PROJECT INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: AB4875

Project Name	PH - Regional Infrastructure for Growth
Region	EAST ASIA AND PACIFIC
Sector	General water, sanitation and flood protection sector (60%); Solid waste management (20%); Sanitation (20%)
Project ID	P108904
Borrower(s)	REPUBLIC OF THE PHILIPPINES
Implementing Agency	Development Bank of the Philippines
Environment Category	[ ] A [X] B [ ] C [ ] FI [ ] TBD (to be determined)
Date PID Prepared	June 16, 2009
Estimated Date of Appraisal Authorization	October 1, 2009
Estimated Date of Board Approval	November 24, 2009

1. Key development issues and rationale for Bank involvement

1. The Local Government Code (LGC) of 1991 empowered local government units (LGU) to improve public services and stimulate growth. LGUs were also provided a significant degree of fiscal autonomy and provided a reliable stream of internal revenue allotments to support their core operations. However, 18 years after the code, many LGUs continue to confront a myriad of problems – poor access to water and electricity, declining literacy rates, environmental degradation, high unemployment, lack of low-cost housing, and inadequate rural services. A review of decentralization experience over this period points to a number of different factors that have influenced this outcome. Firstly, due to significant fragmentation (at all local government levels), existing IRA resources are insufficient to meet the rising cost of delivering services. Secondly, many small LGUs have a limited tax base from which to increase own source revenues and therefore remain dependant on transfers from national government. Thirdly, funds for certain services have not been fully devolved by national government and this has clouded the allocation of responsibilities of national and local government for service delivery. Fourthly downward accountability to customers is weak, and it is unclear whether citizens are satisfied with the services they receive from their local governments.

2. While financial resources have been a key constraint for urban and local development, progress in revenue mobilization at local level has been slow. Currently own source revenue covers only one-third of LGU expenditures on average even though local revenue authority has increased significantly under the 1991 Local Government Code. There is significant variation among LGUs in terms of own-resource mobilization capacity and cities enjoy greater taxing powers than municipalities and provinces. In 2006, own source revenue accounted for 60% of cities' total revenue, while only 13% for provinces and19 % for municipalities[1].

3. Many remain dependent on intergovernmental transfers and grants from the national government. The Internal Revenue Allotment (IRA), an unconditional transfer, finances the majority of LGU expenditures. While IRA has the advantage of being simple and predictable, it is not designed to foster LGU financial

[1] Bureau of Local Government Finance, Statements of Income and Expenditure 2004-2006.

discipline or agenda setting. Furthermore Non-IRA (conditional) transfers, though small compared to IRA (approximately 18% of IRA in 2003), play a critical role accounting for approximately half of LGUs' *capital expenditure*.

4. While the extent of LGU borrowing has increased 27 fold since the LGC, it remains limited, accounting for 2-3% of total revenues and debt service in 2006 while. A number of factors contribute to this low level of borrowing. Firstly, many LGUs are fiscally conservative and therefore see borrowing as an instrument of last resort. Secondly, LGUs lack capacity to prepare "bankable" projects and implement them in a timely fashion. Thirdly, mechanisms for pooling investments across LGUs do not exist and as a result, the scale and impact of sub-projects is often limited. Fourthly, most LGUs have low income and this affects their borrowing capacity[2]. Fifthly, Private sector financiers have played a limited role in extending financing to LGUs mainly because they perceive the playing field to be uneven— IRA (which is used as a form of collateral by GFIs), can only be deposited in GFIs. The Government Financial Institutions (GFI), including the Land Bank of the Philippines (LBP) the Development Bank of the Philippines (DBP), and the Municipal Development Fund Office (MDFO), have played an instrumental role in the last ten years in increasing access to credit financing to LGUs. The LBP is the largest lender, with approximately 64% of market share in 2008, followed by DBP at 14%. The quality of the LGU lending portfolio is good across all GFIs, and the level of non-performing loans (NPL) is almost negligible.

5. In light of the challenges outlined above, the Government has identified a number of policy reforms aimed at improving access to finance for LGUs. These reforms are underpinned by the 1996 LGU Financing Framework which aims to increase access to capital financing to LGUs through both public and private sources. In the past few years, particular focus has been paid to opening up lending to private banks by: allowing LGUs to tap the joint IFC/Bank sub-national finance facility; permitting LGUs to deposit IRA in PFI accounts; identifying mechanisms to allow private banks to lend to LGUs without IRA deposits. These reforms are being pursued in the ongoing Philippines Development Forum (PDF) Working Group on Decentralization and Local Government.

8. The Bank has actively supported local government finance reforms in the Philippines since the mid-1980s when it initiated a series of Municipal Development Projects (Loans 2435, 3146 and 3455)[3]. A review of the MDPs conducted by IEG in 1997 concluded that these operations had succeeded in triggering a reform process in their local government units that led to improvements in fiscal performance (viewed as essential for better management), and resulted in tangible impacts from MDP funding of sub-projects. IEGs findings led to the design of several new initiatives including two sub-national lending facilities with two GFIs (LBP and DBP) aimed at expanding access to middle and upper tier LGUs that were not eligible to borrow from MDFO.

9. These GFI projects, namely Local Government Unit - Urban Water Supply Project (LGU-UWSP) and Water District Development Project (WDDP) were the first in a series of on lending facilities for LGUs. They played an important role in opening up GFI lending to LGUs. Since they were initiated, lending volumes have risen— from less than 5 Billion Pesos in 1997 to 54 billion in 2006. LGU-UWSP which was designed as an APL went on to the second phase before it was decided to discontinue the third phase in favor of an open menu project. The proposed RIG facility would enable DBP to improve access to financing for a broader range of local public services (including water supply systems that were the target of APL 3).

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[2] Borrowing Capacity is capped at 20% of total income.

[3] Developing Towns and Cities: Lessons from Brazil and the Philippines, IEG, 1999.

10. The proposal is consistent with the CAS strategic objectives of *improving the investment climate*. A specific outcome under this strategic objective is "*improved delivery and access to financial services*"—in underserved areas, and to a broad range of private and public clients, for various types of investments. With respect to LGUs, the CAS notes that in order to address weak capacity and limited access to affordable finance for LGUs, the Bank Group will facilitate access to additional sources of finance, such as commercial banks and sub-sovereign lending. The proposed project aims to support these CAS objectives.

2. Proposed objective(s)

The PDO of the RIG project is "*to stimulate integrative investment within regions by improving access to financing for local service providers*".

3. Preliminary description

The proposed RIG project is a USD 100 million lending facility targeted to the expansion of local public infrastructure and services. The primary clients of the project would be local government units (LGUs). Secondary clients would include i) private sector enterprises (PSEs) undertaking private investments or entering into public private partnerships with LGUs; and ii) public utilities or companies (such as water districts) that would serve one or more LGUs. While the project would not exclude any class of LGUs, it would focus on expanding access to finance for 3rd to 4th class LGUs which represent 47.5% of LGUs. Similarly, the project would focus on, but not be limited to, financing physically and economically integrative infrastructure. This effort to prioritize and target integrative investments would be supported through a TA/capacity building program offered to LSPs and an innovation fund to support the development and testing of new incentives and instruments for expanding access to finance (e.g., performance programs aimed at gradually reducing the reliance on IRA as collateral and strengthening the creditworthiness of LGUs). DBP has managed several World Bank projects that on-lend to LGUs, utilities and the private sector, and therefore has relevant project management experience including an appreciation of governance requirements related to financial management and procurement. Further strengthening of this capacity will be ensured in relevant operational manuals and monitoring systems.

The proposed project will have two components:

Component 1 –Support for Regional Infrastructure Investments. The project would improve access to financing for local governments, utilities and private sector entitities, to develop public infrastructure and services. As the project aims to prioritize investments that ensure physical and economic integration, it would support (i) high priority stand-alone investments, (ii) programmatic loans for inter-related investments within a single LGU and across multiple LGUs (e.g., metropolitan area sub-projects). Access to financing would be broadened through (i) direct loans to LGUs, (ii) direct loans to PPP projects of LGUs - not based on LGU credit, but rather on project revenues, (iii) direct loans to private firms developing public services for LGUs, (d) loans to private banks who may on-lending these funds to municipal projects and or firms doing business with LGU, and finally (e) public utilities.

Component 2 – Institutional Strengthening of Local Service Providers. In order to ensure that sub-projects financed under the loan are integrative and enhance inter- or intra-regional coordination, the RIG project would also offer technical assistance to its clients. Sub-components could include: (i) Support (grant funded) for planning and prioritization of local investments (capacity building) to potential borrowers including provinces, municipalities and cities including training and other capacity building for RDC members including DILG, NEDA, line agency staff, LGUs; (ii) Support (possibly grant funded) for sub-project design including feasibility studies, detailed engineering design and contracting arrangements

for public private partnerships; (iii) Support (loan or counterpart funded) for timely and effective project implementation including support to the Project Monitoring Office (PMO) and LSP Project Monitoring Units (PMUs), sub-project supervision, Monitoring and Evaluation (M&E), Environmental and Social Safeguards, and Governance and Anti-corruption plans (GACACP); and (iv) Support (grant funded) for innovation, including the design, pilot testing and establishment of incentive mechanisms and performance benchmarks.

4. Safeguard policies that might apply

The project will trigger the Environmental Assessment (OP/BP 4.01). It is likely to be a Category B project requiring Partial Assessment. DBP requires from its clients the submission of the necessary environmental safeguard documents as part of its minimum requirements for project proposals. Aside from having an Environmental Unit, its regular project staff have developed sufficient capacity to review environmental documents for individual projects. This capacity has been proven in the implementation of World Bank projects such as the Local Government Unit - Urban Water Supply Project (LGU UWSP) and the Rural Power Project (RPP). DBP is an ISO 14000 certified entity for its successful establishment and implementation of an Environmental Management System. The recognition covers its banking, lending and investment activities. The project is also likely to trigger Involuntary Resettlement (OP/BP 4.12). DBP also requires from its clients the necessary social safeguard documents as part of its minimum requirements for project proposals. Its staff have applied these procedures to several recent projects, and have received WB safeguards training to upgrade their skills.

5. Tentative financing

Source:		($m.)
Borrower		0??
International Bank for Reconstruction and Development		100
	Total	100

6. Contact point

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