SUMMARY PROGRAM IMPACT ASSESSMENT

I. Introduction

1. This program's impact assessment (PIA) supports the Local Government Finance and Fiscal Decentralization Program (LGFFD). ADB utilizes policy-based lending to support policy reforms that enhance its DMC's growth prospects and economic efficiency. These policy reforms, which are consistent with the ADB's strategy for the Developing Member Country (DMC) as well as the DMC's own development strategy, are also set forth in the Development Policy Letter which is a part of the Report and Recommendation to ADB's President (RRP). The overall size of a policy-based loan is determined primarily of the development financing needs of the DMC at the broad macroeconomic level.[1] The actual costs of the adjustments and structural reforms are estimated but do not necessarily determine the size of the policy-based loan. This PIA: a) provides a summary of the government's development financing needs; b) documents the formulation of the LGFFD; c) and provides estimates of the costs and benefits of the subprogram. The methodology used for this PIA follows the regulatory impact assessment (RIA) tool commonly used to assess the impact of proposed regulations and other interventions on the economy.[2]

2. The remainder of this PIA is as follows. Section II summarizes the development financing needs of the government. Section III presents a brief summary the methodology used to prepare the PIA. Section IV: a) summarizes the problem; b) discusses the range of feasible policy options, such as regulatory and non-regulatory alternatives for the achievement of the reform objectives; c) identifies the intended impact and outcome of the LGFFD; and d) estimates the potential benefits and costs of the LGFFD.

II. Development Financing Needs

3. The program is estimated to cost $700 million. Subprogram 1 is estimated at $350 million, including cofinancing, and an equal amount is estimated for subprogram 2. The government has requested a loan of $250,000,000 from ADB's special drawing rights equivalent from ADB's ordinary capital resources to help finance Subprogram 1. The loan amount is based on the financing needs of the government, the strengths of the policy package, and its development impact. The Philippines' gross financing needs remain high. In 2013, with a budget deficit target of 2.0%, the government expected to borrow about P735 billion (some $16.5 billion). In 2012, deficit financing was obtained from domestic sources (84%) and external sources (16%), of which some 38% of external borrowing was accounted for by Official Development Assistance (ODA). In 2013, the government will borrow an estimated $1.5 billion through ODA to close the budget gap.

4. The costs of the reform program in terms of government administrative costs and fiscal costs of implementing reforms amount to some $1.36 billion. The latter include the cost of implementation of the Bottom-up-Budget (BuB) initiative (estimated to cost around $1.1 billion over the program's implementation), the Performance Challenge Fund and associated funds to the Seal of Good Governance (with an estimated budget of $170 million between 2011 and

[1] OM Section D4/BP issued on April 1, 2013.

[2] See for example, Office of Best Practice Regulation (2009), *Best Practice Report 2008-09*. Department of Finance and Regulation, Australia Government, Canberra; Treasury (2009), Regulatory Impact Analysis Handbook, New Zealand Government, Wellington; or OECD (2008), *Introductory Handbook for Undertaking Regulatory Impact Analysis*. Brussels.

2015), and costs related to policy development and implementation (conservatively estimated at $5.5 million).The benefits arise from improved allocative and operational efficiencies at the regional government level, not quantifiable at this stage, and from improved revenue collection from tax and non-tax instruments, which are conservatively estimated at $1,400 million over the period.

III. Program Impact Assessment: Methodology

5. As a tool, the PIA provides a consistent methodology for the systematic analysis of reforms to ensure they achieve their defined policy objectives in a cost effective manner. As a process, PIA incorporates evidence-based approaches to regulatory development and policy formulation, considering available options for reform through consultation and regular questioning of policy assumptions. The PIA methodology assists in minimizing adjustment costs from reforms, and helps justifying the proposed regulatory reforms on the basis of the expected net benefits. To achieve these objectives, this PIA is structured along four steps: a) definition of the problem and the regulatory objective of the program; b) the definition of the expected impact and outcome of the proposed program; c) the assessment of costs and benefits.

6. In the assessment of costs and benefits of reform options, the PIA will aim to identify the full range of impacts, including fiscal, economic, social and environmental. The PIA will, to the extent possible, quantify both benefits and costs from the proposed program in order to provide an estimate of net benefits. In general, the costs to government and statutory agencies will be classified as: administrative costs, enforcement costs, and direct fiscal costs. Administrative costs represent those costs incurred by the government and relevant statutory agencies in implementing the program, while enforcement costs represent those costs incurred by government and relevant statutory agencies in enforcing compliance and monitoring the implementation of the program. Direct fiscal costs include the costs of establishing new agencies or expenditure programs, budget increases, forgone revenue collection, etc.

7. The PIA attempts to assess net benefits through a combination of quantitative and qualitative analysis. Following the best international practices in the preparation of RIAs, sophisticated research methods are not required. Flexibility is necessary to ensure the appropriate level of analysis is determined on a case-by-case basis. The impact statement aims to present analysis and be written in a way that the general public and stakeholders can understand, not as an economic research papers. The methodology and analysis chosen is driven by available data and tools suitable for the program.

8. In presenting the results of the PIA, both a summary of the main costs and benefits from the expected reforms, as well as the key assumptions underlying the estimates will be offered. The PIA should: a) show indication that the net benefits from the proposed program outweigh the costs and maximize net benefits, and b) ensure that the loan amount is commensurate with the adjustment costs of the reforms.

IV. Program Impact Assessment: The Developmental Impact of the Program

9. This section summarizes the problem, identifies the intended impact and outcome of the LGFFD, options reviewed, stakeholders consulted, and estimates of the potential benefits and costs of the LGFFD.

A. Definition of the Problem

10. Reducing local disparities in access to services is critical to achieving the government's goal of inclusive growth and poverty reduction. The poverty rate was 27.9% in 2012 (from 28.6% in 2009), above prevailing rates in neighboring countries in Southeast Asia. Although recent high economic growth (6.8% in 2012) is encouraging, earlier growth spurts in Philippines have not been effective in reducing poverty. Geographically, the poor remain concentrated in the southern Philippines and in rural areas. The poverty rate in the Visayas and Mindanao regions is double that in Luzon, and two-thirds of the poor live in rural areas. Provincial poverty disparities are even larger, with several provinces in Eastern Visayas and Mindanao reporting rates of over 40%, while rates in several southern Luzon provinces remain at below 10%. Similar disparities are found in terms of access to services. The average infant mortality rates in 2008 in the Eastern Visayas (45 deaths per 1000 births) and Cagayan Valley (38 per 1000) were more than 50% above the national average of 25 death per 1,000 births. In 2009, six regions of the country reported that less than 80% of their population had access to electricity, compared to almost 99% in the capital region; less than 70% of the population of Central Visayas and Zamboanga had access to potable water in 2009, compared to some 97% in Central Luzon.

11. **Inadequate and inequitable distribution of financial resources.** Flaws in the design of the revenue base of LGUs are partly responsible for the geographical disparities observed in access to services. Following the first drive of decentralization after the approval of the Local Government Code (LGC), subnational government expenditures have remained stable. Between 2001 and 2011, subnational expenditure (including provinces, cities, municipalities and barangays) stayed at around 4% of gross domestic product (GDP), and represented some 17% of total public expenditure in 2011. The composition of LGUs expenditures shows a worrisome declining trend in terms of the allocations made to health, education, and other basic services between 2001 and 2011. Against this background, LGUs collected only 20% of their total income from their own revenue sources in 2011 (the remaining income derived from transfers and revenue sharing). The share of local tax and non-tax as a proportion of LGU revenues is stagnating because of outdated and unproductive tax and non-tax instruments, as well as limited tax effort from local governments. As expected, large differences exist in revenue collection capacity, with the top province collecting more than four times the national average from their own revenue sources in 2011.

12. **Incomplete system of transfers to LGUs**. The increasingly complex distribution of service delivery responsibilities across levels of government in the Philippines has not been matched by a system of transfers that assists the equitable and efficient distribution of financial resources. The Internal Revenue Allotment (IRA) has limited fiscal equalization power, resulting in very significant disparities in LGU expenditures per capita. The implementation of performance-based transfers that encourages LGU governance and efficiency upgrades has lagged behind, and the coordination between central and local authorities is compromised by the absence of efficient conditional grants.

13. **Outdated regulatory framework.** The LGC of the Philippines was passed in 1991, and there is widespread agreement among stakeholders that the code has structural deficiencies that need to be addressed through a government-led LGC review. The deficiencies include lack of clarity in functional assignments, limited and unproductive sources of local revenues, and inadequate and inequitable transfer mechanisms. In addition, the LGC requires a review of the criteria defined for jurisdictional formation, and the simplification of procedures for LGUs to access commercial sources of credit.

14. **Improved LGU transparency through efficient local public financial management systems.** Recent reforms to local public financial management systems have increased the predictability of revenues to LGUs, established the foundations of financial management information systems for LGUs, and improved the capacity of LGU financial management personnel. The latter efforts need to be continued, however, and undertaken within the framework of a medium-term plan for local public financial management reforms that consolidates and harmonizes current initiatives. Policy priorities include the improvement of local revenue forecasting systems and LGU credit worthiness assessments. It would also be required to clarify the legal status of local economic enterprises and LGU alliances, and to incorporate performance measurement systems for local financial management.

15. **Strengthening LGU accountability to its constituents.** The implementation of participatory planning, budgeting and monitoring systems aimed at improving accountability from national and LGUs towards citizens is still work in progress. The latter will allow improvements to allocative efficiency in public expenditure by aligning national and local development priorities for poverty reduction and economic development. A number of parallel local planning processes need to be harmonized around the Comprehensive Development Plan system to allow for more efficient links between planning and budgeting. Additional efforts are required in the development of LGU performance measurement systems. The foundations of a local government performance measurement system (LGPMS) are in place, but significant work is required to expand and increase the system's analytical capacity and its integration with other local government performance tools. Moreover, as these systems are normally based on LGUs self-reported information, instruments that channel directly local constituents' views and preferences on service delivery are required to enhance the efficiency of local budget formulation.

B. Intended Impact and Outcome of the LGFFD

16. The expected impact of the program is improved delivery of services by LGUs. The expected outcome of the program is efficient and transparent local governments with an adequate and equitable fiscal framework. The program includes two subprograms focused on four policy outputs:

i. An intergovernmental fiscal system conducive to inclusive growth;
ii. Adequate and equitable local resource frameworks for fiscal sustainability;
iii. Strengthened local public financial management systems; and
iv. Transparent, accountable and participatory local governance.

C. Options for reform

17. In designing the LGFFD, a number of regulatory and non-regulatory options for reform were considered. The program has been assisting the government in: a) review of the legal framework for intergovernmental fiscal relations; b) improving performance-based LGU financing and monitoring systems; c) improving revenue collection and credit financing by LGUs; d) strengthening the alignment of national and local development expenditure priorities; e) upgrading local government financial management information systems; and f) improving transparency and accountability of local administrations towards their constituencies.

18. **Review of the legal framework for intergovernmental fiscal relations**. A widespread agreement among stakeholders exists on the need to, 22 years after the approval of the LGC,

lead a comprehensive review of the Code that at least deals with fiscal policy issues. Design flaws of the code prevent the implementation of policies that improve the revenue collection capacity of LGUs, allow for improved equalization impact of government transfers and clarify service delivery responsibilities by levels of government. The government-led review must involve representatives from the Congress, to assist the eventual consideration of the proposed amendments to the Code by the Oversight Committee on Decentralization and the Legislative-Executive Development Advisory Council.

19. **Improving performance-based financing and monitoring systems.** The government's drive towards improved quality of public expenditure has been articulated at the LGU level in a number of critical activities. First, the implementation of a performance-based grant, the Performance Challenge Fund, which provides financing for local capital investment projects upon the achievement of certain public financial management standards under the Seal of Good Housekeeping. The further development of the system of Seals of Good Governance (which includes the Seal of Good Housekeeping, but also the Seals of Competitiveness, Disaster Preparedness and Environment among others) will be complemented by monitoring systems that allow a better assessment of the utilization of the 20% of the LGUs' IRA that is devoted to the Development Fund (capital investment projects).

20. **Improving revenue collection and credit financing by LGUs**. Revenue collection by LGUs has stagnated over the recent years due to a combination of limited powers, low productivity of available revenues, lack of adequate tools to estimate revenue potential and shortage of capacity of local tax officials. The first subprogram of the LGFFD supports the development of tools for the estimation of local government revenues, the incorporation of uniformed valuation standards on the property tax, and the establishment of adequate requirements for the appointment of local tax assessors. Over the second subprogram, the government will improve the collection performance of the real property tax by assisting the implementation of the updated local schedules of market values (SMVs) (thus increasing the value of the tax base), exploring new instruments for local revenues (including green taxes) and rationalizing national investment incentives to ensure positive or neutral impact on local administrations.

21. **Strengthening the alignment of national and local development expenditure priorities.** The alignment of expenditure priorities at all levels of government has been improved with the implementation of the BuB initiative and the implementation of new guidelines for the allocation of the Disaster Risk Management Fund. Efforts will continue over the second subprogram with the harmonization of national and local planning guidelines, integrating participatory processes and avoiding duplication. The full implementation of the BuB initiative will proceed, as well as the revision of the Unified Budget Manual (UBOM) to incorporate performance measurement systems recently developed and modifications currently underway to key local government policies such as on Personnel Matters, the Special Education Fund or the regime of Local Economic Enterprises.

22. **Upgrading local government financial management information systems**. Obtaining accurate financial information is key for credible budgets and efficient national government monitoring of local government finances. The government has considerably improved financial management information systems with the implementation of three new modules, on local revenue forecasting, credit worthiness and debt certification. During the second subprogram, these three modules will be rolled-out to the regional offices to assist local level implementation. In addition, a module on local expenditure will be incorporated into the system. The government will, in addition, continue to effectively link the local government performance measurement

system with the local financial indicators system maintained by the Department of Finance (DoF).

23. **Improving transparency and accountability of local administrations towards their constituencies.** Reflecting government efforts towards improved governance, subprogram 1 incorporates progress in the issuance of the Full Disclosure Policy for LGUs, and towards the piloting of the Citizen's Satisfaction Index. The government has implemented training programs for newly elected officials and has facilitated women representation at LGU consultative committees. For subprogram 2, the government will fully implement the Citizen's Satisfaction index and disseminate its first report, while compliance with the full disclosure policy will be required as access condition to a number of sources of finance, such as the Performance Challenge Fund. Efforts will continue on the implementation of performance evaluation systems for local budget officers and treasurers. Finally, performance monitoring systems of LGUs will be upgraded with support to the LGPMS, including the development of decision making tools that assist local budget preparation, and with the integration of the system of Seals of Good Governance into the LGPMS.

D. Impact Analysis

24. The impact of a set of reforms such as the ones proposed for this programmatic approach will extend over several years. In our analysis, we necessarily place the focus on the consideration of static costs and benefits. A dynamic examination of the impact of the regulatory changes proposed would require forecasting, with computer generated equilibrium (CGE) models, the levels of a range of variables over the medium to long term, and then estimating the expected costs and benefits of the set of reforms proposed, based on the evolution of such variables over time. Unfortunately, a CGE model for this program of reforms is not available. As the review and amendment of the LGC proceeds, its implications on improved local revenue collection, allocative efficiency in government expenditure and more equitable distribution of funds to local governments will be amenable for assessment. The impact of the future reforms would extend over the longer term and be nationally distributed.

25. This dynamic analysis is however outside the scope of this assessment. Our focus is on the static net gains derived from the reforms proposed. A static impact analysis of the program offers important insights on the expected gains derived from reforms should critical economic indicators remain at current levels. Even under these somewhat limiting assumptions, the implementation of the package of reforms may usher very sizeable net benefits.

E. Estimate of Costs

26. ADB staff estimates that the direct costs of the subprogram to the public sector could be approximately $1,360 million over the program's medium term period of 2011 to 2015, or 0.006% of GDP. The costs would come from the administrative, enforcement and fiscal costs derived from the implementation of the various policy reforms.

27. We classified costs among: 1) administrative costs (or directly derived from the implementation of the program by government agencies); 2) enforcement costs (incurred during the enforcement or regulations and monitoring of compliance); and 3) fiscal costs (associated to required budgetary expenditures, foregone tax revenue, financial costs, etc.).

28. On that basis, an initial estimate of costs would include:

Table 1. Summary of Cost Estimates for Government from the LGFFD

Types of Adjustment Costs	Government and Statutory Agencies	Total ($ million)
Fiscal Costs	1. Implementation of the Bottom-up-Budget and planning initiative (Government budget allocations and estimates), total of $1180 million at 2012 prices: a. $200 million budgeted in 2013 b. $490 million estimated for 2014 c. $490 million estimated for 2015 2. Implementation of the Performance Challenge Fund (PCF) and Seal of Good Governance, total of $170 million. a. $12 million budgeted in 2011 for PCF b. $24 million budgeted in 2012 for PCF c. $24 million budgeted in 2013 for PCF d. $50 million estimated for 2014 (Including the implementation of the remaining elements of the system of Seals of Good Governance) e. $60 million estimated for 2015 for the implementation of all performance-based transfers. 3. Capacity building programs ($2 million) a. New Elected Officials training program b. Capacity building of local treasurers, local assessors, and local budget officers 4. Local Government Information systems ($2 million) a. New modules added to the electronic statement of receipts and expenditures. b. Proposed upgrading of the LGPMS system.	Approx. 1,355.00
Administrative Costs	1. Legislative initiatives ($1 million): i. Review and amendment of the Local Government Code. 2. Policy and strategy formulation ($1.5 million) i. Review of the Special Education Fund Policy. ii. Review of the regime for Local Economic Enterprises. iii. Review of the policy on intergovernmental cooperation. iv. Harmonization of local planning and budgeting processes. v. Guidelines for the Disaster Risk Reduction Fund, the localization of the Magna Carta for women, and the Compendium of Planning Documents. vi. Review of the Unified Budget and Operations Manual.	2.50
Enforcement Costs	1. Policy implementation i. Implementation of the Full Disclosure Policy at national level ($2 million) ii. Monitoring of the use of LGPMS at local level planning processes ($0.5 million)	2.50
Total Estimates		**$1,360 million**

F. Estimate of Benefits

29. Our analysis provides a qualitative and quantitative approximation to the benefits and transfers derived from the implementation of the package of reforms incorporated into the LGFFD. The latter include allocative efficiency gains from the reassignment of financial resources to local government budgets, the expected impact of increased local government expenditure on regional GDP, and transfers in the form of increased tax collection.

30. **The LGFFD incorporates policy actions that can assist inclusive growth and local economic development through improved allocative efficiency**. The review of the LGC will likely: a) assist higher revenue collection by LGUs; b) improve allocative efficiency through the further clarification of expenditure responsibilities by LGUs; c) assist a more equitable distribution of transfers by LGUs; and d) reduce the cost of access to credit by LGUs. The quantifiable impact of the review however will only be evaluated once the amendments to the Code are passed, likely during the post-program partnership period of the programmatic approach. Allocative efficiency is expected from the transfer of resources to local administrations (either from national government revenues or from taxes), as the LGUs will be better place to identify local economic development priorities and service delivery needs.

31. Contribution of local government expenditure to regional growth. The increase in local public expenditure derived from additional government investment and transfers, and improved local revenue collection will assist regional GDP growth. At this point, no rigorous analysis of the impact of increased local expenditure on regional GDP growth is available and as such this estimation leaves this important component out of the calculation of estimates of benefits. This increases the conservative nature of the benefits estimation contained in this summarized assessment.

32. **Financial management efficiency**. A number of upgrades to financial management information systems have been implemented which will assist efficient local public financial management. First, the new system for local revenue forecasting will allow faster reconciliation of revenue targets between LGUs and national government, improving the credibility of budgets and expenditure efficiency. Second, the new debt certification system will reduce the time required for the issuance of certificates of maximum borrowing and thus reduce compliance costs for access to credit from LGUs. Third, the recently implemented Seal of Good Housekeeping and the Public Financial Management Assessment tool provide incentives for LGUs to upgrade the financial management standards as adequate compliance is required in order to access certain sources of finance. This will translate into greater efficiency in expenditure management all around. These measures, however, as they are at initial level of implementation, cannot be adequately quantified yet.

33. **Transfers from private sector and individual tax payers to LGUs: Improved revenue collection from the Real Property Tax.** The recent government efforts on the updating of the local SMVs have borne initial fruit. DoF estimates that 2012 collection reached P28.2 billion. The DoF expects the update of the SMVs to result in an annual increase in revenue potential of 10%, under their low case scenario (in fact a 6-8% increase is expected even in the absence of SMV updates). Over the next five years, and under the conservative assumption of annual 10% increases, receipts from the real property tax may reach P45.4 billion in 2017, which would represent an increase in revenue collection of P17.2 billion or around $400 million in current 2012 prices.

34. Transfers from private sector and individual tax payers to LGUs: Improved revenue collection from other tax and non-tax instruments. As part of the preparatory work towards the reform of LGUs revenue assignments, the government has submitted to Congress a proposals for the update of a number of tax a non-tax revenue sources. The latter include widening of tax bases, and elimination of exemptions, indexing outdated tax amount and ceiling, and simplifying local taxes. The reforms have the potential to increase LGU revenues by $1 billion annually in current 2012 prices.