A CRITIQUE ON CREDIT FINANCE FOR LOCAL GOVERNMENT UNITS

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In our national search for economic growth, local government units (LGUs) are authorized by law to engage in a financing-gap strategy through credit finance. The intention is to entice local government units to formulate a "local development plan and public investment program"(section 296a LGC, 1991). This thrust also aims to "stabilize local finances" of government units (section 296b LGC, 1991). Thus, credit financing should complement the move of LGUs to become self-reliant and support the efficient and effective delivery of their basic services and facilities.

The grant of local autonomy to the LGUs is spelled out in Section 17(b) of the 1991 Local Government Code (LGC). LGUs are guaranteed "relative freedom from central government control over local affairs and concerns" (Tinagan, 1994:9). It is probably this provision which invited Benjamin E. Diokno to declare that the Local Government Code signed into law by former President Corazon C. Aquino has "decentralized decision making and reduced the scope of state intervention"(Diokno,1994:1).

One systematic approach to enhancing economic growth at the local level is studied by Gilberto M. Llanto (1994) in "Credit Finance for Local Government Units: Some Issues and Concerns." Llanto analyzes the impact of "local issues on the design implementation and financing of projects which have some bearing into the availability and forms of financing for local projects." Although the study offers new insights into local governance and local autonomy, it is micro in perspective. It does not account for larger issues which have far-reaching implications on credit finance for LGUs, on revenue-producing projects, and on the domestic and external debts of the nation.

The present critique, tackles the larger issues left out of the analysis of Llanto. Parallel to the perspective of the Llanto paper, I will address the impact of the state's major economic policies such as "deficit spending" and "floating rate" on local credit finance, and the possible connection of the latter to the domestic and external debt of the country as well as to the purchasing power of the people. The discussion will also make reference to Diokno's jubilant declaration. In my view, these critical issues must be resolved before going into the micro problem of local credit funding.

First, a few questions: Under what economic policies do the credit financing for local government units and income-generating projects operate? Will the economic policies of deficit spending and floating rate support local revenue generating projects? Is credit financing for local government units so well thought out as to avert future increases of domestic borrowings and external debts of the national government? Will this credit financing scheme alleviate the chronic inflation which has eaten up the purchasing power of the general Philippine population? In reference to Benjamin Diokno's pronouncement, does the national government indeed freely allow the LGUs to deliver basic services and facilities?

Credit Financing

Prof. Llanto's paper puts in perspective the opportunities for credit financing of local government units prescribed in Title IV of Book II of the 1991 Local Government Code. Llanto holds that local government units can work with private sectors in developing needed investments to attract investors to schemes like build-operate-transfer, loans, credits, and other forms of indebtedness. Therefore LGUs can fund projects through cost recovery techniques (Llanto, 1994: 12).

But for the LGUs to avail of credit financing, they have to establish fiscal credibility, strengthen their capability to make strategic plans, conduct feasibility studies that will determine viability of the project, or explore and develop revenue-producing projects for funding under borrowing. The projects funded have to ensure a "sound Internal Rate of Return (IRR); a reasonable annual cash flow; programmed annual depreciation; and balance sheet processes of fiscal management" (LGC). Because local chief executives are confronted with frequent elections, Llanto suggests a development of a "professional cadre of local bureaucrats who would implement local projects and maintain the project beyond its project life"(Llanto, 1994:9)

The paper further points out that local LGUs have a variety of financing options to fund their "socially beneficial public goods and services"(Llanto, 1994: 12). Hence, the challenge that is before the local chief executives is to tighten their linkages with NGOs and POs and their strategic allies — the *Sanggunian* members, so that the expanded authorities and responsibilities granted them by devolution will offer exciting new opportunities for them to service their constituents.

Keynesian Spending in Local Economy

For decades, local government units have been dependent on the National Government for projects, beholden to Congressmen for a share of "pork barrel" funds. The politics of patronage has defined the character and nature of local governance in the Philippines. But with the opening to them of credit financing, local government units can now enter into deficit spending. For the first time, local economies will be within the framework of Keynesian economics, which has long been used by the national government.

Keynesian economics asserts that to hit a targeted economic growth rate, governments must use deficit spending to stimulate effective aggregate demand. Deficit spending is encouraged to fund infrastructure projects, and livelihood and other revenue-generating endeavors that will create employment opportunities. Deficit spending is necessary when the private sector does not invest in areas perceived to be high risks.

Credit financing for local government units is a Keynesian attempt to "pump-prime" the economy with investments to generate employment opportunities at the local level. The goal is to induce people to consume through employment. This strategy is not necessarily bad, for we aspire to economic boom. The problem, however, is that capital stimulation through credit finance for local governments is to be activated in a situation where the Philippine economy is suffering from inflation, at an average rate of 30%.

Pump-priming assumes that the economy is experiencing a tight money situation, which occurs only in economic depression. Keynes formulated his theory in an effort to resolve the American depression in 1929. Historically, Keynesian economics is inflationary. It has sometimes snowballed creeping inflation into an economic disaster characterized by recession, depreciation of purchasing power, and mass unemployment in capitalist societies. Given this reality, can we expect deficit spending through credit financing for local government units to worsen or to minimize the inflation problem, which has already eaten away at the purchasing power of the peso?

Market Economy

The market economy is the macro-framework within which the local economy works. Although local finance is understood in the context of the free market, the effects of this paradigm on local finance and local projects are not critically examined by Llanto. In his article, Prof. Llanto calls for a liberal implementation of loans, credits, and other forms of indebtedness of local government units. "Tax exemption of local securities as a source of local financing in the United States (where the market is enormous)" is pointed out as also crucial to the success of developing the local government securities market in the Philippines (Llanto, 1994:6).

But the suggestion to replicate the U.S. financing scheme for local government in the Philippines is substantially flawed. In the first place, the currency of the United States is relatively stable; unlike the weak Philippine currency it cannot be seriously affected by market forces. It should also be pointed out that the market economy of the United States has been recession-ridden. These features assure us that a market model evolved from the American economic experience is inapplicable to the Philippine situation.

In the second place, the issuance of tax exemption on interest income from local securities is part of the overall economic paradigm of the United States. This is "Reaganomics" — the process attacks the supply side of the economy. The U.S. economic planners have adopted tax exemption on interest income, for they want to see the impact of lower taxes on the economic growth rate. The perception is that individual income no longer taxed away will be invested in consumption to increase production.

However, if taxes are reduced, revenues are correspondingly lowered. Therefore, economic growth will decrease if the private sector will not invest in areas that can no longer be funded by (local) government funds. The Philippine government cannot afford this scheme because its National Treasury is cash-strapped. Here, in fact, to make up for gaps in revenue which may have been partly caused by tax exemptions on income, indirect taxes are often imposed on goods and services. This process makes Philippine taxation regressive as evidenced by the predominance of taxes on domestic goods from 1985 to 1990 (Alms et. al., 1992:10). The importation of an economic liberalization from the United States that has not been well thought out will foreclose our future.

The market economy characterized by economic liberalization is based on the thinking of Milton Friedman. In theory and in practice, Friedman's economic formulation is not congruent with Keynesian economics. While Keynesian economics calls for a planned economy, Friedman's economics demands the "remov(al) (of) the system of fixed exchange rates altogether to simply allow the external value of a currency to be determined from day-to-day by market transactions" (Lichauco, 1988:193). Essentially, this formulation is at the heart of floating rate, where currencies are allowed to depreciate in accordance with the dictates of market forces.

Early last year Senate President Edgardo Angara stated that the peso should float as high as P35.00 to $1.00. But this floating behavior would endanger local income-generating projects and local credit. For example, if a project is estimated to be viable at P5-million by a project feasibility study at an exchange rate of $1:P25, but when the project is about to be funded the peso is floated at $1:P35, then the new cost of the project will increase by 40%. From a viable cost of P5-million the price will escalate to P7-million. As a result the project is either aborted or a greatly increased risk of at P7-million is taken. Either way, the floating rate has undermined the project.

Philippine history is replete with projects undermined by the floating rate. Among these are projects initiated by the Iligan Integrated Steel Mill (IISMI), the Elizalde Steel Rolling Mills (ESRM), and the expansion programs of United Laboratories, Inc. and

Mercury Drug (Lichauco,1988:196-198). The floating rate policy of the government weakened IISMI's project to construct a blast furnace that would convert raw iron ore into primary steel. Lichauco noted that at the time of the study, the project was viable at an exchange rate of P3.90 to $1.00. The rate jumped to P6.00 to $1.00 as the project was about to be funded. The ESRM, which was to be operational by 1972 to manufacture blooms, slabs, and plates for building ships and cars, was subverted when "the floating rate increased the total cost of the project by 50%, from P400 million at the old exchange rate to P600 million" (Lichauco, 1988:77). If the floating rate undermined such well-experienced and highly-motivated industrial companies, might we not safely assert that the same floating rate will subvert credit financing of the LGUs, thereby increasing the Philippine debt?

Credit Finance for LGUs and Philippine Debt

As pointed out earlier, credit finance for local government units is a new development. For the first time the national government has authorized local government units to fund services and facilities through loans. The local government units, of course, must provide collateral for the loans they secure from private commercial banks or from other local government units. With failure to pay these debts upon maturity, the collaterals may be sold at public auction in favor of the banks. At the same time, these borrowings are guaranteed by the state. Any remaining indebtedness automatically becomes the debt burden of the national government. Hence, domestic debts of the state will surely grow. Former Secretary Carague reported that domestic borrowing in 1986 was P100 billion. In 1986, this went up to P400 billion (Arroyo,1993:3). These domestic debts were incured to cover the government's deficit spending.

Deficit spending has produced continuous inflation, as evidenced by a quantum leap of the Consumer Price Index since 1978. The floating rate, at the same time, has devalued the peso endlessly. From P2.00 to $1.00 in the 1950's, it jumped to P27.00 to $1.00 in 1994. Inflation and/or devaluation of the peso has triggered another problem, the escalation of Philippine foreign debt even without additional borrowing (NMCL Bulletin,1992:1).

> "Assuming our foreign debt is $27.8 B, our debt burden will increase by P278 M for every centavo devaluation of the peso. In terms of export, we must export P278 M more worth of goods to pay the old amount in dollars to cover P0.01 devaluation"(NMCL Bulletin,1992:1).

Because of import liberalization and emphasis on an export-oriented economy, the Philippines has remained a predominantly agricultural country. In the process of trade, the Philippines exports its cheap agricultural products, to receive in exchange, expensive industrial and manufactured goods. The net result: trade deficit. From 1975 to 1991, the International Trade Statistics Yearbook of the United Nations revealed an uninterrupted communities, are not included in his paper as among the other important issues that local chief executives will have to confront. Governors and mayors are not elevated to become conscious of planning that is rooted in the principle of "think global, act local."

Deficit spending and the floating rate are major economic policies of the state through which the national economy operates. As local economies are components of the national economy, then credit financing for local government units and local projects are affected by these policies. The weight of these national policies on local economics is enormous, and the effects of these policies to undermine local public finance and income-generating projects are overwhelming.

Since local credit requires collateral and guarantees by the state, deficit spending, in effect, mortgages the future, and domestic debt will increase if the LGUs cannot pay their debts. The floating rate, which can effectively undermine local projects, could "foreclose our tomorrows"(Public Ledger, 1992:1).

The impact of deficit spending and the floating rate on local credit finance could lead us to additional problems. Deficit spending is inflationary, but the floating rate could increase local debt even without additional borrowing. Furthermore, with purchasing power diminished by inflation, the floating rate could help deteriorate the people's ability to buy when the peso is devalued. Therefore, local consumption is reduced and production lowered. These problems must be made known to local chief executives as they consider credit financing to fund their projects.

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