26</td>
<td>4.79</td>
</tr>
<tr>
<td>MDFO</td>
<td>11.77</td>
<td>17.31</td>
</tr>
<tr>
<td>Loans from PFIs</td>
<td>8.94</td>
<td>13.15</td>
</tr>
<tr>
<td>Philippine National Bank&lt;sup&gt;a&lt;/sup&gt;</td>
<td>3.67</td>
<td>5.39</td>
</tr>
<tr>
<td>Philippine Veterans Bank&lt;sup&gt;b&lt;/sup&gt;</td>
<td>5.28</td>
<td>7.76</td>
</tr>
<tr>
<td>Bonds outstanding</td>
<td>0.79</td>
<td>1.16</td>
</tr>
<tr>
<td>LGU Guarantee Corporation</td>
<td>0.25</td>
<td>0.37</td>
</tr>
<tr>
<td>Philippine Veterans Bank&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.54</td>
<td>0.79</td>
</tr>
<tr>
<td>Total</td>
<td>68.02</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Bureau of Local Government Finance.

Note: GFIs = Government Financial Institutions, LGU = Local Government Unit, MDFO = Municipal Development Fund Office, PFIs = Private Financial Institutions.

<sup>a</sup> Formerly a GFI that, after its privatization, has retained the ability to hold LGU deposits.

<sup>b</sup> A privately owned bank whose board of directors is appointed by the president, with ability to hold LGU deposits. Not shown is an estimated 20 billion pesos in LWUA loans outstanding to water districts.

<sup>c</sup> This amount may include bank loans that are guaranteed by the Philippine Veterans Bank, as well as bonds.

(Philippine Veterans Bank) or by special authority from the Monetary Board (Philippine National Bank) are authorized to accept deposits from LGUs. It appears that just over 1 percent of LGU debt is owed to other PFIs, which are primarily banks that have bought the bonds issued by LGUs and guaranteed by the LGUGC or the Philippine Veterans Bank.

The Philippine debt service limit is similar to that found in many countries and is, perhaps, a little less generous than that found in others. Many countries place a maximum limit on debt service as a ratio to annual revenues or expenditures. A few countries limit the amount of annual borrowings to a fraction of a government’s total revenues (which may make sense in terms of short-term debt but is not rational when it comes to long-term debt). Overall, the limitation on general obligation borrowing (borrowing is secured by full faith and general revenues such as sales and property taxes of the local government) makes sense. But it does not address the case where an LGU might not pledge its “general revenues” to the repayment of the
debt but relies on enterprise earnings or other “non-general” revenues, where borrowing is secured by specific revenues or self-sustaining revenue generated by the project that is being financed by the debt (this is addressed further, below).

The statutory debt limit is not, however, the deterrence to LGU borrowing in the Philippines. Given the modest demands for loan funds by LGU borrowers, the debt limit is seldom reached. Generally speaking, for the LGU sector as a whole, it appears that total debt service payments, in the aggregate, are equal to only 2–3 percent of “regular” income (depending on how tightly that concept is defined). Furthermore, annual LGU borrowing equals only 2–3 percent of total LGU receipts (recently, 4–6 billion pesos in aggregate borrowing, compared to around 200 billion to 230 billion pesos in total revenues and receipts). According to the BLGF, there have been few cases of LGUs being near (or closely approaching) the debt service limit. Overall, the excellent repayment record of LGUs does not evidence any systematic fiscal strain or imprudence.

The debt capacity limitation, however, leaves one potential LGU borrowing opportunity unchartered. That is, while the debt limit makes perfect sense for those borrowings that are secured on general revenues (including the IRA), it does not contemplate the situation where an LGU might not want to borrow against its general revenues but rather against some specifically pledged revenues or assets. That would be a “revenue bond” or “limited obligation,” in the parlance of the bond markets, where there is not a pledge of general revenues. Currently, there seems to be no explicit regulatory provision for that type of borrowing by LGUs. However, that approach is what the water districts in the Philippines are now using with their “water revenue loans” that are backed by pledged water revenues and “step-in-provisions” that allow the LWUA to take over operation in case of a default.

BLGF has been recognizing “trust funds” in its tabulation of LGU accounts. The “trust fund” to conduct commercial operations within a government is a positive development. The other is the creation of “special districts” or “authorities” that have their own governing body, operate under a trust agreement (contract) with the lenders, and are insulated from the day-to-day budget and political issues of the LGUs. In these cases, either the record of existing operations or strong feasibility
studies are needed. The role of the rating agencies is also often critical, since the ratings provide general benchmarks on the credit quality and debt marketability. Sometimes, there is general obligation support for debt service until the project becomes self-sustaining, at which time its obligations no longer count against the debt limitation. However, as noted by Canuto and Liu (2010), without proper governance structure and financial transparency, the special district types of arrangement can carry fiscal risks and contingent liabilities to the government owners of such special districts.

The adoption of the special fund doctrine as a means of financing LGU capital needs will require legally enforceable contracts where the LGU (or a special fund or district created by it) will be required to run the project as a commercial enterprise and agree to do so with the creditors. Provisions will be needed to protect the investors in case the issuer or borrower defaults on its obligations. The current revolving lending program in the water district areas (which involves PFIs and does not rely on the IRA guarantee) needs to be carefully evaluated since such an evolving financing technique might have broader applications in the Philippines.

**Private Credit and Capital Markets**

LGUs have been able to access private credit markets but, until recently, only indirectly through bond issues, which have been purchased mostly by private banks and guaranteed by the LGUGC (or the Philippine Veterans Bank). Aside from isolated cases, there have been no direct PFI loans to LGUs. Most of the LGU bonds to date have had seven years’ maturity, consistent with the short-to-medium-term nature of the banks’ funds. However, LGU bond flotation has been infrequent since mid-2006. Direct lending by PFIs to LGUs has commenced, using loan insurance and liquidity facilities. These deals are being done in conjunction with a new IFI-sponsored water revolving fund project. These new programs are aiming at getting PFIs to lend directly to LGUs. The LGUGC is currently packaging three such loans.

The PFIs are well aware that LGU lending and depository activities represent a profitable area for the GFIs; they would be anxious to compete if they could overcome the impediments. It is realized that the intercept on IRA payments (or some adaptation of it) is likely
necessary to sustain the high repayment rates of the LGUs.\textsuperscript{47} As noted, it has been difficult for PFIs to get an assignment of the IRA payments (which requires GFI involvement since they act as the LGUs’ depository).\textsuperscript{48} There are also continuing concerns about the ability and willingness of LGUs to pay on their debt, especially given the three-year election cycle. LGUs under the existing “IRA intercept/offset” enforced credit regime, however, have a nearly perfect record of paying their obligations to GFIs.

The Philippines received much international attention for its early efforts to build a municipal bond market, and its innovative use of bond insurance is accomplishing that deed. There was a flurry of activity in the issuance of municipal bonds in the late 1990s and early 2000s. This was made possible by the creation in 1997 of the LGUGC as a “private” insurer\textsuperscript{49} of LGU loans and bonds. Between May 1999 and December 2010, the LGUGC guaranteed 19 bonds amounting to 3.25 billion pesos issued by 16 LGUs.\textsuperscript{50} Projects financed include tourism-related infrastructure such as the Tagaytay City Convention Center and the Caticlan-Boracay Jetty Port. Public markets, commercial centers, public terminals, slaughterhouses, housing projects, a hospital, an academic center, a gymnasium, and an integrated solid waste management system have also been financed. Over 2.7 billion pesos of the LGUGC-guaranteed bonds had already been redeemed by December 2010, and it is estimated that only 590 million pesos of bond principal remained outstanding.\textsuperscript{51}

However, insuring bonds was the first step taken by LGUGC and has not been the limit of its sphere of activity. By 2006, it began to insure bank loans, which did not entail the issuance of marketable bonds, but was geared to individual bank loans or syndicates of bank loans.\textsuperscript{52} Over the last five years, this activity has increased, usually involving water districts and other public corporate borrowers. Table 11.7 presents LGUGC’s overall activity through the end of 2010. As indicated, by the end of 2010, LGUGC’s annual new insurance deals were running about 900 million pesos a year, and overall outstanding guarantees amounted to 2 billion pesos, of which an estimated 589 million pesos represented outstanding LGU bond issues.

The Philippine Veterans Bank also has guaranteed LGU bonds since 2003, amounting to 505 million pesos.\textsuperscript{53} The bonds had a seven-year
maturity and a two-year grace period. However, most bonds had been fully redeemed, and by the end of 2009, the Philippine Veterans Bank had only approximately 100 million pesos in guaranteed bonds outstanding.

On a combined basis, the LGUGC and the Philippine Veterans Bank have guaranteed the issuances of LGU bonds amounting to 3.5 billion pesos, of which only about 500 million pesos (about 15 percent) remain outstanding. There have been no defaults, and early issues have been paid and retired. The rest were redeemed early, long before the end of the maturity period. Most of the redemptions were due to refinancing of the bonds via loans made by GFIs.\textsuperscript{54}

When the LGUGC was started in the late 1990s, there was an initial flurry of bond issues and the hope that the bond market would “take off.”\textsuperscript{55} However, by the mid-2000s, the pace of bond sales slowed greatly. Private creditors were concerned that the GFIs were protective of their LGU business and sought to exclude others from lending to LGUs. The GFIs have a great informational advantage. Because of their holding of the LGU deposits, they are able to track the LGUs’ financial activities and identify potential bond deals.\textsuperscript{56}

In addition, the GFIs were reluctant to enter into assignments of IRAs and other LGU revenues to the PFIs engaged in lending to LGUs, and, in the view of LGUs, bond issues involve additional costs and administrative approval delays.\textsuperscript{57} Such costs and delays can be avoided by seeking GFI lending that is secured by offsets to IRA transfers (which the LGUs were required to deposit in GFIs).\textsuperscript{58} According to the PFIs, this requirement has created an uncompetitive situation in which

<table>
<thead>
<tr>
<th>Type of LGU debt</th>
<th>Million pesos</th>
</tr>
</thead>
<tbody>
<tr>
<td>LGU bonds</td>
<td>589</td>
</tr>
<tr>
<td>Water district loans</td>
<td>748</td>
</tr>
<tr>
<td>Municipal enterprise loans</td>
<td>151</td>
</tr>
<tr>
<td>LGU bank loans</td>
<td>518</td>
</tr>
<tr>
<td>Total</td>
<td>2,006</td>
</tr>
</tbody>
</table>


Note: LGU = Local Government Unit, LGUGC = Local Government Unit Guarantee Corporation.
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the GFI s have strong advantages due to government regulation. It is important to raise an even broader policy constraint for PFIs, which is the Monetary Board policy restricting PFIs from serving as depository banks for LGUs, except for special cases in which the Monetary Board issues a waiver allowing a specific LGU and PFI branch to engage in such a banking relationship. This is a fundamental barrier to direct PFI lending to LGUs.

**Credit Ratings, Project Finance, and Debt Instruments**

There continues to be a lack of timely and generally accessible financial information on LGUs and “independent” published ratings. The LGUGC publishes underlying ratings on the bonds it insures or is intending to insure. These information deficiencies have not been a major problem for the current GFI lenders, which took IRA payments as the primary security. However, if the subnational capital market is to expand, the availability of operational data, well-prepared financial feasibility reports, and credit ratings would become important.

LGU loans receive the same treatment as commercial loans under the bank capital adequacy rules. However, municipal bonds sold with the LGUGC guarantee receive more favorable treatment. The Agri-Agra capital requirements for bank investments continue to be a source of demand for holding LGU loans as assets, since they qualify in meeting the requirements. It is reported that there is sizable demand by long-term investors for LGU bonds and loans. In the past, some of the private bank trusts did come up against diversification limitations in the case of the LGU bonds.

There is also potential in long-term fixed-income demand from institutional investors such as life insurance, pension systems (public and private), and individual trusts. These investors have tended to invest in national government securities. Overall, however, the level of institutional financial investment in the country is not high. The national government has dominated the bond markets (over 95 percent of all bonds), and the growth has occurred most in the commercial paper area. However, the development of the fixed-income exchange by the Philippine Dealing & Exchange Corporation is changing that situation. This should increase liquidity and improve the demand for bonds in the Philippine market. The new exchange has developed a “yield curve” for
government securities that can be used as a benchmark for other fixed-income obligations. However, LGU bonds can be listed on the exchange only if they are of sufficient volume.

There appears to be some headway on attracting PFI investment to the LGU sector. The Philippine Water Revolving Fund (PWRF) was established to mobilize private funds to the water sector and has qualified several PFIs to participate. The Development Bank of the Philippines and PFIs can cofinance the loan with the LGUGC providing credit guarantee. The MDFO (in the case of LGUs) and the Development Bank of the Philippines (in the case of water districts) can make available a stand-by line of credit to refinance the PFI loan if the private lender decides not to extend the tenure beyond the current 10-year tenure. As of February 2011, five private commercial banks had loaned 1.069 billion pesos to nine water districts. Cofinanced loans amounting to 747 million pesos have been given to two water districts.

PFIs seem more comfortable with utility-type investments that are revenue producing. For example, water district lending would appear to be favorable if the credit security issues can be resolved. Many water districts seem to be more professionally managed. The election cycles may impact the behavior of local government officials, who may favor high visibility and fast-payoff projects.

Overall, the PFIs are interested in authorities or districts that are insulated from day-to-day local administration and are professionally managed as enterprises. In such cases, debt issues are controlled by provisions in the underlying project and its loan contracts (“revenue bonds”) and do not depend on general revenues (and the IRA payments).

The development of new legal structures to support project financing deserves greater study, since there appears to be some headway already made in the formulation of LGU accounts. There is now recognition of LGUs having trust accounts that are not part of the regular annual budgetary appropriation, and which function as restricted accounts during the term of the trust. LGU economic operations that can be “ring-fenced”—in the sense that enterprise revenues must be dedicated to —payment for the enterprise’s operations and debt repayment—are potentially feasible if there is a “special fund” doctrine.
Extending loan maturity is important to finance long-term infrastructure assets. The Philippine bond and bank loan market, aside from the IFI funds that are usually provided for long-term maturity, is relatively short to medium term and, in the case of the PFI s, typically carry variable interest rates. Being restricted to the short maturities is a classic difficulty that subnational governments face in many emerging economies (and also in developed economies, especially when there is a substantial threat of inflation). Short maturities and variable rate structure prevent an erosion of asset value to lenders if interest rates rise rapidly.

The classic way to modify the terms of debt in the market under such conditions is to provide options that can protect both the lender and the borrower. In the case of lenders, they will want the ability to protect the value of their investment if interest rates increase. Borrowers, however, will want protection if interest rates decrease and, with a call option, they are permitted to refinance debt at lower interest rates.

These options were not used in the Philippine LGU financial markets until recently.  

Recent Innovations and Prospects in Credit Market Access

In the Philippines, fostering a competitive and diversified subnational credit market has been a long-standing policy goal. It has also been in a protracted phase of experimentation. The private sector financial markets are playing a minor role in LGU financing, except in selective cases. Nonetheless, there are emerging opportunities for that activity to occur.

In the Philippines, as in many other countries, subnational government credit needs have been met for many years by bank loans. Various countries have moved toward a more competitive market structure with the participation of private creditors (Canuto and Liu 2010). Some countries, including the Philippines, have continued to rely mainly on GFI for subnational credit financing. In many cases, this approach was initially necessitated by weak domestic credit and capital markets. Also, local governments were subordinate in the political and economic structure and depended on the central government for guidance and support.
The Local Government Code of 1991 sought to significantly change the relationship of local governments to the central government. It sought to empower local governments to act with greater responsibility and autonomy and provided them with substantial transfers (the IRA payments) that now represent around 65 percent of all LGU revenues. The Code also provided LGUs with substantial powers to borrow. Meanwhile, the LGU financing framework was developed in 1996 to implement the credit-related dimensions of the LGU Code. It envisioned a combined effort by public and private financial entities to provide capital to the LGU sector. The GFIs were to be the lead entities in the case of the higher-income localities and self-supporting projects, and to gradually bring in private sector financial institutions.72

The overarching objective was to move local governments in the direction of sustainability and reliance on private market sources to the greatest degree possible.73 A key role was assigned to the GFIs to act as a conveyor belt for those LGUs that are becoming financially stronger (or have stronger self-supporting projects), and helping them graduate into the private markets. This largely has not happened. The GFIs—because of their superior credit position, their ability to intercept LGU deposits, and their capacity in dealing with LGUs—have incentives to make loans to LGUs. The transition to PFI financing has been slow to materialize.

The development of competitive subnational credit markets will need to address both demand- and supply-side constraints. On the demand side, it is critical to strengthen the local finance and accountability systems for citizens to demand better services. As noted by section three, several factors contribute to the LGUs’ low demand for debt instruments. These factors include a lack of pressure from citizens for better service delivery, difficulty in developing interjurisdictional cooperation in infrastructure provision to take advantage of economies of scale, inadequate debt and fiscal capacity, weak technical capacity to develop projects, and the available alternatives of accessing “pork barrel” projects from the national legislators. These factors collectively make the risks of borrowing by LGUs outweigh the potential rewards for LGU infrastructure investment and financing.

The higher-income LGUs are experiencing pressure for better infrastructure and services, stemming from their transformation into growing urban centers. They are likely to demand more debt
instruments; thus, relaxing the binding constraints can help the higher-income LGUs become more viable borrowers. The national government has adopted PPPs as its main strategy for infrastructure provision at the national and local levels, which creates potential demand for more debt financing at the local level, particularly in major urban centers where the stronger fiscal capacity can make the PPP model more attractive to private players, including private financiers. Developing strict sectoral financing policies will help reduce ad-hoc allocation of central government funds and reduce the incentives for LGU lobbying for the central discretionary resources.

In the Philippines, municipalities and lenders rely heavily on the IRA, in effect making all the municipal debt homogenized as a national credit. In the early state of developing municipal debt markets, debt issued based on fiscal transfers and central government guarantees may help start the market. But the continuing development of the market requires the use of financing instruments that rely more on own-source revenues and credit differentiations among LGUs. There are financing instruments that can forge closer links between own revenue of local governments and their capacity to access the market, which in turn help strengthen local accountability.

Revenue bonds have been used extensively in various countries, including the United States, as a powerful instrument to finance subnational infrastructure by linking project finance with benefit taxation.\textsuperscript{74} The debt service is secured by revenue streams produced by the project financed by the bond instrument. The recent innovation in the water districts in the Philippines has indicated a similar direction—the water districts in the Philippines are securing their “water revenue loans” by pledged water revenues and “step-in-provisions.” The water districts legally exist outside the LGU accounts and act as separate government-owned-and-controlled corporations. The water district design might be adapted into a broader notion of economic development and/or infrastructure districts that would have a degree of insulation from the day-to-day administration of the LGUs.

Another often used instrument—tax increment financing—also helps link LGUs’ own revenue with infrastructure financing. The instrument is used for financing infrastructure and other community-improvement projects in many countries, including the United States.
Tax increment financing uses future gains in taxes to finance current improvements, which are projected to create the conditions for future gains. The completion of an infrastructure project such as power and water often results in an increase in the value of surrounding real estate, which generates additional tax revenue. Tax increment financing dedicates tax increments within a certain defined district to finance the debt that is issued to pay for the project. It creates funding for public or private projects by borrowing against the future increase in these property-tax revenues.

Opening up the subnational credit market to private competition helps lower the financing cost. Attracting PFI investment to the LGU sector has recently gained headway in the Philippines. The PWRD was established with the participation of both public and PFIs to cofinance loans to water districts and LGUs. An important aspect of the subnational credit market is the competition among debt instruments. The private (corporate) bond market is small in many developing countries, and it remains small in the Philippines. Yet, properly secured, infrastructure financing would appear to be an ideal use of long-term bond issues. There is also potential in long-term fixed-income demand from institutional investors such as life insurance, pension systems (public and private), and individual trusts.

**Conclusion: Constraints and Opportunities in the Philippines**

The Philippines represents an emerging economy that continues to chart its own unique course when it comes to developing its subnational debt markets. The Philippines has been innovative in its efforts to extend the legal possibilities for local governments to take initiative in the use of credit and in the design of credit market techniques to make this possible. The Local Government Code, with its broad array of borrowing powers granted to LGUs, and the creation of the LGUGC insurance company to bolster local credits, are pioneering efforts.

Nonetheless, while a few urban and sophisticated Philippine local governments have been able to take advantage of these initiatives, many of the country’s LGUs remain passive in their efforts to move ahead and proactively use the new powers to improve their condition.
There are binding constraints that weaken the capacity of LGUs for better infrastructure service delivery. The constraints relate to the local finance and accountability systems. As has been noted, this low level of accessing the debt markets has averted serious fiscal problems for local governments, but it has also resulted in limited local initiatives to promote economic growth.

Fostering competitive subnational credit markets has been a long-standing policy goal in the Philippines. Notwithstanding the Philippines’s efforts to develop more diversified subnational credit markets, the transition to PFI financing has been slow to materialize, and the GFIIs continue to be the main lenders to LGUs. The development of competitive subnational credit markets will need to address both demand- and supply-side constraints. On the demand side, it is critical to strengthen the local finance and accountability systems for citizens to demand better services. On the supply side, removing constraints to private participation in the market will increase competition and help lower the cost of financing. It is also helpful to experiment with those financing instruments that can forge closer links between own revenue of local governments and their capacity to access the market, which in turn help strengthen local accountability. The recent experiments of encouraging greater partnerships between the local governments and the private sector credit markets could pave the way for a more competitive and diversified subnational credit market.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. The terms subnational government and local government are used interchangeably in this chapter. While the country’s legal framework for decentralization is reflected in the Local Government Code of 1991, the term subnational government is used to maintain consistency with usage in other chapters in this book volume.

3. The government financial institutions mainly consist of the Development Bank of the Philippines and the Land Bank of the Philippines and two specialized onlending institutions: the Local Water Utilities Administration and the Municipal Development Fund. Section four provides details on government financial institutions.


7. As of March 31, 2012. Data from the National Statistical Coordination Board, National Economic and Development Authority.

8. Manasan (2005) and authors’ calculations.


14. The borrowing for long-term capital investment is called the “Golden Rule.” Liu and Waibel (2008) review how various developing countries have adopted the Golden Rule in regulating their subnational debt financing, as part of their regulatory reform in managing subnational finance.


16. Very little appears to be left out of revenues, except extraordinary items and, perhaps, some national grants. The IRA and national wealth payments make up 98 percent of all national payments. No local own-sources seem to be included (except for extraordinary items). For practical purposes, it appears that about 99 percent of all own-source and national-source revenues are included.

17. To calculate the net remaining debt ceiling, from that maximum amount is subtracted the annual debt service (which is called “amortization”) on existing debt. To calculate “borrowing capacity,” the net remaining debt ceiling is multiplied by an annuity factor that corresponds with the maturity terms of the principal repayments and the interest rate on the proposed debt. In other words, the debt capacity certification looks at the particulars of the proposed loan or bond issuance to see whether, after the borrowing is consummated, there is remaining debt capacity.


19. As a policy, DOF will not issue a sovereign guarantee for an LGU loan directly sourced from a foreign lender, including multilateral institutions.


21. For example, an LGU that is unable to fully complete a capital investment project in a given year can carry over the remaining appropriation to the following year and complete the expenditures then. However, the official reporting systems
prior to 2011 did not capture these expenditures from "continuing appropriations," hence, resulting in underreported expenditures and overreported surpluses. A recent LGU data analysis done by the World Bank estimated that the aggregated annual LGU surpluses after adjusting for the expenditures from "continuing appropriations" range from half to one-third of what had been reported.

22. Unfortunately, BLGF does not provide balance sheet information. Also note that borrowing receipts are reported as "income," which is technically incorrect. However, adjustments to the local government income numbers in the aggregate have little impact on the revenue figures because of the low level of borrowing.

23. In that regard, the Bangko Sentral ng Pilipinas has asked the BLGF to review projects to be financed by LGU bonds. However, the BLGF, aside from doing the basic debt burden and capacity measures, does not appear to employ such technical capability at present.

24. The direct debt figure is a bit low because it does not include outstanding debt of water districts or local water utilities, which is considered as indirect debt of subnational governments. Water utility debt amounted to about 17.7 billion pesos as of end-December 2007. However, even if the number were twice as large, the percentage of GDP would still be only slightly over 1 percent. As of end-December 2009, LGU debt as reported by BLGF was 70 billion pesos. There was another 21 billion pesos in loans made to the water districts by Local Water Utilities Administration.


26. An interesting contrast is provided by China, where urban development and finance corporations owned by subnational governments borrow from financial markets to finance mainly infrastructure investments. There are varying estimates of the size of subnational debt in China, averaging around 16 percent of GDP (Liu 2010).

27. The United States, with its federal system, provides a contrast to most other countries. Combined debt of the subnational governments equaled about 20 percent of GDP (U.S. Federal Reserve System, Flow of Funds). In the United States, the vast majority of public services are assigned to the subnational (state and local) governments, and most basic infrastructure facilities (airports, education facilities, highways, ports, sanitation, sewerage, and water) are owned and operated by subnational governments. Private sector provision of infrastructure is dominant in the electricity sector and telecommunications. Overall, state and locally owned facilities represent about 60 percent of ownership, and the private sector represents about 40 percent (see Petersen and Vu 2011, 4).

28. Unless otherwise noted, this section draws mainly from a World Bank mission conducted during January–February 2011.

29. The analysis of the binding constraints draws from the World Bank (2010), which provides a more detailed analysis of these constraints.
30. The examples can be found in the special vehicle arraignments in the United States (see for example chapter 14 by Liu, Tian, and Wallis in this volume), and intermunicipal cooperation arrangements in France covering a range of services such as water supply, household waste collection, and sewerage. France has a large number of small municipalities (see chapter 6 by Liu, Gaillard, and Waibel in this volume).
32. See Virola et al. (2007), whose study used 2004 and 2007 gubernatorial elections data.
33. Under the Land Administration and Management Project Phase II of the World Bank-AusAID. DOF has a property valuation office, which is spearheading efforts to assist interested LGUs with proper land valuation and assessment policies and techniques. The DOF Property Valuation Office will be superseded by a National Valuation Authority under a bill sponsored by the government creating the Authority, if it is voted into law by the Congress.
34. These higher-income LGUs receive a larger share of the IRA, but the share of IRA in their total revenues is smaller than the lower-income LGUs, as noted in section two, mainly due to the greater capacity of higher-income LGUs to raise own revenues.
35. LGUs are reportedly reluctant to undertake large infrastructure projects with the private sector, partly due to their lack of experience in working with the private sector on such projects.
36. The central government departments and agencies include the Department of Public Works and Highways, the Department of Transportation and Communications, and regulatory bodies such as the Toll Regulatory Board, and the Energy Regulatory Commission.
37. LGUs would first have to organize a water district. LWUA was established to lend to water districts.
38. The Municipal Development Fund is not a GFI per se but is lumped with the Land Bank and the Development Bank of the Philippines to form the three biggest government lending institutions providing loans to LGUs. Technically, MDFO is a bureau of the Department of Finance and is not a “free-standing” GFI institution. All GFIs and MDFO are subject to DOF oversight.
40. To this day, the exact status of the Philippine National Bank seems uncertain. While the bank has private ownership, it is still listed as a GFI by the Department of Finance for purposes of dealing with the LGUs (see “Department of Finance Annual Report” 2010).
41. It is estimated that about 80 percent of lending to LGUs is for capital projects and the other 20 percent is for cash flow purposes (borrowing in anticipation of collections of taxes or aid payments).
42. For a review of fiscal rules with respect to debt service limits, see Liu and Waibel (2008).
43. International statistics vary on the definitions. Generally, the U.S. numbers for subnational units include both limited and unlimited obligations as local debt. The other OECD countries usually do not count locally owned enterprises that are self-sustaining as local government debt, and the limitation caps do not cover that debt. Practices vary and this can lead to some of the differences in local debt numbers.

44. Discussions with Philippine bankers over the years indicate cautious interest in lending to LGUs without resorting to the IRA pledge. For example, a self-financing project could “pay for itself” without using up the borrowing capacity of the LGU. This can be done through the use of a “trust fund” that would have assigned revenues, such as from an enterprise’s operations. (This is called the “special fund doctrine” in the United States and is the basis of the “revenue bond” structure.) Typically, debt limitations do not apply to this form of debt, which is viewed as “commercial,” although carried out by a government unit. That is true in the United States and in the European Union. The test for issuance is purely a market test: Will investors feel secure in holding the debt, given the security that is pledged? They have no recourse to general revenues. Not surprisingly, there are many bonds that are “mixtures.” In the case of a loan default, we understand that the LWUA has a “step-in provision” that it will operate the utility instead of the defaulting water district.

45. These obligations are called “double-barreled bonds” since they are revenue bonds when they are self-supporting but can become general obligations when they are not self-sustaining. The general practice is to not count them against debt limitations when they are self-sustaining.

46. A large private commercial bank has total LGU loan approvals of around 322 million pesos, up from 61 million pesos in 2007, without the benefit of a depository relationship with LGUs. It lends only to 1st and 2nd class LGUs under a loan guarantee provided by the LGUGC, and further secured by a deed of assignment of the IRA that is signed by the LGU borrower. At present, the LGUGC has given a loan guarantee of 3 billion pesos to LGU loans of this commercial bank. Only the MDFO is allowed to use the IRA intercept before IRAs (or other national government payments) are deposited. When it comes to GFIs and the private banks, the loan security is the deposit accounts of the LGUs. Those deposits consist of the IRA, own-source revenues, and other LGU receipts. More accurately, banks can seize those deposits, but not the IRA funds, per se. This is formally known as a right of offset, where the banks can make up any shortfall in the loan payments.

47. The repayment rate on LGU loans is high—about 98 percent. This level of repayment is also enjoyed by the MDFO, which has a full-fledged intercept (as opposed to the offset privilege used by the GFIs).

48. GFI loan officers are reportedly under pressure to keep their LGU clients.

49. At its inception, 51 percent of the LGUGC was owned by the Bankers Association of the Philippines and 49 percent by the Development Bank of the Philippines. In 2002, the Asian Development Bank bought a 25 percent ownership.
50. Caloocan City issued three bonds amounting to 620 million pesos on December 5, 2000. The 185 million pesos in bonds sold for a public market was fully redeemed by May 14, 2003.

51. LCUCG records as of December 2010.

52. As a matter of policy, the LGUGC will insure 100 percent of the debt service payments on bonds. It will insure only up to 85 percent of the debt service on insured bank loans.

53. From 2003 to 2006, several cities issued bonds backed by the Philippine Veterans Bank. These cities included Batangas, Masbate, and Tacloban. The bonds financed, among other things, a fishing port, a cold storage facility, a public market, and a transport terminal.

54. There were some timing factors. Interest rates in the Philippines fell rapidly in the mid-2000s, which allowed the GFIs to refinance the earlier municipal bond deals. However, it was believed by PFI market participants that the refinancing done by the GFIs on attractive terms was intended to deter market entry.

55. The 200-million-peso bond flotation of Cagayan Province for the construction of a commercial center in Tuguegarao City was guaranteed by a private insurance company, with a sister company acting as trustee bank.

56. The GFIs have extensive branches (particularly the Land Bank). About 65 percent of all Land Bank deposits are those of governmental units, including the LGUs. The Land Bank has a central role in the payments mechanism: it acts as the paying agent for all national government transfers to the LGUs, so the vast bulk of payments (including IRAs) are made through its accounts.

57. Bonds and loans require approval by the local sanggunian (municipal councils). However, bond issues must also be reviewed by the Philippine central bank.

58. Other program lenders have noted that the use of the IRA offset against debt service (popularly known as the intercept) discourages LGU borrowing from other programs that required meeting various program requirements. Historically, the costs of bond issues have typically ranged from 3 to 5 percent of the bond size, including the LGUGC insurance premium of 1–2 percent. See Exhibit C of Appendix E.1 of ARD (2001).

59. In the case of IFI loans, the national government imposes a surcharge of 4 percent on top of the IFI Libor-based loan rate. When the Libor is 4 percent, then the all-in IFI loan rate is 8 percent for the GFI. To this rate, the GFI may add a markup of 3 or 4 percent, which means a loan rate of 11–12 percent to the LGU. That rate might be compared to a conventional market rate (say, on long-term mortgages). But, as is recounted in this report, the GFIs are the main lender to LGUs and have LGU deposits and can use the “intercept” to back up their loans. Thus, from a credit perspective, the intercepted-reinforced LGU loan is virtually riskless and close to the credit quality of the national government’s own obligations, although they are clearly not as liquid.
60. The Land Bank has its own internal rating system for LGU borrowers, which is proprietary. The LGUGC screen ratings (which are an overall guide and not attached to a particular loan) are public information.

61. The LGUGC is attempting to get its insured loans made to LGUs and water districts (as opposed to its insured bonds) also eligible for the favorable Agri-Agra treatment.

62. The Agri-Agra requirements are much like community investment requirements in the United States that are aimed at encouraging bank investment in local businesses.

63. Based on January 2011 field interviews with a number of private financial institutions.

64. The Japan Bank for International Cooperation, the United States Agency for International Development, the Development Bank of the Philippines, MDFO, and LGUGC worked together and established the PWRF.

65. This recognizes that some LGU-sponsored projects may not involve the pledge of IRAs (or other general tax receipts) but would be secured solely on project earnings. Recent loans involving water districts evidently carry this “limited recourse” provision, where the reserves and income accounts are pledged by assignment to the repayment of debt.

66. The management of water districts is overseen by a board of directors, who serve overlapping six-year terms. Directors can only be removed for “cause” and do not serve “at the pleasure” of the mayor or governor. As a practical matter, the water districts are generally insulated from the day-to-day politics of the LGUs.

67. This lack of repute among investors (no matter what the credit record) could be an argument for intermediation such as a bond bank, where individual “names” are submerged into the portfolios.

68. The security can be provided through the loan contract by empowering LWUA to take over the operation if there is a default (the step-in provision). This is already the practice—the step-in provision is in the agreements with water districts.

69. The special fund doctrine means that the revenues in the funds are dedicated to a particular purpose and cannot be used for other purposes. In revenue-bond transactions, the operation of the fund is restricted and carried out in accordance with the loan contract (an indenture). Such funds can be subsidized by general funds but can only transfer revenues to the general fund as is consistent with the contract. Often, the indenture is closed, meaning that all revenues and any surpluses must go to retiring debt. An alternative is to create the fund as a separate legal entity (a special district). The water districts in the Philippines are separate corporations and provide a model for that approach.

70. Water district financing under the revolving fund will have a put option for PFI banks. Evidently, at five to seven years, private banks can exercise a put option, which obliges the Development Bank of the Philippines or MDFO to absorb or “buy back” the loan. LGUGC is providing the insurance “wrapper.”
71. See, for example, ARD Government Finance Group (2001), Chapter 6.
72. This included the use of BOT (build-operate-transfer)-type financing and the use of municipal bonds. The lower-income LGUs and more social or environment-oriented projects would be supported by the MDFO, as it was then called, with an emphasis on long-term loans, matching grants, and technical assistance.
73. See Appendix 1-A in Pellegrini and Soriano (2002).
74. For the development of revenue bonds in the United States, see chapter 14 by Liu, Tian, and Wallis in this volume. The adoption of the special fund doctrine as a means of financing LGU capital needs will require a regulatory framework that establishes financial rules, enforces contracts, and ensures transparency and disclosure.
75. Sales-tax revenue may also increase, and jobs may be added, although these factors and their multipliers usually do not influence the structure of the tax incremental financing.

**Bibliography**


