



Report and Recommendation of the President to the Board of Directors

Project Number: 44253-013
January 2014

Proposed Programmatic Approach and Policy- Based Loan for Subprogram 1 Republic of the Philippines: Local Government Finance and Fiscal Decentralization Reform Program

CURRENCY EQUIVALENTS

(as of 13 January 2014)

Currency unit	–	peso/s (P)
P1.00	=	\$0.0224
\$1.00	=	P44.59

ABBREVIATIONS

ADB	–	Asian Development Bank
AFD	–	Agence Française de Développement
BUB	–	bottom-up budgeting
CCD	–	Coordinating Committee on Decentralization
DBM	–	Department of Budget and Management
DOF	–	Department of Finance
DILG	–	Department of the Interior and Local Government
ESRE	–	electronic statement of receipts and expenditures
IRA	–	internal revenue allotment
LGC	–	Local Government Code
LGFBR	–	Local Government Finance and Budget Reform
LGPMS	–	local government performance measurement system
LGU	–	local government unit
LIBOR	–	London interbank offered rate
OCD	–	Oversight Committee on Devolution
PCF	–	Performance Challenge Fund
PFM	–	public financial management
TA	–	technical assistance

NOTE

In this report, “\$” refers to US dollars.

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PROJECT AT A GLANCE

1. Project Name: Local Government Finance and Fiscal Decentralization Reform Program		2. Project Number: 44253-013									
3. Country: Philippines		4. Department/Division: Southeast Asia Department/ Public Management, Financial Sector, & Trade Division									
5. Sector Classification:											
Sectors		Primary	Subsectors								
Public sector management		√	Decentralization								
			Public expenditure and fiscal management								
6. Thematic Classification:											
Themes		Primary	Subthemes								
Economic growth			Promoting economic efficiency and enabling business environment								
Governance		√	Public administration (national, decentralized, and regional)								
6a. Climate Change Impact		6b. Gender Mainstreaming									
No Climate Change Indicator available.		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td>Gender equity theme (GEN)</td> <td></td> </tr> <tr> <td>Effective gender mainstreaming (EGM)</td> <td></td> </tr> <tr> <td>Some gender elements (SGE)</td> <td style="text-align: center;">√</td> </tr> <tr> <td>No gender elements (NGE)</td> <td></td> </tr> </table>		Gender equity theme (GEN)		Effective gender mainstreaming (EGM)		Some gender elements (SGE)	√	No gender elements (NGE)	
Gender equity theme (GEN)											
Effective gender mainstreaming (EGM)											
Some gender elements (SGE)	√										
No gender elements (NGE)											
7. Targeting Classification:		8. Location Impact:									
General Intervention	Targeted Intervention										
	Geographic dimensions of inclusive growth	Millennium development goals	Income poverty at household level								
√											
9. Project Risk Categorization:		Complex									
10. Safeguards Categorization: The program is categorized as C for Environmental, Indigenous Peoples and Resettlement.											
11. ADB Financing:											
Sovereign/Nonsovereign	Modality	Source	Amount (\$ Million)								
Sovereign	Program loan	Ordinary capital resources	250.0								
Total			250.0								
12. Cofinancing:											
Financier	Category	Amount (\$ Million)	Administration Type								
Agence Francaise de Developpement	Official-Loan	150.0	Not administered by ADB								
Total		150.0									
13. Counterpart Financing: \$ 1million in kind.											
14. Aid Effectiveness:											
Parallel project implementation unit		No									
Program-based approach		Yes									

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed programmatic approach for the Local Government Finance and Fiscal Decentralization Reform Program, and (ii) a proposed policy-based loan to the Republic of the Philippines for subprogram 1 of the Local Government Finance and Fiscal Decentralization Reform Program.¹

2. The program aims to improve service delivery in the Philippines by assisting the development of efficient and transparent local governments within an adequate and equitable fiscal framework. In close alignment with the government's reforms, the program assists efforts toward improved efficiency of public expenditure, enhanced accountability of local government administration, and the creation of a fiscal framework conducive to job creation.²

II. THE PROGRAM

A. Rationale

3. **Efficient service delivery for inclusive growth.** The Philippine Development Plan, 2011–2016 identifies specific challenges for local government units (LGUs) in the achievement of its main goals: promoting inclusive growth and generating employment, improving governance and human development standards, and achieving macroeconomic and fiscal sustainability.³ Reducing local disparities in access to services is critical to achieving the government's goal of inclusive growth and poverty reduction. The poverty incidence was 27.9% in 2012 (a decrease from 28.6% in 2009), which is above the prevailing rates in neighboring countries in Southeast Asia.⁴ Although recent high economic growth (6.8% in 2012) is encouraging, earlier growth spurts in the Philippines have not been effective in reducing poverty. Geographically, the poor remain concentrated in the southern Philippines and in rural areas. The poverty incidence 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 poverty incidence in several southern Luzon provinces remains 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 1,000 births) and Cagayan Valley (38 per 1,000) were more than 50% above the national average. 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 national capital region; and 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.

4. **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 1991 (LGC), subnational government expenditures have remained stable. Between 2001 and 2011, subnational expenditure (including provinces, cities, municipalities, and *barangays*) stayed at about 4% of gross domestic product, and represented some 17% of

¹ The design and monitoring framework is in Appendix 1.

² The Asian Development Bank (ADB) provided project preparatory technical assistance for Local Government Finance and Fiscal Decentralization Reform Program (TA 8390).

³ Government of the Philippines, National Economic Development Authority. 2011. *Philippine Development Plan 2011–2016*. Manila.

⁴ Report from the National Statistical Coordination Board. 2012. (http://www.nscb.gov.ph/pressreleases/2013/PR-201304-NS1-04_poverty.asp)

total public expenditure in 2011 (25% if debt amortization is excluded). The composition of LGU 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 an average of 24% of their operating income from their own revenue sources between 2008 and 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 efforts 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 its own revenue sources in 2011.

5. **Incomplete system of transfers to local government units.** 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 in service delivery is compromised by the absence of a system of conditional grants.

6. **Outdated regulatory framework.** There is widespread agreement among stakeholders that the LGC has structural deficiencies that need to be addressed through a government-led review.⁵ 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.

7. **Improved transparency of the local government units through efficient local public financial management systems.** Recent reforms to local public financial management (PFM) systems have increased the predictability of revenues to LGUs, established the foundations of financial management information systems, and improved the capacity of LGUs' financial management personnel. The latter efforts need to be continued, however, and undertaken within the framework of a medium-term plan for local PFM reforms that consolidates and harmonizes current initiatives. Policy priorities include the improvement of local revenue forecasting systems and LGU credit worthiness assessments. In addition, there is a need to clarify the legal status of local economic enterprises (to prevent these enterprises from jeopardizing the fiscal stability of LGUs due to unclear accounting practices) and of LGU alliances (currently formed by non-legally binding agreements that limit long-term cooperation in service delivery).

8. **Strengthening accountability of the local government units to their constituencies.** The implementation of participatory planning, budgeting, and monitoring systems that improve the accountability of the national government and LGUs to their citizens is still ongoing. These systems will allow improvements to allocative efficiency in public expenditure by aligning national and local development priorities for service delivery. 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

⁵ The code instructs regular reviews every 5 years, but none has taken place since its enactment. The recommendation for the review of the LGC was included in the statement of the recent Philippines Development Forum 2013.

required to expand and increase the system's analytical capacity and its integration with other local government performance tools. Because these systems are normally based on LGUs' self-reported information, instruments that directly channel local constituents' views and preferences on service delivery are also required to enhance the efficiency of local budget formulation.

9. **Sustaining and expanding local government reforms.** The Asian Development Bank (ADB) supported government efforts in local government finance reforms in the Philippines through the Local Government Finance and Budget Reform (LGFBR) Program, consisting of two policy-based loans and several technical assistance (TA) projects.⁶ LGFBR support focused on strengthening national and local PFM systems, improving the efficiency of budgeting processes, assisting access to credit by LGUs, and laying the basis of LGU performance monitoring systems. The completeness, timeliness, and transparency of the release of LGU shares in national government revenues was improved, and LGU revenues increased by 30% (mostly from transfers) between 2007 and 2009. Regulations were passed providing for the automatic appropriation of the IRA from 2007 and for the timely estimation and certification of the IRA shares. Under the LGFBR, support was provided for the development, computerization, and implementation of the electronic statement of receipts and expenditures (ESRE), the financial reporting system for LGUs. These efforts are being sustained in the proposed program. The LGFBR supported the development of the government's performance-based grant policy, which has materialized upon the establishment of performance-based grants. Also, the LGFBR supported the development of the LGPMS, while the proposed program will assist the further development of accountability mechanisms for LGUs.

10. **Lessons learned.** The experience gained from the LGFBR and subsequent country analytic work on critical development constraints, decentralization, and local governance in the Philippines has generated a number of important lessons. First, the implementation of the LGFBR program underlined the need to sustain a long-term commitment to reforms, ensuring future initiatives are demand-driven. Second, the importance of local government reforms in the achievement of high, inclusive, and sustainable growth needs to be made more explicit. Thus, the program will support high and sustainable growth through several channels, including (i) improved service delivery by LGUs, (ii) the rationalization of local revenue frameworks to assist local business development, and (iii) strengthened PFM systems. Third, earlier work on decentralization has shown that the reform program needs to be anchored in a rich institutional framework. The first government-led review of the LGC since 1991 will be articulated through robust consultative mechanisms that will include all stakeholders. Lastly, during program design, ADB drew upon its experiences from supporting decentralization in other countries in the region. As a result, attention has been focused on supporting capacity development, strengthening accountability mechanisms, and encouraging LGUs' tax effort for enhanced fiscal autonomy and lower transfer dependence.⁷

11. **Programmatic approach and innovative features.** The comprehensive nature of the reforms needed requires a lending modality that offers a flexible and long-term framework for ADB support. The programmatic approach is favored based on past experiences supporting similar reforms in the region. The Philippines displays an adequate institutional setting for intergovernmental relations and a rich—although inconsistent—policy framework, making

⁶ ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan and Technical Assistance Grant to the Republic of the Philippines for the Local Government Financing and Budget Reform Program Cluster (Subprogram 1)*. Manila; ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan and Technical Assistance Grant to the Republic of the Philippines for the Local Government Financing and Budget Reform Program Cluster (Subprogram 2)*. Manila.

⁷ ADB. 2013. *Completion Report: Local Government Financing and Budget Reform Program Cluster in the Philippines*. Manila.

policy-based loans the most effective lending modality. The program adopts, in comparison with the LGFBR, a more ambitious approach to local government reforms, including (i) a review of the regulatory framework for intergovernmental fiscal relations; and (ii) an emphasis on demand-side aspects of local governance and performance-based monitoring approaches, while fostering incremental progress made through earlier PFM reform initiatives.

12. The country partnership strategy, 2011–2016 identifies supporting local government finance and fiscal decentralization reforms as priority.⁸ The program has been designed by the Government of the Philippines, ADB, and the Agence Française de Développement (AFD). It is informed by the sectoral assessments produced jointly by ADB and AFD by the lessons from the implementation of TA projects,⁹ and by the dialogue sustained with national government institutions, local government representatives, private sector organizations, academe, and civil society. The processing team is coordinating the program design with the European Commission's LGU public financial management reform program and the Decentralization and Local Government (DIALOG) Trust Fund.

B. Impact and Outcome

13. The impact will be improved delivery of services by LGUs. The outcome will be efficient and transparent local governments with an adequate and equitable fiscal framework. The Government has completed all of the 35 reform actions (7 policy triggers and 28 milestones) for subprogram 1.

C. Outputs

14. The program includes two subprograms structured around four policy outputs: (i) creating a conducive fiscal framework for inclusive growth; (ii) developing an adequate and equitable resource framework for fiscal sustainability; (iii) strengthening public financial management to assist efficient LGU service delivery; and (iv) fostering good local governance, transparency, and accountability.

15. **Conducive fiscal framework for inclusive growth.** The government is reviewing the outdated regulatory framework for intergovernmental fiscal relations. For the first time since it was approved, the LGC will undergo a government-led substantive review led by the Department of the Interior and Local Government (DILG). The review is articulated under the Coordinating Committee on Decentralization (CCD).¹⁰ The scope of the review includes LGU expenditure and revenue assignments, and fiscal transfers; and it will be supported by an ADB TA.¹¹ For subprogram 2, the proposed amendments to the LGC will be submitted through the Cabinet Cluster on Good Governance and Anti-corruption to the Oversight Committee on Devolution (OCD) and to the Legislative- Executive Development Advisory Council. The OCD includes representation from national agencies, the leagues of local governments,¹² and the legislature (House of Representatives and Senate).

⁸ ADB. 2011. *Country Partnership Strategy: Philippines, 2011–2016*. Manila. This was confirmed in ADB. 2012. *Country Operations Business Plan: Philippines, 2013–2015*. Manila.

⁹ ADB. 2009. *Technical Assistance to the Republic of the Philippines for Support to Local Government Financing*. Manila; ADB. 2011. *Technical Assistance to the Republic of the Philippines for Support to Local Government Revenue Generation and Land Administration Reforms*. Manila.

¹⁰ Chaired by the DILG, the CCD acts as the technical secretariat of the Oversight Committee on Devolution and includes representatives from all central agencies and the leagues of local governments.

¹¹ ADB. 2013. *Technical Assistance to the Republic of the Philippines for Support to Local Government Finance and Fiscal Decentralization Reform*. Manila.

¹² Established under the LGC, the leagues are associations of LGUs that are formed to defend their interests. There is a league for each level of local government (provincial, cities, municipalities, and barangays).

16. **Adequate and equitable resource framework for fiscal sustainability.** As part of the government's drive toward good governance and fiscal sustainability, the DILG has developed performance-based financing mechanisms for LGUs, incentivizing efficient and transparent financial management under subprogram 1. The Performance Challenge Fund (PCF), established in 2010, is a performance-based transfer that requires, as an eligibility condition, that LGUs be awarded the Seal of Good Housekeeping.¹³ For the seal to be awarded, LGUs are required to obtain a no adverse or disclaimer opinion from the Commission on Audit and to comply with the Full Disclosure Policy. In 2013, the PCF already budgeted over P1 billion for capital development projects at the local level, for which LGUs must provide cofinancing. The DILG approved, in addition, new guidelines for the appropriation and utilization of the 20% of the IRA that is devoted to capital investment projects.

17. The Department of Finance (DOF) has improved the revenue collection capacity of LGUs. A new computer module including a tax payer database and a system for the estimation of the business tax has been developed. The system assists accurate estimates of local government revenues. The DOF has developed uniform valuation standards of real estate for the local assessors' manual, and requested all assessors to be licensed as a condition for appointment. In addition, the flow of information between the Bureau of Internal Revenue and the LGUs for tax collection purposes has been improved, and the DILG has produced guidelines for the preparation of local revenue codes and local incentives codes with the aim of improving consistency between them. The lack of consistency in local regulations has been highlighted regularly by the private sector as one of the major constraints to investment at the local level.

18. Substantive improvements to financial information systems have been achieved, allowing for enhanced access to credit by LGUs. The DOF has developed a creditworthiness system that assists evaluations of prospective LGU borrowers by creditors. This represents an important step toward the improved transparency of LGUs. In addition, the DOF has developed an LGU debt certification system that facilitates the issuance of certificates on maximum borrowing and debt service capacities.

19. For subprogram 2, the government will continue to improve the quality of local expenditure with the implementation of a monitoring system for the LGU capital investment projects and through the full development of the Seal of Good Governance for LGUs (including the seals of competitiveness, disaster preparedness, and environment). The DOF will improve the collection performance of the real property tax by assisting the updating of the revised LGU's schedules of market values. These schedules define the base of the property tax and in many cases have not been updated for years. The government will explore options for expanding LGUs' revenue assignments, including green taxes,¹⁴ and will work toward ensuring the timely and equitable release of mining revenue shares to LGUs. Efforts will continue toward the rationalization of national fiscal incentives to investment, with a view toward ensuring their positive impact on local economic development and fiscal revenues. Finally, the government will complete the roll out of the new modules on credit worthiness and debt certification to DOF regional offices and will work toward establishing a single agency LGU loan monitoring system.

¹³ The Seal of Good Housekeeping for LGUs aims to recognize LGUs with good performance in internal housekeeping focusing in four areas: (i) good planning; (ii) sound fiscal management; (iii) transparency and accountability; and (iv) valuing of performance information. The Seal of Good Housekeeping is a component of the system of Seal of Good Governance.

¹⁴ Green taxes (also called "environmental taxes" or "pollution taxes") are excise taxes on environmental pollutants or on goods whose use produces such pollutants (<http://www.taxpolicycenter.org/briefing-book/key-elements/environment/what-is.cfm>).

20. **Strengthened public financial management for efficient service delivery of local government units.** Under subprogram 1, the government—in coordination with all relevant agencies—is developing the strategic planning framework for local PFM reforms. In particular, the Department of Budget and Management (DBM) has initiated the drafting of the medium-term LGU public financial management road map, which is expected to be completed early in 2014 and will contain the policy actions incorporated in subprogram 2.

21. The alignment of national and local expenditure priorities has been improved by a number of initiatives. The DBM has implemented the bottom-up budgeting (BUB) and planning initiative, encouraging participatory planning processes at LGUs and gender-sensitive project selection.¹⁵ In 2013, P8 billion was budgeted, with 595 LGUs participating in the initiative. The DILG has developed guidelines for the allocation and utilization of the Disaster Risk Reduction Management Fund, and has finalized the compendium of planning documents required for the preparation of LGUs' comprehensive development plans.

22. The accuracy of revenue target setting by LGUs has been strengthened with the development of an ESRE module on LGU revenue forecasting. This instrument allows for the reconciliation of LGU targets with the assessment from DOF regional offices, thereby improving the credibility of budget preparation. In addition, a limitation to the use of certain LGU transfers for personnel salaries of local economic enterprises and public utilities has been issued.

23. During subprogram 2, the government will produce the first implementation report of the medium-term road map for LGU PFM reforms. Efforts will be made to harmonize the LGU planning processes and to integrate participatory planning principles in the consolidated guidelines. The implementation of the BUB initiative will proceed, including the preparation of a government-led evaluation of it and the review of its budgetary allocation formula. The DBM will initiate the revision of the Budget Operations Manual¹⁶ to incorporate policies in participatory budgeting, performance-based mechanisms, and policy changes to the Special Education Fund and the regime of local economic enterprises. The DBM will incorporate an expenditure module to the ESRE and work toward the approval of the new guidelines for the establishment, divestiture, and operations of local economic enterprises.

24. **Good local governance, transparency, and accountability.** Assisting inter-local cooperation for economic development and service delivery is a government priority. Under subprogram 1, the DILG has undertaken a review of the financing framework for LGU alliances to guide the implementation of a new policy framework that defines the corporate powers of LGU alliances, clarifies their legal personality, and defines their financing options.

25. The DILG has improved the transparency and accountability of LGUs toward their constituents by issuing the Full Disclosure Policy, mandating LGUs to publicly disclose key operations reports. In addition, through the Civil Society Participation Fund, the government is facilitating the capacity building of civil society organizations to improve their analytical capacity. To generate feedback from constituents on LGU service delivery performance, and thus assist with budget formulation and policy design, the DILG is piloting the Citizens' Satisfaction Index System, which should become a key tool for measuring LGU performance.

¹⁵ The BUB is a conditional grant from line agencies to LGUs to assist national development priorities through locally implemented projects. It encourages local good governance (through the Seal of Good Housekeeping) and participatory planning and budgeting practices.

¹⁶ The manual systematizes methods and procedures in budget preparation, authorization, execution, and accountability for LGUs (Department of Budget and Management. 2012. *Operations Budget Manual*. Manila).

26. The capacities of local government officials and local government political representatives continue to improve. The Newly Elected Officials program trained 100% of newly elected officials after the 2010 elections. The program has since undergone substantive redesign, and full participation of all new officials has been pursued after the 2013 elections.

27. Important steps toward assisting women representation at LGU committees have been taken, and the government remains committed to the implementation of gender-responsive planning and budgeting systems, such as through the recent BUB initiative. In addition, LGUs have adopted a referral system on violence against women.

28. The government continues to strengthen performance monitoring systems to assist local accountability relationships. In particular, the DILG has improved the coverage of the LGPMS where over 90% of LGUs now provide data that is used in preparing their comprehensive development plans. The information provided is also used to prepare the state of local governance and the state of local development reports, which are regularly uploaded into the LGPMS website and are publicly available.

29. During subprogram 2, the government will implement the reviewed policy on LGU alliances and will integrate compliance to the full disclosure policy as a condition of eligibility to LGU financing programs such as the PCF, or the BUB initiative. Efforts to improve the capacities of local officers will continue with the development of a performance evaluation system for local budget officers. The improved assessment of gender and development plans and budget implementation from LGUs will be pursued, with a view toward increasing the gender responsiveness of LGU budgets. The LGPMS will be substantially revised with two main goals: (i) it will be integrated with the Seal of Good Governance, and (ii) its analytical capacity will be improved in order to assist LGU decision making.

D. Development Financing Needs

30. The program is estimated to cost \$802 million. Subprogram 1 is estimated at \$401 million, including cofinancing, and an equal amount is estimated for subprogram 2 (Table 1). The loan size is based on the financing needs of the Philippines, the strength of the policy reform package, and its development impact. The Philippines' gross financing needs remain high. In 2013, with a budget deficit target of 2%, the government will need to borrow P735 billion (\$16.5 billion). In 2012, deficit financing was obtained from domestic sources (84%) and external sources (16%). About 38% of external borrowing was accounted for by official development assistance. In 2013, the government expected to borrow an estimated \$1.5 billion through official development assistance to close the budget gap. The subprogram 1 loan proceeds will support key development spending in the 2013 budget, including the BUB initiative (approximately \$190 million) and the PCF (approximately \$20 million).

31. The government has requested a single tranche loan of \$250 million from ADB's ordinary capital resources to help finance subprogram 1, which will be disbursed in two installments of \$125 million each during 2014. The government requested two installments in order to ensure efficient cash flow management by minimizing the incidence of negative carry that may occur due to a potential mismatch in timing between disbursement of the full loan amount and its full utilization. The government also aims to minimize the burden of financing charges that would arise due to higher interest payments payable on a fully disbursed loan as compared to lower commitment charges payable on a loan disbursed in two installments. The loan will have a 15-year term, including a grace period of 3 years (30% annuity amortization method), an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other

terms and conditions set forth in the draft loan agreement. Based on this, the average loan maturity is 12.1 years, and there is no maturity premium payable to ADB. The financing plan is in Table 1. The government has provided ADB with (i) the reasons for its decision to borrow under ADB's LIBOR-based lending facility based on these terms and conditions, and (ii) an undertaking that these choices were its own independent decision and not made in reliance on any communication or advice from ADB. The loan proceeds will be used to finance the full exchange cost (excluding local taxes and duties) of items produced and procured in ADB member countries, excluding ineligible items and imports financed by other bilateral and multilateral sources, in accordance with the provisions of ADB's Simplification of Disbursement Procedures and Related Requirements for Program Loans.¹⁷ The proceeds of the policy-based loan will be disbursed to the Republic of the Philippines as the borrower. Subprogram 1 will receive parallel cofinancing of \$150 million from the Agence Française de Développement.

Table 1: Financing Plan

Source	Subprogram 1	Subprogram 2	Share of Total
	Amount	Amount	
	(\$ million)	(\$ million)	(%)
Asian Development Bank	250.00	250.00	62.30
Ordinary capital resources (loan)			
Agence Française de Développement (loan) ^a	150.00	150.00	37.40
Government of the Philippines (in kind)	1.00	1.00	0.30
Total	401.0	401.00	100.00

^a Negotiations with the Department of Finance on the cofinancing agreement were being finalized at the time of Board circulation.

Source: Asian Development Bank.

E. Implementation Arrangements

32. The subprogram 1 period is from September 2010 to June 2013, and the subprogram 2 period is from July 2013 to June 2015. The DOF will be the executing agency for the program and will be responsible for the overall implementation of both subprograms and the medium-term results framework. The CCD will serve as the steering committee for the program, as it includes all the implementing agencies and relevant stakeholders. The CCD will lead the review of the LGC, and the recommendations will be submitted to the OCD for consideration. The program's implementing agencies include the DOF, the DILG, the DBM, and the National Economic and Development Authority. The implementing agencies will be responsible for the day-to-day implementation of subprogram 1. The DOF will coordinate with implementing agencies and meet with them as required to monitor the progress on subprogram 1 reforms.

III. DUE DILIGENCE

A. Economic and Financial

33. The implementation of the reform program include the cost of implementation of the BUB initiative, the PCF, the associated funds to the Seal of Good Governance, and costs related to policy development and implementation. The benefits expected include allocative efficiency gains from the reassignment of financial resources to local government budgets, the expected impact of increased local government expenditure on regional gross domestic product, and savings from financial management efficiency.¹⁸

¹⁷ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

¹⁸ The Summary Program Impact Assessment (accessible from the list of linked documents in Appendix 2) provides details on the expected costs and benefits associated with the program.

B. Governance

34. Good governance and anticorruption remain permanent priorities of the government. The government's PFM plan was announced in February 2011, and its local counterpart—the medium-term LGU public financial management reform plan—is currently being drafted, with the support of development partners.¹⁹ ADB has assisted local government finance and budget reforms since 2007, starting with the LGFBR reform program loan completed in 2009. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the DOF, the DILG, the DBM, and the National Economic and Development Authority.

C. Poverty and Social

35. The program will assist the government to reduce poverty and achieve inclusive growth by (i) helping prioritize and improve the coordination of pro-poor expenditures at national and local governments; (ii) assisting in the creation of predictable and transparent LGU revenue policies that support private entrepreneurship and business investment; and (iii) developing participatory and accountable planning, budgeting, and monitoring systems for LGUs that allow for good project selection and good governance practices in implementation.²⁰ The impact on efficient service delivery is expected to be felt over the medium term, and particularly upon low income individuals. Implementation of reforms will greatly assist the government's rehabilitation strategy of local governments in areas affected by the Yolanda typhoon. Subprogram 1 is classified as having some gender elements. Key gender designs include the mainstreaming of gender issues in local expenditure programs, women's participation in local governance processes, inclusion of gender indicators in the LGPMS, and the inclusion of women in capacity-development initiatives.

D. Safeguards

36. In accordance with ADB's Safeguard Policy Statement (2009), subprogram 1 is classified under category C for environment, involuntary resettlement, and indigenous peoples.

E. Risks and Mitigating Measures

37. Major risks and mitigating measures are summarized in Table 2 and described in detail in the risk assessment and risk management plan.²¹

Table 2: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Global economic downturn prompts reduced investment and limits fiscal revenue growth.	The government has taken measures to increase revenues. The Sin Tax Law (an act restructuring the excise tax on alcohol and tobacco products) came into effect on 1 January 2013 and is expected to result in expected additional revenues of P33.96 billion for the first year of implementation. ADB will provide TA to support capacity development in the Bureau of Internal Revenue. This program's emphasis on updating the schedules of market values for the RPT will contribute to higher revenues at the LGU level.
Wavering commitment to reforms to the system of intergovernmental fiscal relations.	An ADB TA project will finance studies to review LGC provisions on intergovernmental fiscal relations, which will be prepared and discussed in a participatory way to ensure

¹⁹ Development Coordination (accessible from the list of linked documents in Appendix 2).

²⁰ The Summarized Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2) provides further details.

²¹ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

Risks	Mitigating Measures
	full ownership among oversight agencies and LGUs.
Parliamentary consideration and approval of ad hoc LGC reform proposals without providing an opportunity for consideration by stakeholders	The review of the LGC will incorporate representatives from the Senate and the House of Representatives from the outset to ensure their ownership of the process.
Lack of coordination in policy formulation among central government agencies may undermine the pace of reform.	To resolve possible issues and to ensure continued progress, the CCD has been organized to address issues in intergovernmental coordination regarding the LGU issues. The CCD has been accepted by oversight agencies and LGU leagues as a forum for openly discussing conflicting positions.
Distortion of allocation of budget due to weak PFM and procurement systems and lack of oversight.	The government is implementing a PFM road map with AusAID support. ADB support will focus on (i) results-based budgeting, (ii) CSO initiatives related to mitigating public financial management and procurement risks at the local government level, (iii) piloting innovations introduced under the PFM reform map in ADB-supported sectors, and (iv) analytical work in procurement.
Availability of resources for capacity development of LGUs.	This program is developed in close coordination with the Philippines Development Forum working group for decentralization and local government, and financing for training programs will be provided by various development partners, such as the European Commission.

ADB = Asian Development Bank, AusAID = Australian Agency for International Development, CCD = Coordination Council on Decentralization, CSO = civil society organization, LGC = Local Government Code, LGU = local government unit, PFM = public financial management, RPT = real property tax, TA = technical assistance.
Source: Asian Development Bank.

IV. ASSURANCES

38. The government and the DOF have assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents.

V. RECOMMENDATION

39. I am satisfied that the proposed programmatic approach and policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

- (i) the programmatic approach for the Local Government Finance and Fiscal Decentralization Reform Program, and
- (ii) the loan of \$250,000,000 to the Republic of the Philippines for subprogram 1 of the Local Government Finance and Fiscal Decentralization Reform Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

21 January 2014

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
<p>Impact</p> <p>Improved delivery of services by local government units.</p>	<p>By 2017, overall performance index increased by 15% (2011 baseline: 4.31)</p> <p>By 2017, CSIS increased by 10% from its 2013 baseline, currently under preparation.</p>	<p>DILG CSIS reports</p> <p>DILG LGPMS</p>	<p>Assumptions</p> <p>Sustained implementation of good governance reforms with greater emphasis on LGUs.</p> <p>Sustained economic growth and macroeconomic management performance allows for reform.</p> <p>Risks</p> <p>Asian economic downturn prompts reduced investment and limits fiscal revenue growth.</p> <p>Wavering commitment to reforms to the system of intergovernmental fiscal relations.</p>
<p>Outcome</p> <p>Efficient and transparent local governments with an adequate and equitable fiscal framework.</p>	<p>By 2015, LGU PFMAT average score improved by 20% (2013 baseline: 2.34)</p> <p>By 2015, real property tax collection increased by 20% (2010 baseline: P29.6 billion)</p> <p>By 2015, local government expenditures increased by 20%. (2011 baseline: 17% of total expenditure)</p>	<p>DBM PFMAT reports</p> <p>DOF ESRE</p>	<p>Assumption</p> <p>Sustained political climate for reform at the local government.</p> <p>Risks</p> <p>Short terms of local chief executives limit the incentives for reform implementation.</p> <p>Lack of coordination in policy formulation among central government agencies may undermine the pace of reform.</p>
<p>Outputs</p> <p>1. A conducive fiscal framework for inclusive growth.</p> <p>2. An adequate and equitable local resource framework for fiscal sustainability.</p>	<p>Completion of a government-led review of the Local Government Code by 2015</p> <p>Establishment of the Performance Challenge Fund in 2011</p> <p>Implementation of new credit worthiness and debt management modules for the ESRE LGU system in 2012</p> <p>At least 35 cities and 25 provinces update their SMVs</p> <p>Rationalization of investment</p>	<p>OCD report</p> <p>DILG PCF reports</p> <p>DOF (BLGF)</p> <p>DOF (BLGF)</p> <p>DOF, legislature</p>	<p>Assumptions</p> <p>Representatives of the local government committees of the House and Senate participate and lead OCD work.</p> <p>Sustained economic growth maintains local government revenues through transfers and allows the expansion of national government programs for LGUs.</p>

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
<p>3. Strengthened public financial management to assist efficient LGU service delivery.</p> <p>4. Good local governance, transparency, and accountability.</p>	<p>incentives to ensure neutral impact on LGU fiscal bases by 2014</p> <p>Establish a single LGU loan monitoring agency by 2014 and streamline procedures and remove limitations to access to private credit from LGUs</p> <p>Approval of the medium-term LGU PFM reform road map, 2013–2015 in 2014, incorporating gender targets for PFM capacity building</p> <p>Over 1,200 LGUs participate in the BUB, with more than P20 billion budgeted in 2015</p> <p>BUB gender-sensitive project identification process implemented by 2014</p> <p>Revision of the UBOM by 2015</p> <p>Harmonization of CDP and BUB planning guidelines by 2014</p> <p>Containment of personnel salary growth through the use of job orders by 2015</p> <p>Approval of new guidelines for the establishment and operation of local economic enterprises by 2014</p> <p>Approval of corporate and financial policy framework for LGU alliances by 2015</p> <p>Issuance of the full disclosure policy in 2011</p> <p>90 LGUs adopt the CSIS in 2015, incorporating gender topics.</p> <p>Redesign of the LGMPS completed by 2015, including alignment with the Seal of Good Governance and mainstreaming gender aspects</p>	<p>DOF, BSP</p> <p>DBM, DOF, DILG memorandum</p> <p>DBM</p> <p>DBM annual reports on BUB</p> <p>Updated DBM manual</p> <p>DILG</p> <p>DBM circulars</p> <p>DBM circulars and UBOM updates</p> <p>DILG</p> <p>DILG reports</p> <p>DILG reports</p>	<p>Continued implementation of national public financial management reform program.</p> <p>Risk Parliamentary consideration and approval of ad hoc LGC reform proposals without providing an opportunity for consideration by stakeholders.</p>

Activities with Milestones	Inputs
<p>1. Conducive fiscal framework for inclusive growth.</p> <p>1.1 Workplan of the Cabinet Cluster on Good Governance includes review of the LGC (November 2013).</p> <p>1.2 Approval of the scope of the review and leading agency(November 2013).</p> <p>2. Adequate and equitable local resource framework for fiscal sustainability.</p> <p>2.1 Establishment of the Seal of Good Housekeeping and the PCF (September 2011).</p> <p>2.2 Implementation of local revenue forecasting, credit worthiness and debt management modules and roll out to regional offices (March 2012).</p> <p>2.3 Issuance of guidelines for the review of a revised SMV by LGUs and the completion of training for regional offices (June 2014).</p> <p>2.4 Completion of the study on the rationalization of investment incentives and their impact on LGU fiscal revenues (December 2014).</p> <p>3. Strengthened public financial management to assist efficient LGU service delivery.</p> <p>3.1 Review of the UBOM and the incorporation of reviewed policies on LEE, SEF, and participatory budgeting (December 2014).</p> <p>3.2 Approval of the medium-term local PFM road map (June 2014).</p> <p>3.3 Approval and piloting of the BUB initiative, and issuance of new revised guidelines (2012).</p> <p>3.4 Establishment of joint committees on LGU personnel matters and LEE (June 2014).</p> <p>4. Good local governance, transparency and accountability.</p> <p>4.1 Finalization of the baseline report on LGU alliances and preparation of position paper on corporate powers and financial framework (June 2014).</p> <p>4.2 Piloting of the CSIS in highly urbanized and component cities (June 2014).</p> <p>4.3 Approval and implementation of the competency and performance certification system for local treasurers (December 2014).</p> <p>4.4 Preparation of a position paper on the redesign of the LGPMS to align it with the Seal of Good Governance (June 2014).</p>	<p>ADB: \$250 million equivalent for subprogram 1 AFD: \$150 million equivalent for subprogram 1 Government: \$1 million in-kind contributions</p> <p>ADB: \$250 million subprogram 2 AFD: \$150 million subprogram 2 Government: \$1 million in-kind contributions</p>

ADB = Asian Development Bank, AFD = Agence Française de Développement, BLGF = Bureau for Local Government Finance, BSP = Bangko Sentral ng Pilipinas (Central Bank of the Philippines), BUB = bottom-up budgeting, CDP = comprehensive development plan, CSIS = Citizens' Satisfaction Index System, DBCC = Development Budget Coordination Committee, DBM = Department of Budget and Management, DILG = Department of the Interior and Local Government, DOF = Department of Finance, ESRE = electronic statement of receipts and expenditures, JFPR = Japan Fund for Poverty Reduction, LEDAC = Legislative–Executive Development Advisory Council, LEE = local economic enterprises; LGC = Local Government Code, LGU = local government unit, LGPMS = Local Governance Performance Measurement System, OCD = Office of Committee Decentralization, PCF = Performance Challenge Fund, PFM = public financial management, PFMAT = public financial management assessment tool, SEF = Special Education Fund, SMV = schedule of market values, TA = technical assistance, UBOM = Updated Budget Operations Manual.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=44253-013-3>

1. Loan Agreement
2. Sector Assessment (Summary): Public Sector Management (Decentralization and Local Governance)
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Country Economic Indicators
6. International Monetary Fund Assessment Letter
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

Supplementary Document

10. Summary Program Impact Assessment

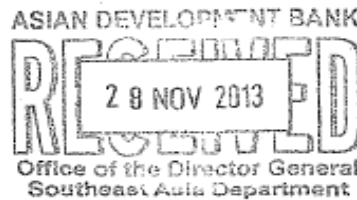
DEVELOPMENT POLICY LETTER



Republic of the Philippines
DEPARTMENT OF FINANCE

Roxas Boulevard Corner Pablo Ocampo, Sr. Street
 Manila 1004

Mr. Takehiko Nakao
 President
 Asian Development Bank
 Manila, Philippines



21 October 2013



Subject: Local Government Finance and Fiscal Decentralization reform program (LGFFD)

Dear Mr. Nakao:

This letter outlines the Government of the Philippines's policy for the reform of local government finance and intergovernmental fiscal relations, and our request for financial assistance from the Asian Development Bank (ADB). It should be read in conjunction with the attached policy matrix in which we have identified key policy initiatives under our medium-term reform agenda. Eliminating constraints for improved service delivery by local government units (LGUs) is a priority of our administration. The Social Contract with the Filipino People and the Philippine Development Plan (PDP), 2011–2016 identify specific challenges for LGUs in the achievement of the Government's main goals: promoting inclusive growth and generating employment, eliminating corruption, and achieving fiscal sustainability.

Substantive local government finance and fiscal decentralization reforms will be required to address the critical development constraints related to more efficient, effective and equitable social service delivery. The Government has achieved important progress in strengthening local government's monitoring and evaluation mechanisms, public financial management and performance management systems. Progress towards good local governance has been achieved through a series of reforms aimed at increasing transparency and accountability of local administrations and facilitating constructive civil society engagement at the sub-national level. The latter include the institutionalization of the Full Disclosure Policy in 2010, and the introduction of the Seal of Good Housekeeping. In addition, the Government has supported national government programs that improve the alignment of national and local development priorities and provide incentives to improved LGU performance, such as the Performance Challenge Fund, and the Bottom-up Budgeting (BuB) initiative. However, more needs to be done to ensure that citizens benefit from improved local service delivery.

In order to assist the implementation of local government reforms, the Government of the Philippines is entering a medium-term partnership with ADB articulated into the Local Government Finance and Fiscal Decentralization (LGFFD) reform program, which includes two subprograms. The first subprogram is expected to be approved by the ADB Board of Directors in November 2013 for a total of \$250 million, and will include an additional \$100 million co-financing from the Agence Française de Développement. The

proceeds of the proposed first subprogram will be used primarily to support local government reform spending as defined in this policy letter. This includes, among others, the cost of implementation of the Performance Challenge Fund, the BuB initiative and the upgrading of local government performance measurement systems among others. The second subprogram is expected to be approved by the ADB Board of Directors in September 2015 for a total of \$250 million.

Reflecting the evolution of government's policy, and building upon a rich history of collaboration in the development of local governments, the LGFFD adopts a more ambitious governance approach to reforms, including a review of the regulatory framework for intergovernmental fiscal relations; and due emphasis on demand-side aspects of local governance and performance-based monitoring approaches. The LGFFD will make a critical contribution in support of local government reforms in the Philippines. It will assist the Government's goals of promoting inclusive growth and generating employment, eliminating corruption, and achieving fiscal sustainability.

A Conducive Fiscal Framework for Inclusive Growth

Ever since the enactment of the Local Government Code (LGC) in 1991, LGUs have played a critical role in service delivery and in facilitating local economic development. More than 20 years since its approval, the LGC, as expected, has structural deficiencies that need to be addressed through a government-led review. Sub-national government expenditures represented 4% of gross domestic product and around 17% of total public expenditure in 2011 (25% if debt servicing is excluded). The composition of LGU expenditures is a critical tool in the achievement of inclusive growth and in facilitating employment creation. To that extent, adequate budgetary allocations in the areas of health, education, and other basic services are needed, for which further clarity in functional assignments of LGUs is required. In addition, LGUs will need to increase their contribution to revenue collection with a view towards reducing their dependency on government transfers. LGUs collected only 20% of their total income from their own revenue sources in 2011, and derived their remaining income from transfers and revenue sharing. The share of local tax and non-tax as a proportion of LGU revenues needs to be improved through a combination of determined tax effort from LGUs, and improvements to the productivity of tax and non-tax instruments. Large differences exist in revenue collection capacity leading to disparities in expenditures per capita. There is therefore a need to improve the equalizing power of the system of LGUs transfers without jeopardizing the country's hard earned fiscal stability.

The Government is aware of the important role of LGUs in facilitating employment creation and inclusive growth. Reflecting this assessment, the Government will address the shortcomings of the regulatory framework for inter-governmental fiscal relations through the first comprehensive review of the LGC since its enactment, as announced during the recent Philippines Development Forum 2013. The review of the LGC has been incorporated into the work plan of the Cabinet Cluster for Good Governance and Anticorruption for 2013–2015. The Department of Interior and Local Government (DILG) will lead the review through the Coordinating Committee on Decentralization. For subprogram 2 of the program, the proposals for the amendment of the LGC will be submitted for their consideration to the Oversight Committee on Decentralization and to the Legislative-Executive Development Advisory Council.

Developing and Adequate and Equitable Resource Framework for Fiscal Sustainability

For the second consecutive year, revenue collection in the Philippines has increased by double digits. Coupled with prudent but sustained increases in expenditure, this has allowed the reduction of the fiscal deficit to 2.3% of the gross domestic product in 2012. The government will continue to pursue fiscal sustainability while improving LGUs' revenue frameworks and targeted local expenditures. Led by the Department of the Interior and Local Government (DILG), the government has implemented the Performance Challenge Fund, providing a performance-based transfer to LGUs that encourages good financial management through the Seal of Good Housekeeping. During the second subprogram, the DILG will continue to implement performance-based financing mechanisms anchored on the system of Seals of Good Governance. This will include the full implementation of the Seal of Disaster Risk Management, and the Seal of Competitiveness among others. The DILG will lead the development of systems to monitor the utilization of the 20% of the Internal Revenue Allotment that is devoted to the Development Fund, supporting the Government's drive for improved efficiency of public expenditure.

With the aim of assisting higher revenue collection by LGUs, the DOF has developed instruments for the estimation of local government taxes, and continues to improve information flows between the Bureau for Internal Revenues and the LGUs. Looking forward, the department aims to increase the collection performance of the real property tax. This will require the concerted efforts of the local government assemblies in updating their schedules of market values, for which DOF will be providing capacity building and technical assistance. In addition, within the context of Government efforts to rationalize the system of fiscal incentives to investment, efforts will be made to coordinate the local revenue and investment incentives codes, and to ensure national government incentives do not impinge upon the fiscal autonomy of LGUs.

Prudent access to, and adequate monitoring of credit financing by LGUs are important elements of a system of intergovernmental fiscal relations. The DOF has implemented a debt certification system that allows the issuance of certificate of maximum borrowing by LGUs, thus simplifying access to credit. In addition, an LGU creditworthiness system was developed that assists the accurate evaluation of prospective LGU borrowers by creditors. Over the second subprogram, the system will be rolled out to DOF's regional offices, while the DOF, led by the Bureau of Local Government Finance, continues to streamline procedures for credit financing by LGUs and to implement efficient debt monitoring systems.

Strengthening Public Financial Management to Assist Efficient LGU Service Delivery

The Government, led by the Department of Budget and Management (DBM), has made tremendous progress in the improvement of public financial management systems. National public financial management reforms have contributed to improve the Philippines' fiscal profile and macroeconomic stability, allowing the upgrading of the country's credit rating to BBB- by two of the leading rating agencies. The Government is complementing these efforts with key improvements to the financial management systems of LGUs. The DBM is leading the drafting of a medium-term LGU public financial

management reform plan, expected to be completed during the program's second subprogram. The plan will provide a strategic vision for the reforms for the period 2013–2015 and beyond. The review of LGU financial management systems will translate into the revision of the Budget and Operations Manual for LGUs to include developments in the performance-based and accountability systems, the incorporation of participatory planning and budgeting processes, and improvements to the treatment of local economic enterprises and disaster risk management plans among others.

The BuB is a leading government initiative towards improved budget transparency, the alignment of national and local development priorities, and the implementation of meaningful consultative planning and budgeting systems. In its piloting year, the BuB budgeted P8 billion in 2012, with 595 LGUs benefiting from the allocations. By 2014, the government expects to budget P21 billion under the initiative, with over 1200 LGUs receiving allocations. Over the second subprogram, DBM will sustain efforts on the implementation of the BuB with a view towards improving participatory planning process and budget allocation criteria. The Government, led by the DILG, will continue to harmonize the planning and budgetary processes of the BuB with that of the LGUs' comprehensive development and investment plans, in order to avoid duplication of procedures.

Mindful of the difficulties encountered by small LGUs in raising an adequate level of revenues that facilitates service delivery, the Government will explore further the potential for LGUs alliances. The joint provision of basic services or joint implementation of projects by two or more LGUs (e.g. disaster management plans, larger infrastructure projects, etc.) require the development of the legal personality of such alliances, and the clarification of the financing modalities available to them. This is an underdeveloped area under the LGC that will be further addressed during the second subprogram period.

Fostering Good Local Governance, Transparency and Accountability

Improving the interaction of constituents with their locally elected representatives has been a priority of this administration. Led by the DILG, the government has improved the transparency and accountability of LGU operations with the institutionalization of the Full Disclosure Policy. As a result, LGUs are now mandated to disclose key reports that assist in the performance monitoring of civil society organizations and individual constituents alike. Compliance with the policy will be a requirement to access performance-based sources of financing by the national government, such as the Performance Challenge Fund. The Government is piloting, in addition, the upcoming Citizen's Satisfaction Index, a key instrument to guide LGUs policies by gathering the perception of citizens on the coverage and quality of service delivery in their jurisdictions. Over the second subprogram period, the DILG will finalize the implementation of the index, and produce the first report on its implementation.

Improving the capacities to local officials and assisting the work of elected local representatives will remain a top priority for the government. The redesigned training program for new elected officials is being implemented in 2013, aiming to include all councilors, and specifically all female new councilors. The DBM will, in addition, lead the development and implementation of a performance evaluation system for local budget officers, along the lines of the similar system recently designed for local treasurers.

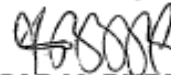
The Government aims to apply the highest standards to the performance evaluation of its units. As such, during the second subprogram, the local government performance measurement system (LGPMS) will be aligned with the system of Seals of Good Governance and upgraded to improve its analytical capacity. This will include the incorporation of benchmarking and other decision making tools that provide LGUs with good guidance as to the determination of expenditure priorities in their areas.

Conclusion

In closing, Mr. President, the Government reiterates its commitment to the development of efficient and accountable local governments. We will continue to work in coordination with ADB, the Agence Française de Développement, and other development partners to fully implement the policy framework outlined in the LGFFD. The role of LGUs in achieving the development goals outlined in the Social Contract and the Philippine Development Plan 2011–2016 will continue to be exceedingly important.

We deeply appreciate ADB's leading role in support to local government finance and fiscal decentralization reforms over the long term. To assist continuation of recent, successful efforts, we look forward to a rich policy dialogue with the ADB in the framework of the post-program partnership framework, and the early consideration of the proposed policy-based loan for the first subprogram of the LGFFD.

Very Truly Yours,



CESAR V. PURISIMA
Secretary

009683

POLICY MATRIX

Development Partner Coordination	Objectives and Policy Actions	Subprogram 1 (Phase 1) Actions Accomplished Under Subprogram 1 (2010-2013)	Subprogram 2 (Phase 2) Milestones for Subprogram 2 (2013-2015)	Post-Program Partnership Framework
A. Creating a conducive fiscal framework for inclusive growth				
<p>ADB TA <i>Local Government Finance and Fiscal Decentralization reforms</i> will provide technical and logistical support to the review of the LGC.</p>	<p>A1. Review and amendment of the legal framework for intergovernmental fiscal relations</p>	<p>1. The 2013-2015 work plan of the Cabinet Cluster on Good Governance and Anti-corruption includes a review of the Local Government Code 1991</p> <p>1.1 The scope of the proposed review of the local government code includes expenditure and revenue assignments, and fiscal transfers of the LGUs (DILG).</p> <p>1.2 The work plan identifies the DILG as the leading agency for the LGC review (DILG).</p>	<p>1. The proposals for amendment of the Local Government Code are submitted, through the Cabinet Cluster on Good Governance and Anti-corruption, to the Oversight Committee on Devolution and to the Legislative-Executive Development Advisory Council (DILG).</p> <p>1.1. The amendment proposals include aspects of the expenditure and revenue assignments, and fiscal transfers of the LGUs.</p> <p>1.2. The proposed amendments of the LGC are presented to the Good Governance and Anti-corruption cluster.</p>	<p>Processing of amendments to the LGC.</p> <p>Development of implementing regulations for the amended LGC.</p>
B. Developing an adequate and equitable resource framework for fiscal sustainability				
<p>Design of the Performance Challenge Fund was assisted by the DIALOG Fund and ADB TA 7451 <i>Support to Local Government Financing</i></p> <p>Subprogram 2 policy actions will be supported with ADB, AFD (Seal of Disaster Preparedness) and CIDA (Seal of Competitiveness)</p>	<p>B1. Improve performance-based financing and monitoring systems</p>	<p>DILG has developed performance-based financing mechanisms for LGUs, incentivizing efficient financial management by:</p> <p>1.1. Establishing the Performance Challenge Fund.</p> <p>1.2. Jointly with DBM, formulating and approving Guidelines on the appropriation and utilization of the IRA's development fund.</p>	<p>1.1. The DILG has developed systems to monitor the utilization of the 20% of the IRA devoted to the Development Fund. First monitoring report completed.</p> <p>1.2. The DILG continues development of the system of Seals of Good governance for LGUs:</p> <p>1.2.1. Design of the Seal of Competitiveness, the Seal of Disaster Preparedness and the Seal of Environment.</p> <p>1.2.2. Review of the Seal</p>	<p>Continued implementation of the system of Seals of Good Governance and performance monitoring mechanisms for local government expenditure.</p>

			<p>of Good Housekeeping.</p> <p>1.2.3. Establishment of the Seal of Good Governance as a composite index of all individual indexes.</p> <p>1.3 Developing a new policy for the utilization of SEF with DBM and Department of Education.</p>	
<p>Assistance to the completion of SP1 was provided under ADB's TA 7451 <i>Support to Local Government Financing and REGALA initiative. (Support to Local Government Revenue Generation and Land Administration Reforms).</i></p> <p>Support to SP 2 implementation is expected to be financed under REGALA 2 <i>Strengthening Local Government Revenue Generation and Land Management</i> from 2014 onwards and the WB's LAMP2 extension.</p>	B2. Assist improved revenue collection by LGUs	<p>The DoF has improved revenue collection capacity of LGUs by:</p> <p>2.1. Developing a computer module including a local tax payer database and a system for the estimation of presumptive income level.</p> <p>2.2. Incorporating uniform valuation standards in the 2010 addendum to the real property assessors' manual, and training assessors on the new standards.</p> <p>2.3. Civil service commission memorandum circular passed requesting the licensing of all local assessors as a condition for appointment.</p> <p>2.4. Issuing a memorandum circular as a reiteration of tax information sharing between the BIR and the LGUs.</p> <p>2.5 Issuing draft guidelines for the preparation of Local Revenue codes and Local Investment and Incentive codes (DILG and DTI).</p>	<p>2.1. The DoF improves collection performance of the property tax by:</p> <p>2.1.1. Issuing guidelines for BLGF regional offices' assessment of the revised LGU Schedules of Market Values (SMVs) for technical compliance with Philippines Valuation Standards and Mass Appraisal Guidebook (BLGF).</p> <p>2.1.2. Conducting training for BLGF regional offices to ensure capacities to review revised LGU SMVs.</p> <p>2.1.3. BLFG issues circular enjoining LGUs to allocate funds for the conduct of general revision of SMVs in their budgets.</p> <p>2.2. Establishing monitoring compliance on information sharing between the BIR and the LGUs (BLGF).</p> <p>2.3 Conduct a detailed study on expanding revenue assignments to LGUs, including green taxes (BLGF).</p> <p>2.4 Rationalization of fiscal incentives to investment, ensuring neutral or positive impact on local</p>	Government explores additional instruments for LGU revenue collection out of the review of the LGC

			economic development and fiscal revenues (DoF). 2.5 Review policy for mining revenue sharing with LGUs to ensure timely and equitable distribution of resources (DoF).	
SP1 policy actions were assisted by ADB <i>TA 7451 Support to Local Government Financing</i> SP2 policy actions will be supported by the EU's PFM reform program.	B3. Assist credit financing	3.1. The BLGF has developed LGU creditworthiness systems that assist the accurate evaluation of prospective LGU borrowers by creditors. 3.2. The BLGF has developed an LGU debt certification system that allows for facilitating the issuance of certificates on maximum borrowing and debt service capacities. 3.2.1. BLGF financing modalities and debt management manuals developed.	3.1. Completed roll out of new eSRE modules on credit worthiness and LGU debt certification system to BLGF regional offices. 3.2 All relevant personnel at regional offices and selected provincial treasurers receive training on the effective use of new eSRE modules. 3.3 Recommending proposals for streamlined procedures for the processing of necessary clearances and opinions required by DOF and BSP for LGU loans; and reviewing requirements for debt servicing accounts (BLGF). 3.4 Establish a single agency LGU loan monitoring system and improve debt monitoring system (BLGF).	Implementation of integrated systems for LGU loan monitoring and simplification of procedures for LGU access to credit from commercial banks
C. Strengthen public financial management to assist efficient LGU service delivery				
TA support to the preparation of the Medium-Term Plan under <i>EC's Support to Local Government Units for More Effective and Accountable Public Financial Management</i>	C1. Improve Local PFM strategic planning	1.1. The Government has initiated drafting of the Medium-Term LGU PFM road map incorporating all relevant stakeholders (DBM).	1.1. Medium – Term LGU PFM reform strategy and road map approved and under implementation, with annual progress reports web-posted (DBM).	Annual implementation reports produced and webposted
TA for the design and review of the BuB initiative has been provided by AusAID and the DIALOG Fund.	C2. Align national and local development priorities into national and local planning	The Government has improved the alignment of national and local development priorities by: 2.1 Approving and piloting	2.1. Harmonization of National and LGU planning processes (including CDP, BuB and others), integrating	Consolidation of planning guidelines to avoid overlapping processes and inefficient

<p>TA for BuB implementation provided under EC's <i>Support to Local Government Units for More Effective and Accountable Public Financial Management</i></p> <p>Proposed review of the budgetary allocation formula under SP2 will be provided by ADB TA</p>	<p>processes and improve participatory processes</p>	<p>the bottom-up planning and budgeting policy (BuB), encouraging participatory planning and gender-sensitive project selection (DBM).</p> <p>2.1.1 Budgeting P8 billion under the BuB in 2013, with 595 LGUs participating in the process (DBM).</p> <p>2.2 Improving disaster risk reduction management by approving new guidelines on the allocation and utilization of the DRMF (DILG).</p> <p>2.3 Finalized Compendium of Planning Documents and of the nationwide regional training of trainers for the comprehensive development plan (DILG).</p>	<p>participatory processes in consolidated guidelines (DILG).</p> <p>2.2. Finalize implementation of the BuB and improve participatory planning and budgeting processes (DBM):</p> <p>2.2.1 A total of P21 billion budgeted under the BuB and over 1200 LGUs receiving allocations by 2014.</p> <p>2.2.2 A government -led evaluation of the BuB initiative is completed and shared with stakeholders.</p> <p>2.2.3 Review of budgetary allocation formula for BuB aiming at a more equitable distribution of resources.</p> <p>2.2.4 Enhanced engagement of civil society on the BuB process through implementation of the Empowerment Fund and the provision of capacity building to CSOs during social preparation stages.</p> <p>The DBM strengthens linkages between project development, planning, investment programming and budgeting by:</p> <p>2.3 Initiating revision of the UBOM to incorporate:</p> <p>2.3.1 Localization of the OPIF system.</p> <p>2.3.2 Participatory budgeting processes at LGU level.</p> <p>2.3.3 Performance-based mechanisms and accountability</p>	<p>expenditure planning</p>
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			measures. 2.3.4 Policy changes to the SEF, LEE and Disaster Risk Management plans.	
SP1 policy actions supported under ADB TA 7451 SP2 policy actions will receive support under the EC's <i>Support to Local Government Units for More Effective and Accountable Public Financial Management</i> and ADB TA	C3. Improve the availability and quality of information for financial management.	The DoF has improved the accuracy of revenue targets between BLGF regional offices and local treasurers, enhancing budget formulation and execution by: 3.1 Developing an eSRE module on LGU fiscal capacity (BLGF) 3.1.1. The BLGF has developed a new cash flow forecasting model that will assist improving budget formulation and execution. 3.2 Migrating year-end financial status report of LGUs to eSRE format.	3.1 Completed roll out of new eSRE modules to BLGF regional offices. 3.1.1 All relevant personnel at regional offices and selected provincial treasurers receive training on the effective use of the systems. 3.2 Expenditure management module incorporated into the eSRE (BLGF). 3.3 Effective linking of the LGFPMS and the LGPMS (DILG and BLGF). 3.4 Issuance of the Joint Circular between DBM and DOF on the guidelines on the adoption of the SRE reporting format.	Roll out of the expenditure module of the eSRE to regional offices of the BLGF.
SP 2 policy actions will receive support under the EC's <i>Support to Local Government Units for More Effective and Accountable Public Financial Management</i>	C4. Rationalize LGU expenditure patterns (personal matters and Local Economic Enterprises)	The DBM continues to rationalize LGU personal expenditure to ensure efficient use of resources by: 4.1 Implementing limitations to the LGU use of transfers and advances to LEEs / PUs, particularly for payment of PS requirements and providing options to enable LEEs to fund PS requirements.	4.1 Recommendations from the Joint Committee on Local Government Personnel matters are submitted to the Oversight Committee on Decentralization (DBM). 4.2 Approval of new guidelines for the establishment and financial management of LEEs. (DBM).	Implementation of new policy on LEE as per new guidelines.
D. Fostering good local governance, transparency and accountability				
Support will be provided under ADB and AFD TA for SP2. WB, and CIDA have provided assistance in this area to the Government for SP 1.	D1. Assist the development of inter-local cooperation for improved service delivery and local economic development	1.1 Policy review on potential for and benefits of a financing framework for LGU alliances' projects including loan financing and shared revenue options (DILG).	1.1 Implementation of a reviewed policy framework for LGU alliances promoting inter-local cooperation for service delivery, including: a) the development of corporate powers of LGU alliances; b) clarification of	

			financing modalities for joint service delivery; c) definition of legal personality of LGU alliances (DILG).	
<p>SP1 policy actions have been assisted by the DIALOG Fund, which will continue to provide TA for SP2 implementation.</p> <p>Assisted by RETA 6445: <i>Support for Implementation of the Second Governance and Anticorruption Action Plan</i></p>	D2. Improve transparency and accountability of local administrations and involve civil society as LGU partner	<p>ne DILG has continued to improve the transparency and accountability of local government operations by:</p> <p>2.1 Issuing the Full Disclosure Policy of Local Budgets and Finances, Bids and Public Offerings.</p> <p>2.2 Implementing capacity building activities for CSOs to assist their analytical capacity on understanding the LGU disclosed documents.</p> <p>2.3 Development of “Civil Society Participation Fund” Guidelines.</p> <p>2.4 Piloting the “Citizen Satisfaction Index System” to generate feedback on the service performance and programs of the government.</p>	<p>2.1 Integration of compliance to full disclosure policy as a necessary indicator in various programs grants and award systems for LGUs i.e. (DILG),</p> <p>2.1.1 Performance Challenge Fund</p> <p>2.1.2 BuB Initiative</p> <p>2.1.3 Gawad Pamana ng Lahi</p> <p>2.2 Developed Full Disclosure Policy View Portal system; functionalities tested by DILG and LGUs in NCR.</p> <p>2.3 Citizen’s satisfaction index implemented and with a first report issued and widely disseminated (DILG).</p>	Joint review of the results from the Citizen’s satisfaction index and preparation of recommendations for LGU policy reform.
<p>SP2 policy actions will be assisted by the EC’s <i>Support to Local Government Units for More Effective and Accountable Public Financial Management.</i></p>	D3. Improve capacities of local government officials, budget officers, planning officers and treasurers	<p>3.1 Newly Elected Officials (NEO) Program implemented after the 2010 election with 100% new officials trained on general administration issues (DILG).</p> <p>3.1.1 Assessment of the NEO completed and recommendations for NEO review endorsed by PDF.</p> <p>3.1.2 Redesign the NEO program and development of a monitoring framework to assess its impact.</p>	<p>3.1 Re-designed NEO program implemented in 2013 with all first time elected officials trained, including 100% female councillors (DILG).</p> <p>3.2 Development and implementation of a performance evaluation system for local budget officers (DBM).</p> <p>3.3 Capacitate Local Planning Officers in selected Regions.</p> <p>3.4 Performance evaluation rating system for local treasurers, with first performance assessments completed (BLGF).</p>	Review of the results from the performance evaluation for local treasurers and budget offices and preparation of recommendations for action.

	D4. Improve women representation in LGU representative committees and implement gender sensitive planning and budgeting systems	The DILG facilitated women representation at LGU consultative committees by: 4.2 Ensuring the inclusion of Women NGO representatives in the Local Development Council. 4.3 Enjoining LGU adoption of a referral system on violence against women.	4.1 Assessment of LGU GAD plans and budget implementation completed with recommendations disseminated among stakeholders (DILG). 4.2 Increasing gender responsiveness of LGU budgets as measured by GAD guidelines (DILG). 4.3 Guidelines for the localization of the Magna Carta for Women at the LGUs issued (DBM and DILG).	
Earlier ADB TAs assisted work on the implementation of the LGPMS. SP2 actions will be assisted by additional ADB TA resources.	D.5 Strengthen performance monitoring systems to assist local accountability relationships.	The DILG has improved the coverage and effective use of local performance monitoring systems by: 5.1 Ensuring that 90% of provinces, cities, and municipalities provide data to the LGPMS and use it in the formulation of LGU's comprehensive development plans. 5.2 Uploading to the web the revised state-of-local-governance and state-of-local-development reports. 5.3 At least 10 LGUs make public their full state-of-local-governance report based on the LGPMS and local government financial monitoring system.	5.1 Redesign of the LGPMS to align with the System of Seals of Good Governance (DILG). 5.2 Improve the analytical capacity of the LGPMS (DILG): 5.2.1 Implement benchmarking tools for LGUs 5.2.2 Incorporate results from the citizen's satisfaction index. 5.2.3 Provide decision making tools for investment decisions.	LGUs incorporate new decision making tools from the LGPMS into their planning and budgeting processes.

ADB = Asian Development Bank, AFD = Agence Française de Développement, BIR = Bureau of Internal Revenue, BLGF = Bureau of Local Government Finance, BUB = bottom-up-budgeting, CDP = Comprehensive Development Plan, CIDA = Canadian International Development Agency, CSO = civil society organization, DBM = Department of Budget and Management, DOF = Department of Finance, DILG = Department of the Interior and Local Government, DTI = Department of Trade and Industry, ESRE = Electronic Statement of Receipts and Expenditures, EU = European Union, IRA = Internal Revenue Allotment, LEE = Local Economic Enterprises, LGC = Local Government Code, LGUs = Local Government Units, LGPMS = Local Government Performance Measurement System, NCR = National Capital Region, NEO = Newly Elected Officials, PS = Personnel Service, PUs = Public Utilities, SEF = Special Education Fund, SMV = Schedule of Market Values, TA = Technical Assistance, WB = World Bank.