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Improving the Financial Management of Local Economic Enterprises

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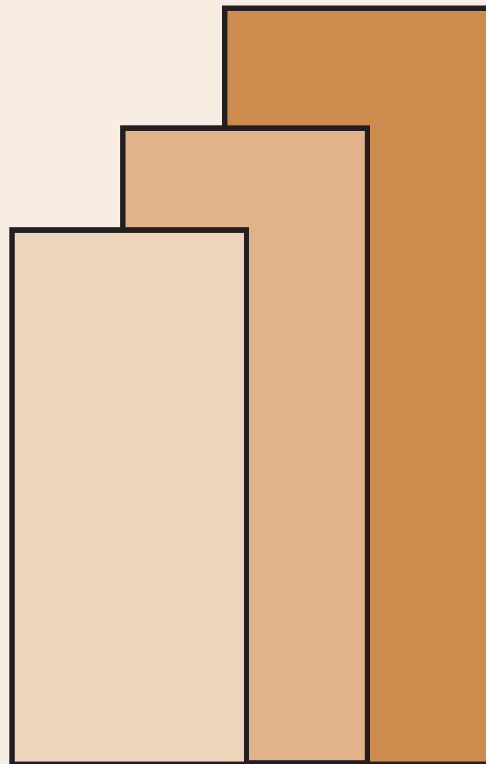

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IMPROVING THE FINANCIAL MANAGEMENT OF LOCAL ECONOMIC ENTERPRISES

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ABSTRACT

Although LEEs are meant to be self-sustaining, if not revenue-generating units, many of them actually incur losses on a continuing basis. Current practice in many LGUs does not engender a clear appreciation of the true cost of the local economic enterprise. COA has documented many cases where the operation of LGU economic enterprises was not treated as special accounts in the General Fund contrary to the provisions of the Local Government Code (LGC) of 1991. The less than transparent reporting of the actual financial condition and profitability of these enterprises may have some adverse effect on decisions taken by LGU officials. On the one hand, economic enterprises are oftentimes used as the vehicle for charging casual employees who are utilized elsewhere in the LGU system so as to circumvent the 45%-55% limitations on personal services (PS) expenditures of LGUs. On the other hand, part of the cost of LEE operation and management is sometimes charged under other offices in the LGU. Overall, the less than business-like approach to local enterprise management has resulted in large arrearages and low collection efficiency.

Key words: economic enterprise, state-owned enterprise, public enterprise, alternative service delivery modes, government budgeting, one-fund principle, cost recovery

1. INTRODUCTION

Local economic enterprises (LEEs) may include public markets, slaughter houses, hospitals, public cemeteries, parking areas, sports, recreational and cultural facilities, public utilities such as water and power supply and distribution and telecommunications, garbage collection and disposal, and public transport and terminal services, among others.

Earlier studies (e.g., Pardo and Zipagan 2008, Manasan 2003) have pointed out that although LEEs are meant to be self-sustaining, if not revenue-generating units, many of them actually incur losses on a continuing basis. Current practice in many LGUs does not engender a clear appreciation of the true cost of the local economic enterprise. COA has documented many cases where the operation of LGU economic enterprises was not treated as special accounts in the General Fund contrary to the provisions of the Local Government Code (LGC) of 1991. The less than transparent reporting of the actual financial condition and profitability of these enterprises may have some adverse effect on decisions taken by LGU officials. On the one hand, economic enterprises are oftentimes used as the vehicle for charging casual employees who are utilized elsewhere in the LGU system so as to circumvent the 45%-55% limitations on personal services (PS) expenditures of LGUs. On the other hand, part of the cost of LEE operation and management is sometimes charged under other offices in the LGU. Overall, the less than business-like approach to local enterprise management has resulted in large arrearages and low collection efficiency.

Objective of the study. The objective of the study is to review and assess existing financial management and budgeting systems of LEEs with the end in view of providing inputs towards the improvement of existing guidelines and guidance on the financial management of LEEs.

In the conduct of this study, a survey questionnaire was sent out by the study team in collaboration with Regional Operations Coordination Service (ROCS) and all the Regional Offices of the Department of Budget and Management (DBM) in the second quarter of 2008 on the types of LEEs operated by LGUs and the results of operation of these LEEs. The response rate was 28% provinces (23 out of 81), 58% for cities (79 out 136) and 40% for municipalities (593 out of 1495).

As part of this study, field visits to 25 LGUs were also undertaken during which LGU officials were interviewed. These LGUs include the following: the provinces of La Union, Leyte, Iloilo, Guimaras, Davao del Norte, and Agusan del Sur; the cities of Quezon, San Jose del Monte, Tagaytay, Tacloban, Iloilo, Butuan, Surigao, Bayugan, Tagum and San Fernando (La Union); and the municipalities of Bauang and Caba in La Union, Asuncion and Sto. Tomas in Davao del Norte, Basey in Samar, Palo in Leyte, Sta. Barbara in Iloilo, Tubay in Agusan del Norte and Trento in Agusan del Sur. In addition, many other LGUs attended the consultation workshop in November 2008.

In addition, a desk review of relevant legislation, manuals and regulations governing LEE operation and COA Annual Audit Reports for various cities and provinces for the years 2005-2007 was also undertaken.

2. LOCAL ECONOMIC ENTERPRISE SITUATIONER

2.1. Increasing Number of LEEs

Because there is no baseline information on the total number of LEEs as of any given reference year it is difficult to categorically say that there is a big increase in the total number of LEEs today compared to say, the pre-Code period. However, there are indications that this is in fact the case. First, the character of LEEs appears to have evolved over the years. From traditional LEEs providing municipal services like markets, slaughterhouses, cemeteries and water services, today's LEEs include enterprises that produce goods and services that are more in the realm of private goods (i.e., good and services which are normally provided by the private sector) like shopping malls, buildings for lease, hotels and recreational facilities.[1] Many of the newer LEEs (like state-of-the-art hotels, asphalt batching plants and tomato processing plants) involve more complex operations than the more traditional ones.

Markets and slaughterhouses are still the most popular forms of LEEs at present. For instance, 100% of cities and 93% of the municipalities who responded to the LEE survey operate markets while 95% of cities and 71% of municipalities operate slaughterhouses in 2007 (**Table 1**). On the other hand, 54% of cities and 44% of municipalities operate cemeteries while 11% of cities and 36% of municipalities operate water utilities.

However, a sizable number of LGUs operate the more non-traditional types of LEEs. For example, 34% of cities operate public transport terminals, 23% operate garbage collection and disposal facilities, 18% operate parking lots, 14% operate cultural/ sports/ recreational centers, and 9% operate hotels. On the other hand, 17% of municipalities operate garbage collection and disposal facilities, 12% operate parking lots, 10% operate public transport terminals and 4% operate cultural/ sports/ recreational centers.

[1] More formally, in economics, private goods (as opposed to public goods) are defined as goods which exhibit two properties: "rivalness" in consumption and "excludability." A good is said to be characterized by rivalness in consumption if an individual's consumption of the good necessarily results in a reduction in the supply of that good that is available for the consumption of other individuals. On the other hand, a good is to be non-excludable if the provision of the good to one individual will automatically make it available to other individuals. In more practical terms, excludability means that it is possible/ feasible for producers to charge a price for the good so as to prevent those individuals who are not willing to pay the price from consuming/ enjoying the benefits of the said good.

Table 1. Proportion of LGUs (as % of total number who responded to survey) operating LEE, by type of LEE, 2007 *a/*

Type of LEE	Provinces	Cities	Munis
Water utilities	0	11	36
Garbage collection/ disposal	0	23	17
Telephone	0	3	2
Electric/ power utility	0	3	2
Public transport terminal	4	34	10
Other utilities, not elsewhere classified	4	18	9
Markets	0	100	93
Slaughterhouses	0	95	71
Cemeteries	0	54	44
Commercial center	0	1	0
Cultural/ sports/ recreational centers	13	14	4
Parking lots	4	18	12
Hotels	0	9	1
Hospitals	48	16	3
Tertiary schools	4	9	3
Other LEEs, not elsewhere classified	104	35	39

a/ multiple answers allowed

Source of basic data: LEE survey

Some cities and municipalities have also ventured into managing their hospitals and special/ tertiary schools as LEEs. For instance, 16% of cities and 3% of municipalities operate hospitals while 9% of cities and 3% of municipalities operate special/ tertiary schools. On the other hand, 48% of provinces run their hospitals as LEEs while 13% of provinces operate cultural/ sports/ recreational facilities.

More significantly, a big number of LGUs operate LEEs that belong to the "others, not elsewhere classified" category despite the care taken during the formulation of the questionnaire to include, in the list from which respondents are asked to tick off the type of LEE they operate, many of the newer LEEs. To wit, 35% of cities, 39% of municipalities and 104% of provinces operate LEEs in the said category.

Second, many LGUs are operating multiple number of LEEs at present. On the average, cities operate more than four LEEs each while municipalities operate more than three LEEs each in 2007. On the other hand, provinces operate around 2 LEEs each on the average in the same year.

2.2. What Drives the Trend Towards Greater Number of LEEs?

Key informant interviews undertaken as part of this study suggest that there are primarily three reasons why LGUs create and operate LEEs. First, LGUs are looking for more diversified sources of local revenue. LEEs promise to be one such source. In particular, LEE income account for 11%-12% of total own-source revenue of all LGUs in the aggregate and around 4% of their total income in 2005-2007 (**Table 2**). Income from LEEs contributes a significantly larger portion of the total own-source income of provinces (20%-24%) and municipalities (19%-20%) relative to that of cities (8%) in

2005-2007 perhaps because the own-source revenue base of provinces and municipalities are more limited than that of cities. In contrast, the contribution of LEE income to total income from all sources is less invariant with the level of government. Income from LEEs accounts for 3%-4% of total LGU income of all provinces combined, 4% of total LGU income of all cities as a group and 4% of total LGU income of all municipalities in the aggregate in 2005-2007.

Table 2. LGU Income from Local Economic Enterprises, 2005-2007

	2005		2006		2007	
	million pesos	%	million pesos	%	million pesos	%
Provinces						
Income from LEEs	1,495		1,602		2,066	
Total own-source income	7,414	20.2 a/	7,663	20.9 a/	8,456	24.4 a/
Total income	45,515	3.3 b/	51,535	3.1 b/	52,611	3.9 b/
Cities						
Income from LEEs	3,472		4,012		4,406	
Total own-source income	45,633	7.6 a/	52,367	7.7 a/	53,854	8.2 a/
Total income	83,349	4.2 b/	95,660	4.2 b/	100,747	4.4 b/
Municipalities						
Income from LEEs	2,765		2,957		3,197	
Total own-source income	14,155	19.5 a/	15,378	19.2 a/	16,411	19.5 a/
Total income	69,064	4.0 b/	78,638	3.8 b/	82,018	3.9 b/
All LGUs						
Income from LEEs	7,733		8,570		9,669	
Total own-source income	67,202	11.5 a/	75,408	11.4 a/	78,721	12.3 a/
Total income	197,927	3.9 b/	225,833	3.8 b/	235,376	4.1 b/

a/ LEE income as % of total own-source revenue

b/ LEE income as % of total income

Source: LGU Statement of Income and Expenditures, BLGF

Unfortunately, many LGUs continue to extol their LEEs for their contribution to LGU coffers in terms of gross receipts even as they turn a blind eye on the net losses that the very same LEEs generate year after year, a point we will go back to later in this report.

Second, some LGU officials interviewed during the field visits said that LEEs are desirable because of the need for the LGU to have "catalytic" investments in order to generate greater local economic development. In line with this, they argue that local governments should invest and operate economic enterprises because private sector investment is not forthcoming and because said investments will give the necessarily push to generate more private sector investments in allied areas.

Needless to say, the direction where LGUs lean on this issue depends on the orientation of LGU officials on the appropriate role of government in local economic development. Put differently, it depends on whether LGU officials believe (i) in having an activist/ interventionist government, or (ii) in having a market-oriented government. While the first group argues in favor of a more aggressive stance in the creation of LEEs on the grounds of "crowding in" or stimulating the increased flow of private sector investments, the second group raises the question; "does government have any business being in business?"

Third, some LGUs appear to operate certain activities as LEEs for a number of dysfunctional reasons. On the one hand, many LGUs officials very candidly say that they put up LEEs because they have difficulty complying with the personal services (PS) expenditure cap in the Local Government Code. Note that Section 325 (a) of the LGC provides that the total appropriations for personal services of an LGU for one fiscal year shall not exceed 45% in the case of first to third class provinces, cities, and municipalities, and 55% in the case of fourth class or lower, of the total annual income from regular sources realized in the next preceding fiscal year but the allowances of officials and employees of public utilities and economic enterprises owned, operated and maintained by the LGU shall not be included the computation of the maximum allowable amount for personal services. On the other hand, some LGUs officials apparently establish certain activities as LEEs because of the perception that doing so allows them increased flexibility in the grant of allowances to employees of the LEEs.

2.3. Many LEEs Incur Losses Year after Year

Eighty-nine percent of provinces, 58% of cities and 56% of municipalities posted net losses on their aggregate LEE operations in 2006 (**Table 3**). Although there was some improvement in net results of operations of LEEs operated by provinces in 2007, there was a movement in the opposite direction in the case of LEEs operated by cities. Thus, the net result of aggregate LEE operations was negative in 77% of provinces, 63% of cities and 56% of municipalities in 2007. At the same time, the projections for 2008 show that LGUs are not expecting the financial positions of their LEEs to be very much different from that in the previous year. In other words, the data suggests that LGUs expect their LEEs will continue to operate in negative territory in the future.

In the aggregate, the net result of operations of LEEs of all LGUs combined was negative in 2006-2007. The aggregate net loss from LEE operations was PhP 0.9 billion – PhP 1.1 billion for provinces, PhP 9.6 billion - PhP 10.8 billion for cities and PhP 1.3 billion - PhP 1.5 billion for municipalities in 2006-2007 (**Table 3**).

On the average, gross receipts from LEEs cover less than a third of the total cost of their operations. For instance, gross receipts from LEEs accounted for 14%-15% of the total LEE expenditures of the cities that posted net losses in their aggregate LEE operation in 2006-2008 (**Table 3**). The corresponding figures for provinces and municipalities were 30%-33% and 32%-36%, respectively.

Table 3. Results of operation of LEEs, 2006-2008

	2006 actual	2007 actual	2008 projected
Provinces			
% of LEEs posting net loss	89	77	75
Net profit (loss) of LEEs in the aggregate (in mill pesos)	(931)	(1,071)	(1,384)
Gross receipts as % of total expd of lossing LEEs	30	33	33
Gross receipts as % of total expd of profitable LEEs	272	113	248
Cities			
% of LEEs posting net loss	58	63	64
Net profit (loss) of LEEs in the aggregate (in mill pesos)	(9,582)	(10,881)	(13,068)
Gross receipts as % of total expd of lossing LEEs	14	15	14
Gross receipts as % of total expd of profitable LEEs	138	144	156
Municipalities			
% of LEEs posting net loss	56	56	47
Net profit (loss) of LEEs in the aggregate (in mill pesos)	(1,265)	(1,482)	(1,380)
Gross receipts as % of total expd of lossing LEEs	36	34	32
Gross receipts as % of total expd of profitable LEEs	136	137	139

Source of basic data: LEE survey

Based on the detailed information provided in the LEE survey, hospitals and heavy equipment motor pools operated by LGUs as LEEs were unprofitable with no exception. Tertiary schools also had a high likelihood (86%) of posting net losses (**Table 4**). In contrast, water systems tended to have 60% probability of being profitable. On the other hand, the likelihood that public markets, slaughterhouses and cemeteries will be profitable is less than 50%.

Table 4. Percentage of LEEs posting net losses, by type LEE, 2007

All LGUs combined	
Markets	53
Slaughterhouses	56
Cemeteries	55
Water system	40
Heavy Equipment/ Motorpool	100
Hospitals	100
Tertiary schools	86

Source of basic data: LEE survey and COA Annual Audit Reports, 2007

Based on the key informant interviews conducted for this study, the reasons for LEE losses are attributable to a number of factors. First, LGUs have generally shown weak institutional support towards the operations of their LEEs. At times, the needed policy support for the successful operation of an LEE appears to have been overlooked. For instance, in one LGU, the public transport terminal failed because of the ordinance mandating the re-routing of public transport vehicles was not passed. Also, there were a number of cases where the infrastructure support (e.g., rehabilitation/ construction of

access road) to a commercial facility was not put in place thereby resulting in low business traffic for the LEE. Moreover, many Sanggunians have shown a reluctance to pass an ordinance that will set LEE rentals/ tariffs at appropriate levels.

At the same time, the technical capability, first, in assessing feasibility studies of LEEs and, subsequently, in tariff setting, collection and overall LEE management appears to be weak in many LGUs. For example, in one of the LGUs visited for this study, LGU officials reported that the demand for slaughterhouse services projected in the feasibility study was as large as the total demand for the entire province despite the fact that there were already existing slaughterhouses in other LGUs in the province.

Second, as a direct result of both the weak policy support and the inadequacies in the technical know-how on LEE operations, the tariffs or user charges charged by LGUs for the good and services provided by their LEEs appear to be low relative to the cost of providing said goods and services. Third, many LEEs also tend to have poor collection efficiency.

2.4. Increasing Financial Risks Assumed by LGUs and LEEs

Gross borrowings of all LGUs as group grew at a rate of 20% yearly on the average from PhP 4.2 billion in 2002 to PhP 10.3 billion in 2007 (**Table 5**). This rapid growth in gross borrowings necessarily resulted in increasing LGU indebtedness. Thus, outstanding debt of all LGUs combined nearly doubled from PhP 24.1 billion in 2002 to PhP 45.8 billion in 2007. The debt stock of municipalities grew fastest, with the debt stock of provincial governments coming in a close second.

Table 5. Gross borrowings and outstanding long-term liabilities of all LGUs, 2002-2007 (in billion pesos)

	2002	2003	2004	2005	2006	2007	% increase 2002-2007
Gross borrowings	4.2	5.6	6.9	6.7	8.2	10.3	145.3
Provinces	1.5	1.8	1.7	1.4	2.9	2.3	57.9
Cities	1.8	2.0	4.0	3.7	2.9	5.5	200.2
Municipalities	0.9	1.9	1.1	1.6	2.4	2.5	177.3
Outstanding long-term liabilities	24.1	28.2	31.8	37.8	36.8	45.8	90.2
Provinces	5.0	6.7	7.2	7.5	9.4	10.5	110.1
Cities	14.3	14.8	17.5	21.8	17.0	24.1	67.9
Municipalities	4.8	6.7	7.2	8.6	10.4	11.3	136.1
Gross borrowing as % of GDP	0.11	0.13	0.14	0.12	0.14	0.16	
Outstanding LT liabilities as % of GDP	0.62	0.65	0.65	0.70	0.61	0.69	

Source: COA LGU Annual Financial Report, various years

Although there is no systematic information on what part of LGUs' borrowings were used to finance LEE-related investments, a perusal of COA Annual Audit Reports in recent years suggests that a significant chunk of LGU debt are indeed used for LEEs. The examples provided below are by no means representative but they are presented here to illustrate and highlight the problem at hand.

Case study number 1. A province in the northern part of the country initially issued bonds worth PhP 205 million for the construction of a commercial complex (known as the "Mall" for short) in 2003. The Mall is a 3-story building located at the provincial capital's central business district. It is composed of commercial stalls and a department store. It was envisioned to be a major component of the provincial government's economic enterprise to generate additional revenues for the province while at the same time serving as venue for the promotion and marketing of the province's major products and industries (COA Annual Audit Report for the Province 2007).

The proceeds of the bond floatation was subsequently augmented by PhP 69.1 million from the General Fund and PhP 17.3 million from the interest income earned on deposits (Project Fund/Sinking Fund) in order to defray the total construction cost of the Mall which reached PhP 291.4 million. The Mall formally started its operation on June 1, 2006.

In April 30, 2006, the bonds were redeemed and the outstanding principal and interest of PhP 166.5 million was paid through the proceeds of a loan of the same amount from the Philippine Postal Savings Bank (PPSB). The buy-out scheme has a 5.25% interest payable in 7 years, and required a hold out deposit equivalent to the amount of the loan until it is fully paid.

When a new governor assumed office in 2007, the loan was transferred to the Land Bank of the Philippines, in August of that year, with an outstanding balance of PhP 141.0 with 4.25% interest and payable in 13 quarters or until the year 2010. The buy-out scheme also required a hold out deposit equivalent to the amount of the loan until it is fully paid, earning an interest based on the regular rate of savings deposit (COA Annual Audit Report for the Province 2007).

In the first half year of its operations, the Mall posted a net loss of PhP 2.4 million. However, it registered a net income of PhP 6.4 million for the full year of 2007. The COA estimates that from 2008 onwards the total amount to be recouped amounts to PhP 310.3 million, including the interest payments due in 2008-2010. If the yearly income of the Mall is pegged at its 2007 level, the COA then estimates that it will take the province 48 years, which is 32 years beyond the payback period of 12 years in the feasibility study and 18 years beyond the estimated useful life of the building of 30 years.

However, the COA notes that there are still unoccupied spaces which could add to the income of the Mall, including a function hall that could be rented out for seminars, weddings, meetings and the like. The COA estimates that the vacant spaces could earn additional rental income equal to PhP 4.0 million per year. Thus, if it is assumed that all

the stalls and the function room will be fully occupied from 2008 onwards, the payback period is estimated to be reduced to 30 years, still much higher than what is assumed in the feasibility study. Moreover, the internal rate of return is estimated to be 0.04% instead of the 24% that was shown in the feasibility study.

Furthermore, the COA noted that while the loan is not yet fully paid, hold out deposits equal to the total amount of the loan is held by the creditor bank. Although hold out deposits earn interest at the regular rate for savings deposit, the hold out deposits cannot be used for the implementation of projects which deprives the province's constituents of the benefits from said projects.

Case study number 2. A province in the southern part of Luzon borrowed PhP 238 million from the Land Bank of the Philippines (LBP) for the construction of a Port and Livelihood Center (called the PLC for short) in 2003. The PLC is located in the port area right in front of the fast craft terminal building. The establishment of the PLC was envisioned to enhance economic activity in the province and serve as a springboard for promotion and investment. It was also initiated to address the socio-economic problems brought about by the re-development of the port area wherein many illegal settlers were displaced.

The PLC is a two-storey commercial building with the central passenger terminal as the main feature of the complex. Retailing activity is envisioned to be the main function of this facility, with the small and medium entrepreneurs, especially the displaced settlers benefiting from this project. The rentals/fees for this economic enterprise are to be approved by the Provincial Economic Enterprises Board.

Although the construction of the building was completed in the June 2004, the project did not materialize as planned. The COA reports that none of the projections were realized except for nominal parking fees that were collected. The building and other equipment continue to depreciate. In 2007, landing and parking fee collections amounted to PhP 5.2 million. Interest expenses of PhP 19.3 million and other operating expenses totaling PhP 1.1 million were incurred, resulting in a net loss of PhP 15.3 million. In addition to this, the amortization of the loan amounting to PhP 14.8 million was paid to the Land Bank in 2007.

The COA, thus, puts forward the following opinion: "The objective of the provincial government in establishing the PLC is not attained for evident reasons:

- Poor planning. The feasibility study was haphazardly done, just to comply with LBP requirements. The PLC was built on a borrowed fund with LBP and the projected income is not realizable.
- Investors turned-off by the very onerous conditions.
- Marketing wise, packaging and promotion is weak. The PLC building lacked the necessary amenities to be taken seriously by investors.
- Lack of political will in containing the problem brought about by the stallholders comprised of the illegal settlers.

The new administration is proposing to reinvent/ reengineer the PLC from being a "white elephant" to being self-liquidating by:

- Negotiating for the restructuring of the province debt-obligation with LBP
- Considering the possibility of the PLC building as site of the following:
    - Shipping Lines
    - Call Center
    - Maritime School
    - Hotel
    - "Tiangge: Divisoria Style
    - Regional Offices
    - Combination of the above
- Inviting LBP to put up a branch office at the PLC building
- Repairing the PLC building.

Case study number 3. A Metro Manila city borrowed PhP 450 million in 1995 from the Development Bank of the Philippines (DBP) for the purchase of a lot and building in what used to be its premier financial district for the use of its city college. Subsequently, the city prepaid the balance of the DBP loan by taking out another loan from the Philippine National Bank (PNB) worth PhP 330 million in 2001.

The COA reports that the city government did not conduct a feasibility study prior to the acquisition of the building, contrary to sound management practice (COA Annual Audit Report for the City 2007). It further notes that this resulted in lack of adequate guidance in ascertaining the viability and economic sustainability of the project.

Moreover, it was found that only 6 floors are being used by the city college in 2007. The remaining floors, the 7th to 13th floors, were left vacant. The COA concludes that the vacant floors and spaces could have been developed for lease or rent in order to generate self-sustaining income to help defray the interest expense on the loan.

In addition to the loan for the acquisition of the building for the city college, the city also took out a loan worth PhP 239 million in 2003 and another one worth PhP 176 million in 2006 for the renovation of its public markets. However, the COA reports that all of city's local economic enterprises generated net losses in 2007.

Case study number 4. Another Metro Manila city issued bonds worth PhP 225 M in 2001 for the construction of a parking and commercial building complex. The operations of the commercial complex generated a total income of PhP 32.5 million in 2003-2007. However, the rental earnings did not sufficiently meet the city's bond flotation obligations which amounted to PhP 236 million for the same period. Given this, it is estimated that the commercial complex has to almost double its current rental income for it to be able to break even in its operations in the next 15 years assuming a 5% rate of interest.

This does not appear to be likely, however, given that 30 of the 51 stalls in the complex are not occupied in 2007. Some city officials attributed the vacancies to the allegedly

"excessive" rental rates that were set for the commercial complex. In fact, a reduction in the rental rates was being considered at the time of the audit (COA Annual Audit Report for the City 2007).

3. OUTSTANDING ISSUES

Given this perspective, the outstanding issues that impinge on the financial management of LEEs are examined more closely in this section. These issues include: (i) the need for a clear policy framework for the creation and continued operation of LEEs, (ii) the need for greater clarity in the treatment of LEEs in budgeting; and (iv) the need to strengthen LGU capacity in operating LEEs more efficiently.

3.1. Need for a Clear Policy Framework for the Creation and Continued Operation of LEEs

Central to arriving at a clear policy framework for the creation and continued operation of local economic enterprises is an unambiguous definition of term "economic enterprise." An appreciation of the rationale or "reason for being" of economic enterprises and the advantages of LEEs over other modalities of service delivery are also important inputs to this process.

The term "economic enterprise" is not well defined in the Philippines as we shall see below. Thus, it is useful to start by reviewing how the term is defined in the international literature. In this regard, it is notable that the closest concept to "economic enterprise" in the international literature is that of "state-owned enterprise" or SOE. In the following sub-section, we also review the theoretical and empirical underpinnings for the existence of state-owned enterprises.

Review of literature: What are SOEs? Why/ Why not SOEs? In the international literature, the term "state-owned enterprise" (also known as public enterprises, public sector enterprises, government business enterprises, parastatals, or government owned and/ or controlled corporations) is used to refer to government owned or government controlled economic entities that generate the bulk of their revenues from selling goods and services (e.g., Jones 1982, World Bank 1995). This definition emphasizes two distinct characteristics of SOEs, namely: the public dimension and the enterprise dimension. The enterprise dimension relates to government ownership, control and/ or management. On the other hand, the enterprise or "marketedness" dimension limits the application of the term to entities that produce marketable outputs (i.e., goods and services for which prices/ fees may be charged). The enterprise dimension implicitly relates to the achievement of some level of cost-recovery, if not profit-orientation, and the potential for the enterprise to earn a return on investment. In a more restricted sense, the enterprise dimension is sometimes used to refer to production entities that "operate according to commercial principles." Shirley (1989), however, clarifies that since many entities that have the potential to be financially viable may also have non-commercial objectives, sometimes with the latter dominating the commercial objectives, SOEs may have to be categorized

in terms of “their potential to earn a positive return as well as the way such enterprises commonly operate elsewhere.” In other words, the term public enterprise or SOE may refer to entities which have both social and commercial objectives.

Other analysts (e.g., Shirley 1989) use the term “state-owned enterprise” in a more limited sense by defining an “SOE as a publicly owned entity with a *separate legal personality* and separate accounts that earns the bulk of its revenue from the sale of its goods and services.” This definition thus adds a third dimension to the basic SOE definition by putting emphasis on SOEs having “separate legal personality” and implying that SOEs take the corporate form.

The economic justification for SOEs essentially says that public enterprises are a better alternative to their private sector counterpart (i) if they overcome market failures and (ii) if they are superior to regulatory alternatives (Shapiro and Globerman 2004). On the one hand, the argument for government ownership rests primarily on the potential of government of public enterprise ownership to correct the inefficiencies that arise from various types of market failures, e.g., natural monopoly, underdeveloped capital market, and externalities. First, it is argued that government ownership allows government to prevent a natural monopoly from setting prices so high that their products are no longer affordable to a wider segment of the community while at the same time avoiding the difficulties associated with the regulation of natural monopolies.[2] Second, private sector investors may be unwilling to invest in projects that have high returns in the long run but carry high risks in the short term because capital markets have an inherent bias towards short-term gains and do not like risky, large-scale projects with long gestation periods. Third, private sector investors may not have the incentive to invest in industries which benefit other industries without being paid for the service thus provided (Chang 2007).

On the other hand, the case against government ownership (through SOEs) recognizes market failure but argues that the risk of government failure may even be greater. Public ownership of the SOE implies that “no one has a clear stake in SOE returns, hence no one has the responsibility and motivation to set clear performance goals and assure they are attained. Instead, politicians, bureaucrats, employees, and other interest groups thrust upon SOEs multiple and often conflicting goals (e.g., profit maximization, employment maximization, and a host of other social objectives) while simultaneously imposing a bewildering and sometimes contradictory collection of constraints (e.g., restricting layoffs, price increases, and the choice of suppliers or markets). Multiple objectives and multiple constraints increase transaction costs, distort the incentives facing SOE managers and reduce managerial effort” (World Bank 1995).

However, government regulation involves contractual arrangements that are difficult to manage. For example, all contingencies and certain aspects of performance are difficult to define in advance. The contract negotiations and the legal disputes that sometimes occur as part of contract enforcement may involve substantial transactions costs (Chang 2007).

[2] Government ownership of many public utilities is often justified on this ground.

Many of the arguments in favor of SOEs are premised on the assumption that political markets are efficient.[3] However, some analysts (e.g., Boycko, Shleifer, and Vishny 1996) assert that "political intervention in public enterprises is likely, since politicians who manipulate SOE operations for political reasons receive all of the benefits of such interventions, but bear little of the direct (subsidies) or indirect (inefficiencies) costs." It is also argued "that it is more transparent and difficult for politicians to overtly subsidize private firms than to slant SOE operations so as to serve their political goals" (Shirley and Walsh 2000).

Thus, the choice between private and government ownership depends on the tradeoff between market failure, on one hand, and government failure, on the other. The World Bank (1995) notes that the empirical evidence show that private regulated firms tend to perform the same as or better than SOEs in most studies (Shirley and Walsh 2000)

3.1.1. Need for a greater clarity in the use of term "economic enterprise"

Both the Local Government Code and Manual on the New Government Accounting System (NGAS) for Local Government Units (COA 2002) do not provide an explicit definition of the term "economic enterprise". However, the NGAS Manual implicitly defines the term by way of enumerating the various types of public utilities and economic enterprises that LGUs operate and assigning each one a sub-code number (Section 108).

The Updated Budget Operations Manual or UBOM (DBM 2005) provides an explicit, if still ambiguous, definition of the term "economic enterprise." The UBOM says economic enterprises are "*income-generating* establishments created for the purpose of improving production & delivery of *basic goods and services* for a specified market or client group" while public utilities are "*revenue-raising* undertakings created for the purpose of providing a *basic need or service* to the general public which otherwise cannot be provided adequately by the private sector" (p. 188, FAQS-A).

This definition of an economic enterprise/ public utility in the UBOM is vague and may be interpreted to mean that any activity that delivers goods/ services <u>and</u> generates some income/ revenue should be classified as such. As a result, even income from traffic management is considered as LEE income by some LGUs.

Also, the "enterprise" dimension of public enterprise that we find in the international literature is not quite as evident in UBOM definition. First, the use of the phrase "the production and delivery of *basic goods and services*" may be interpreted to be a reference to the production and delivery of *public goods* instead of "*marketable goods and*

[3] In turn, the arguments against efficient political markets are coach in terms of the principal-agent problem between voters and politicians. On the one hand, voters are not well informed about the actions taken by politicians and the consequences of said actions because of information asymmetry. On the other hand, the incidence of the benefits of "good" policy tends to be widely dispersed while the incidence of losses tends to be more concentrated in a few. Thus, the potential beneficiaries tend to free ride on any effort to support the "good" policy but the potential losers have the incentive to work harder to defeat said policy. Moreover, elections are not good mechanisms for producing information on voter's preferences because they are held infrequently and are not constrained to deal with any specific issue (Shirley and Walsh 2000).

services." Second, the use of the qualifiers "income-generating" and "revenue-raising" falls short of saying that public utilities and economic enterprises receive the bulk of their revenues from selling their outputs.

The "enterprise" dimension of LEEs is also not obvious from the Local Economic Enterprise Codes and the ordinances creating LEEs that have been enacted by many LGUs. For example, the LEE code of a small city in Mindanao states:

> "Policy statement – It is the policy of the city government to be self-reliant and self-sustaining by engaging in viable and stable economic enterprises that provide a wide range of opportunities that will uplift the socio-economic well being of its constituents, improve fiscal management and enhance good governance."

Recommendation. The oversight agencies (DBM, DOF/ BLGF, DILG, NEDA) should adopt a common definition of the term "local economic enterprise" emphasizing enterprise dimension. In this regard, the definition of Jones (1982) and the World Bank (1995) may be adopted: *LEEs are local government owned economic entities that generate the bulk of their revenues from selling goods and services.*

3.1.2. Elements of New and Improved Policy Framework for LEEs

There is considerable ambiguity with regards to the intent for the creation of or "reason for being" of LEEs. The NGAS manual makes an oblique reference to enterprise nature of LEEs. It states that objective of maintaining special accounts in the General Fund for public utilities and economic enterprises is "to determine whether the income these entities generate is sufficient to meet their respective operating costs" (Section 106 of NGAS Manual).

The UBOM does provide a clearer articulation of the enterprise nature of LEEs. It states that "economic enterprises and public utilities shall be established after the conduct of a feasibility study showing proof of its *economic* and social *viability* in the long run" (UBOM, FAQS-A.2.2, p. 188). It also provides that "a business development plan shall be prepared (long-term, medium-term and annual plan) stating its mission or purpose, clients or beneficiaries, strategies, activities and projects, organization structure, financial plan or budget and *expected returns*" (UBOM, FAQS-A.2.3, p. 189). The UBOM says further: "After two years of operation, or as reflected in its business development plan, the *funding requirements of economic enterprises and public utilities shall be sourced from its operating income or user fees*" (UBOM, FAQS-A.2.8, p.189).

The UBOM further elaborates on the rationale *and* criteria for the establishment and operation of local economic enterprises and public utilities as follows:

- LEE satisfies both the economic and social objectives of the concerned LGU.
- It fills in service gaps not adequately provided by the private sector.
- It shall operate with a lean and mean staffing complement to satisfy the income objective of the economic enterprise/ public utility.
- It shall operate like a *corporate* body with a separate strategic plan and budget. (FAQS-A.2.4 p. 189).

The guidance on LEEs found in the LGC, the NGAS and the UBOM is generally consistent with conceptual framework found in the international literature. However, existing policy framework as best articulated in the UBOM appears to lean more towards the public ownership model. In this regard, two items appears to be missing: (i) guidance on what the different alternatives to the creation of LEEs are, and (ii) cautionary statement on potential government failures that may arise with the establishment and continued operation of LEEs.

As a result of the weaknesses in the LEE policy framework, the use of the term LEE is not actually limited in practice to activities that produce goods/ services that are not being provided by the private sector as FAQS – A.2.4 of the UBOM indicates (refer to **Section 2** above). In fact, many LEEs compete directly with private sector enterprises. On the other hand, while FAQS – A.2.8 seems to imply that LEEs should be self-sustaining with full recovery of at least their operating costs, in practice many LEEs are not deemed or have not been officially declared by concerned LGUs to attain some degree of cost recovery. Many LGUs report that their LEEs are established to address social objectives as well. And, in fact, many LEEs post net losses year after year as shown in **Section 2** above.

Also, there is a need for the UBOM to clarify what it means when it says that LEEs should operate like a corporate body. Admittedly, the corporate form is arguably effective in promoting more business-like behavior of public enterprises by providing their managers greater operational autonomy and flexibility to "manage for results." The corporate form is also said to help public enterprises mimic the corporate discipline available in private sector through the application of commercial principles in their operation. Furthermore, the corporate form may help in shielding the enterprise from political interference.

To date, there are only three chartered LEEs – the Pamantasan ng Lungsod ng Maynila, the Quezon City General Hospital, and the La Union Medical Center. These LEEs were created as corporations by Congressional legislation.

At present, there are outstanding legal issues pertaining to the use of the corporate form for LEEs when Congress is not inclined to pass a law creating one (**Box 1**). Because of this, most of the discussion that follows would concern itself with how to improve the policy framework for LEEs given the existing legal framework, i.e., one where the use of the corporate modality for LEEs is limited.

It is also worth emphasizing that good results are possible even if the LEE operates as an organic part of the LGU. There are many examples in this regard. Tagum City is one such example. In many of these good practice examples, the establishment of a dedicated to oversee LEE operations appears to promote good outcomes.

BOX 1. Can LGUs create corporations?

A number of LGUs (e.g., Misamis Oriental and Quezon City) have attempted to operate their LEEs by registering their LEEs as corporation with the Securities and Exchange Commission (SEC) under the Corporation Code. However, the Department of Interior and Local Government (DILG) in an opinion dated July 22, 1997 (as cited in Pardo and Zipagan 2008) asserts that an LGU, being a juridical person by virtue of it being a corporation itself, cannot be an incorporator of a private corporation. This opinion is based on the fact that Section 10 of the Corporation Code provides that: "Any number of natural persons not less than five but more than fifteen, all of legal age x x x may form a private corporation for any lawful purpose or purposes x x x."

On the other hand, the COA points out government corporations can only be created by Congress (Sec. 16 Art. XII of the Philippine Constitution). It also says that the LGC does not vest in the Sangguniang Bayan the power to create corporations (Supreme Court in Engr. Ranulfo Feliciano, Leyte Metropolitan Water District vs. COA, GR No. 147402, dated January 14, 2004).

In response to the aforementioned opinion of the COA, the Quezon City government maintains that the jurisprudence cited is not on all fours applicable to the case of the QC-Housing and Urban Renewal Authority (QC-HURA). It further asserts that only a competent court can declare a law/ ordinance unconstitutional.

In its rebuttal, the COA insists that the principle laid down by the Supreme Court (SC) Feliciano versus COA is applicable to QC-HURA where the SC clarified the Local Government Code did not delegate in the Sangguniang Bayan the authority to create corporations. Furthermore, the COA states:

> "While it is concurred that only competent courts can declare whether or not a law or ordinance is constitutional, the COA is not precluded in the exercise of its constitutional duty to review the propriety of the investment in question since it involves the disbursement of public funds. …. Considering that creation of QC-HURA is infirmed, consequently therefore, any investment made for the purpose has no leg to stand on."

Recommendations. Given this perspective, the need to establish a clearer and more comprehensive policy framework to govern the creation of new LEEs and continued operation of existing ones is critical. Many of the elements of the existing framework will still be part of the new framework but a number of new features will have to be put in place.

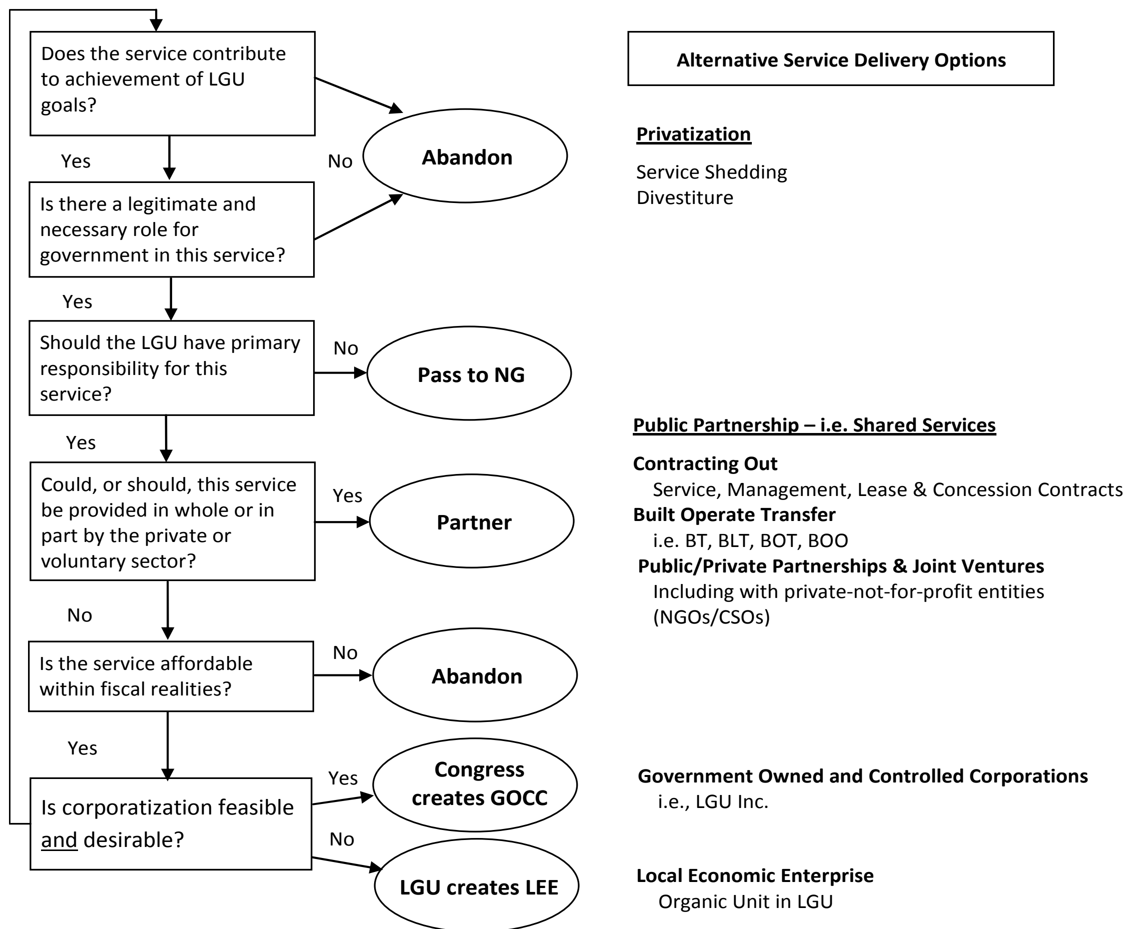
Basic principles

First, the new policy framework should be anchored on the basic principle that LGUs need to focus on their core functions. It should also be premised on the superiority of private-sector led development unless a strong case can be made for government intervention. The framework should thus establish guidelines when government provision of marketable output is justified.[4] These guidelines should take into account the tradeoffs between market failures and government failures as elaborated in the review of literature above.

[4] These guidelines may simply provide criteria that will assist LGUs decide whether it should be engaged in the direct provision of marketable goods/ service and may include either a positive list of what marketable goods/ services are appropriate or not appropriate for LGU provision.

The new policy framework should also recognize that some marketable goods/ services are better delivered by the government central[5] and that the LEE modality is but one of a number of alternative service delivery modes. The LGU decision making process with respect to the creation/ continued operation of LEEs under the new policy framework is illustrated graphically in **Figure 1**.

Figure 1. Graphical Presentation of LGU Decision Making Process Relative to Creation of LEEs



Adapted from: SEQUUS. 2003. "Developing the Public Economic Enterprise in the Philippines – The LGSP Way", Draft report submitted to the Local Government Support Program (LGSP), Canadian International Development Agency (CIDA).

[5] The assignment of expenditure responsibilities across levels of government is largely defined by the Local Government Code.

Thus, when an LGU is confronted with the need to decide whether to provide a given good/ service, the LGU should be advised to first check the alignment of said good/ service with its goals and core functions. Once the LGU deems it appropriate to provide a given service, it should then assess the suitability of the alternative service delivery modalities in the context of its own particular situation. Such an evaluation should take into account the financial risks, managerial problems and political realities that come into play against the inherent strengths and weaknesses of each of the various alternative service delivery modes.

Service delivery can be done either (i) through organizations external to the LGU like private sector enterprises and non-governmental organizations (NGOs) via various types of public-private partnerships arrangements like service contracts, management contracts, leases, concessions, and licenses or (ii) directly by the LGU either through an LEE or through a regular unit or office in the LGU. In other countries, public service delivery through external organizations is commonly used for public utilities and social services like education. The different public-private partnership modalities are discussed in some detail in **Box 2**.

Box 2. Alternative Service Delivery Modalities Using Private Enterprises/ NGOs

The alternative service delivery options using the private enterprise sector or non-government organizations differ in terms of how the contractual arrangements between the LGU and the private sector/ NGO are defined with respect to the following areas: (i) ownership of the assets, (ii) responsibility for capital investment, (iii) responsibility for operation and maintenance, (iii) relationship to the consumer/ citizens, (iv) regulation of user charges or tariffs, (v) receipt of operating revenue, (vi) sharing of financial risks, (vii) degree of LGU subsidy, and (viii) extent of monopoly rights.

Service contracts. The LGU may contract an external organization to delivery the service. The scope of this service contract can vary from a fairly limited one involving just part of the service to a more extensive one involving the entire service itself.

Under the service contract approach, the LGU continues to own the assets but the service contractor is responsible for the repair and maintenance of the assets and usually for the replacement of some equipment necessary for the delivery of the service. The operating income is controlled by the LGU and goes to its accounts. The contractor is simply paid for the service based on the agreed price. As an example, a service contract might be issued for the reading of water meters. The revenue collected from the water meters belongs to the LGU while the service contractor is paid based on the amount agreed in the service contract.

Management Contracts. The use of management contracts can take two forms: (i) without sharing of the service income or (ii) with sharing of the income received from the delivery of the service. If there is no sharing of income, the LGU maintains ownership of the assets and is responsible for investments in construction and other capital requirements. The LGU also sets the tariffs for the service, is directly responsible to the citizen for the service and assumes all financial risks. The operation and maintenance are met from the income received for the service and any operating surplus or deficit is the responsibility of the local government unit. The service contractor, on the other hand, is simply paid a fixed fee for the service. Therefore, under this option, the LGU bears all responsibilities and financial risk.

In contrast, the revenue received from the delivery of the service is shared between the LGU and service contractor under the income sharing option. While the LGU has the same responsibilities and risks as in the "no-income-sharing" approach, two additional features are generally present under the income sharing option. One, the service contractor usually has discretion to charge less (but not more) than the regulated tariffs. Two, the service contractor receives a fixed percentage share of the operating surplus on top of the fixed contract fee.

Box 2. Con't (2)

The income sharing option is usually considered for those activities that are not expected to need an operating subsidy from the LGU although it is also used in some cases for services that may collect fees or charges while also receiving a subsidy. The contractor might still receive some share of the operating surplus after the subsidy is received into the funds.

Leasing. The LGU may lease some of the assets it owns to a service provider in exchange for a rental price that the service provider will pay. The service provider is directly responsible to those consuming the service and not to the LGU. The service company thus bears all the financial risks associated with the operation of the service.

In this approach, the LGU still owns the assets and is responsible for the investment and debt service associated with the assets. The service provider is responsible for operation, repair and maintenance, and for replacement of short-life equipment. The service provider must return the assets to the LGU in good condition at the end of the lease period, less normal wear and tear on equipment.

The service contractor collects the operating income and meets the operating costs. In some cases, the LGU may regulate the tariffs for the service. The payment options for the service provider may take the following forms: (i) a straight rental price for the use of the asset, or (ii) a percentage share of the revenue, or (iii) both, a fixed fee for the asset use and a share of the income generated from the use of the asset.

Concessions. In a concession, a service contractor is given an exclusive right to provide a service for a fixed period of time, but has to invest capital in the constructing and providing the necessary infrastructure. The service contractor is responsible for all costs, including capital, repair, operation and maintenance, and is responsible to the consumers of the service. All the financial risks are borne by the service contractor. A concession may be useful for large scale infrastructure projects, such as public utilities, toll roads, and communication networks.

The competitive approach to awarding the concession is generally used and the concession award may require service levels and charges/tariff limits. Tariffs may be reviewed periodically and indexed to inflation or return on investment calculations. Essentially, tariffs and the period of the concession is calculated based on the recovery of operating costs, full amortization of the initial capital investment, and a reasonable rate of return on the investment. Thus, the period of the concession is generally for a long period of time, from 15 to 30 years. At the end of the concession, the assets become the property of the local government unit. A Build-Operate-Transfer (BOT) is a form of concession.

The financial arrangements may take several forms. The LGU may provide initial subsidy or funding for the undertaking of the investment. In this case, the LGU may have some claim to the operating income. The LGU may also pay a subsidy to the service contractor as a means of lowering the charges/tariffs to the public for the delivery of the service. This is often used for public transport service delivered by a service contractor under a concession arrangement.

Licensing. A service provider may be licensed to invest in and operate a service on the same conditions as a concession, but the licensed service contractor does not have the exclusive rights that a concession agreement has for the service contractor. This approach is often used where there is potential for competition and the service requires lower investment costs. Licenses are often used for transport services, such as taxis, buses, etc or even refuse collection. In these cases, the service contractor retains the assets used for the delivery of the service at the expiration of the license period.

Funding Agreement. LGUs may enter into a contract with a non-profit organization to provide to the service organization a grant to provide certain services, such as social, sports, recreation, or cultural activities. The service organization is responsible for all investment and operating costs, owns the assets used and bears the financial risks.

Box 2. Con't (3)

This type of contract normally covers a particular program or activity, and not the whole operations of the service contractor. The agreement would cover the broad content of the program and set standards of quality to be maintained. Payment of the grant would be dependent on adherence to these standards and to periodic review of the activities being undertaken.

Source: Wright, Glendal. 2008. "A Review of Alternative Service Delivery Options." Report submitted to the Asian Development Bank (ADB) under the Technical Assistance 4778 Project.

<u>Criteria for evaluating pros and cons of using external providers versus direct service delivery by LGU</u>

Second, the new policy framework should also provide LGUs guidance on the criteria that they may use in analyzing the advantages/ disadvantages of using external organizations to deliver public services as opposed to direct service delivery by the LGU itself. In this respect, two factors have to be taken into account: (i) market orientation, and (ii) alignment with the public interest. On the one hand, the fixing of tariffs or prices in the LEE is normally done by fiat or through an administrative process and is thus more subject to political interference. Political pressure also tends to be strong on the LGU service provider in the area of staffing and personnel administration. In contrast, external service providers tend to operate in a more competitive environment and are thus subject to the discipline of the market place when they determine the appropriate number of their personnel complement as well as the level of tariffs that they should charge. Consequently, the LGU service provider and external providers tend to be substantially different in terms not only of the incentives for efficiency and economy but also in terms of their cost structures (Wright 2008).

On other hand, it is usually assumed that direct delivery of service by the LGU can be more easily aligned with the public interest in terms of access and coverage (e.g., servicing of areas with low traffic volume), tariffs/ service charges (e.g., lifeline pricing and subsidization of poorer segment of the population), quality of service (e.g., LGU service providers directly accountable to clients but compliance to service standards is typically part of contractual agreements between LGU and external service provider), and innovations in service delivery (e.g. external provider might be more willing and capable of introducing service improvements especially if contractual arrangements provide the incentives to do so (Wright 2008).

However, the feasibility of public-private partnership type arrangements may be limited by two factors: (i) the availability and capacity of the private sector/ non-government organizations to undertake the delivery of these services, and (ii) the capacity of the LGU to manage the necessary contractual and regulatory arrangements which can be both complex and costly at times. Wright (2008) notes that the international experience tends to show that the use of contracting/ concession methods and joint ventures yields favorable results when (i) the LGU does not assume all of the financial risks that come with the operation of the external service providers while being able to maintain control over the delivery of the services, (ii) the LGU is able to come up with a precise definition

of the required service delivery levels, (iii) there is transparency in the regulation of the external providers' performance, and (iv) the LGU has access to the technology, expertise and experience that is more often available to the external provider. However, these advantages are only available if the following conditions exist: (i) there is some level of competition in the market with several providers capable of providing the service at comparable cost and performance, (ii) there is a fairly high level of expertise in LGU to formulate the metrics for outputs/ service performance assessment, and (iii) corruption and other ethical infringements do not come into play.

Guidance on creation of LEEs

If the LGU deems it best to provide the service directly by itself, it then has to choose whether to do so via an LEE or through a regular unit or office in the LGU. These two approaches differ in terms of (i) staffing, (ii) tariff setting, (iii) investments in capital assets and maintenance of the same and (iv) overall performance orientation in the delivery of services. LEEs are less subject to restrictions on staffing and have some flexibility in terms personnel remuneration allowing them to better attract professional and technical personnel. However, this approach opens up the possibility for abuses in hiring of staff and paying of the staff. On the other hand, LEE tariffs are set by Sanggunian legislation and are determined, in principle, with some degree of cost recovery in mind because by their very definition LEEs raise the bulk of their revenues from the sale of their outputs. Given these considerations, LEEs tend to have greater inclination and wherewithal to make the necessary investments to maintain the equipment and facilities needed to deliver the service. Also, LEEs may have greater drive for results and performance especially when the performance measures are clearly defined and monitoring/ evaluation systems are established and enforced.

The new policy framework should provide explicit guidance on the creation of LEEs. The guidance should specify that LEEs should be established by enacting an ordinance that specifies in unequivocal terms: (i) LGU policy on degree of cost-recovery of LEE up front in terms of what percent of cost will be recovered from user charges, (ii) tariff rates or user charges that will be charged for goods/ services provided by LEE, and (iii) who will be subsidized and by how much;[6] including schedule of rates by income bracket of clients where applicable.

Note that the need for ordinance is provided in the UBOM (FAQS-A.2.5, p.189) but the UBOM does not call for the specification of the cost recovery rate up front. In this regard, the government has the option to provide guidance on minimum rate of cost recovery for different classes of LEEs. For example, guidelines may be issued suggesting that full cost recovery is a must for markets/ slaughterhouses and enterprises engaged in purely commercial operations like hotels, resorts, malls, commercial buildings but allowing less than full cost recovery for certain types of public utilities and enterprises

[6] This means that subsidy given to LEEs is an ex-ante conscious decision on the part of the LGU rather than an ex-post item that finances whatever the resulting gap between revenue and expenditure is. The La Union Medical Center provides a good example of how a well articulated policy on providing subsidy to the poor contributes to the efficient operation of the LEE.

with social service orientation. If this is followed then there is a need to revise FAQS-A.2.8 (p.189) of the UBOM to allow for less than full cost recovery as may be provided in the LEE ordinance.

The new policy framework should then distinguish between LEEs created by ordinance with well articulated policy on cost recovery as described above and "LEE-like" activities (i.e., activities that are commercial in nature but from which LGU has little or no intent to recover cost). Subsequently, the policy framework should provide for the differential treatment of these two groups of activities in terms of budgeting and need for the maintenance of special accounts.

Institutionalization periodic review of existing LEEs

Third, the new policy framework should reiterate and re-emphasize the importance of the maintenance of special accounts for LEEs as prescribed by the COA under the NGAS. The maintenance of special accounts for LEEs is essential in tracking the results of LEE operations and how closely LGUs follow their intent for creating LEEs.

In addition, the framework should also institutionalize the periodic review of the operation of existing LEEs to help LGUs decide whether these LEEs deserve to continue their operation especially in the light of changing market environment. For instance, some LEEs may have been created at a time when no private sector providers were present in the LGU jurisdiction but in the interim the private sector has entered the marketplace. If the review shows that the continued operation of some LEEs is no longer justifiable, the new policy framework should then provide guidance on what the alternative options available to the LGUs in LEE divestment.

3.2. Need to Clarify Treatment of LEE in the LGU Budget

A number of LGC provisions related to budgeting create some confusion. At the same time, we argue that the budget format sends signals on how budget execution should proceed and thus affects LGU spending behavior, particularly as it relates to LEE operations.

3.2.1. LGC provisions not quite clear on use of LGU income

First, one of the fundamental principles of local fiscal administration in the Local Government Code of 1991 states:

> "No money shall be paid out of the local treasury except in pursuance of an appropriations ordinance or law" [Section 305 (a)]

Second, the Local Government Code also provides that:

> "Profits or income derived from the operation of public utilities and other economic enterprises, after deduction for the cost of improvement, repair and other related expenses of the public utility or economic enterprise concerned, shall first be applied

> for the return of the advances or loans made therefore. Any excess shall form part of the General Fund of the LGU concerned" (Section 313 – second part).

Third, FAQS-A.2.7. of the UBOM provides:

> "The budget for and economic enterprise and a public utility shall be presented separately under the General Fund Annual Budget of the local government subject to the usual budgetary process."

Section 313, particularly the part quoted above, appears to be a source of confusion among LGUs as it seems to suggest that some degree of "use of income" or even some degree of "income retention" for the purpose of funding "cost of improvement repair and other related expenses" (which may be interpreted to include other types of operating expenses) of LEEs. However, it should be stressed that such an interpretation of the Section 313 directly contradicts the basic principle of local fiscal administration set out in Section 305 (a) of the LGC. It will be seen below that this confusion appears to have caused a number of LGUs much grief.

In practice, different LGUs exhibit different ways of treating their LEEs not only when they prepare their budgets but also when they execute their budgets. On the one hand, there are LGUs (e.g., Tagum City) that treat their LEEs just like any other unit/ office when they prepare their budget such that the income of the LEEs are shown as part of the income estimate for the General Fund and all expenditure proposals related to LEE operation are shown as part of the expense items in the proposed budget. As a corollary, the same budget format is carried over in the appropriation ordinance. This way of preparing the LGU budget proposal is shown as Option 1 in **Box 3**.

On the other hand, key informant interviews and discussions on the floor during the consultation workshops conducted as part of this study reveal that some LGUs essentially treat their LEEs off-budget. LEE income does not form part of the total income estimate that is use as basis for budget preparation. In like manner, proposed expenditures of LEEs do not form part of the spending proposals in the proposed budget of the Executive. However, proposed subsidies to LEEs (if any) are shown as an expenditure item in the proposed budget. This same budget format is carried over subsequently in the appropriation ordinance. This way of preparing the LGU budget proposal is shown as Option 2 in **Box 3**.

During budget execution, revenues earned from an LEE's operation are credited to an intra-agency receivable account known as "due from operating units account" while the operating expenditures of the LEE are debited from the same account by the LGUs that prepare their budgets in the manner of Option 2 above. In this way, income derived from the operation of LEEs is utilized in the payment of operating expenses without passing the usual budget procedures in direct violation of the basic principle of local fiscal administration that no money shall be paid out of the local treasury except in pursuance of an appropriations ordinance.

The COA annual audit reports for 2007 for the two provinces, that were earlier referred to as case study numbers 1 and 2 in **Section 2,** uncover that these provinces follow Option 2 as well. The COA also reports that the province in the southern part of Luzon (case study number 2) passed a provincial ordinance that provides that separate accounts for each individual economic enterprise shall be maintained in the General Fund. The same ordinance also provides that only the net receipts from the LEE (i.e., revenue less expenditures, improvement, repair, personal services, MOOE, capital outlay and other related expenses) shall form part of general fund. The COA audit also disclosed that the collection from each LEE is deposited in a separate bank account. In the accounting books, the collections were credited to an "other payables" account and the account was simply debited for the payment of operating expenses and acquisition of assets pertaining to the LEE.

Box 3. Alternative Options for the Treatment of LEEs in Budgeting Using Numerical Illustration

In this short note, the implications of alternative budget formats especially as they relate to LEEs are assessed not only in terms of their form and appropriation language but, more importantly, in terms of the implications on budget execution and overall financial management of the LEE and the LGU itself.

To foster a better appreciation of the alternative ways of treating LEEs in the budget, this short note makes use of a numerical example. Suppose the budget of LGU A for the year 2009 is being prepared. Further suppose that the income estimates for 2009 are as follows:

- Total income of the General Fund Proper (I_P) including IRA, local tax revenues, service income but excluding receipts from LEE – PhP 500 M
- Receipts from LEE (I_L) – PhP 75 M

Suppose also that the proposed expenditures for 2009 are as follows:

- Total personal services (PS) expenditure for all offices in GF Proper (PS_P) excluding PS expenditure for LEE – PhP 200 M
- Total MOOE for all offices in GF Proper ($MOOE_P$) excluding MOOE of LEE and subsidy to LEE from GF Proper – PhP 155 M
- Total capital outlay in GF Proper (CO_P) excluding capital outlay for LEE – PhP 100 M
- Total PS expenditure of LEE (PS_L) – PhP 50 M
- Total MOOE for LEE ($MOOE_L$) – PhP 70 M
- Subsidy from GF Proper to LEE (S_{PL}) – PhP 45 M

Three alternative ways of treating LEEs in the budget are presented below. The following sections outline different ways of presenting the LGU budget for 2009 corresponding to these different options.

OPTION 1

*Description***.** Under Option 1, estimates of income from various sources, including income from LEEs, are explicitly shown in the income estimate portion of the proposed budget. On the other hand, the expenditures for each of the different offices in the General Fund (broken down as to PS, MOOE and CO) are shown in the expenditures portion of the proposed budget. Moreover, spending proposals for LEE (also broken down as to PS, MOOE and CO) are shown explicitly in the expenditure portion of the proposed budget. The budget presentation for Option 1 using the illustrative data given above is shown below.

GENERAL FUND BUDGET FOR 2009 (in million pesos)

Income estimates:	
I_P	500
I_L	75
Total income	575

Box 3. Con't (2)

Expenditures:

PS_P	200
$MOOE_P$	155
CO_P	100
Total expd for GF Proper	455
PS_L	50
$MOOE_L$	70
Total expd for LEE	120
Total expd in GF	575

Assessment. This presentation is consistent with one-fund principle. Although PS expenditure for the LEE is shown explicitly in the budget, it is not difficult to exclude it from the computation to check compliance from the PS cap. However, the subsidy to LEE operations is not obvious/ transparent from the presentation although it can be derived.

During budget execution, if actual collections of I_P were to fall short of the estimate in the course of the budget year, then it is likely that actual expenditures both for the GF proper and the LEE will be affected. The same holds true for shortfalls in actual collections of I_L.

OPTION 2

Description. In this presentation, only expenditures under the General Fund Proper are appropriated. Because subsidy to LEE is part of General Fund Proper), it is also appropriated. However, LEE expenditures for PS, MOOE and CO are not appropriated.

Although an annex is included showing LEE operations, this annex is presented just for information purposes and does not form part of the appropriation ordinance *per se.* Under this option, LEEs are allowed to use their receipts/ income without need for the Sanggunian authorization. The budget presentation for Option 2 using the illustrative data given above is shown below.

GENERAL FUND BUDGET FOR 2009 (in million pesos)

Main Body

Income estimates:

I_P	500

Expenditures:

PS_P	200
$MOOE_P$	155
CO_P	100
S_{PL}	45
Total expd	500

Annex: Information on LEE Operations

Income estimates:

I_L	75
S_{PL}	45
Total income	120

Expenditures:

PS_L	50
$MOOE_L$	70
Total expd for LEE	120

Box 3. Con't (3)

Assessment. This budget presentation runs counter to the one-fund principle. Thus, the incentives for efficiency under Option 2 are weaker relative to Option 1 above and Option 3 below.

During budget execution, if actual collections of I_P were to fall short of the estimate in the course of the budget year, then it is likely that the impact on LEE spending will be limited to the extent that subsidy from the General Fund Proper might be affected. However, if actual collections of I_L were to fall short of the estimate in the course of the budget year, then it is likely that only actual expenditures for the LEE will be affected. Conversely, if actual collections of I_L were to be exceeded, LEE spending may increase correspondingly even if they are not necessary, a problem common to revenue earmarking.

Because LEE operations are essentially treated off-budget, the actual results of operations of the LEE will not be apparent. Also, since the expenditures of the LEE are not appropriated, PS spending of LEE is clearly excluded from computation of compliance with PS cap.

OPTION 3

In this presentation, the budget is divided into three parts. Part 1 shows the income estimates and spending proposals (including subsidy to LEE) for the General Fund Proper. Part 2 shows the income estimate and spending proposal for the LEE. Part 3 shows the consolidation of Parts 1 and 2. This implies that Sanggunian authorization for LEE spending is required. Moreover, LEE spending is broken down by object of expenditure. The budget presentation for Option 3 using the illustrative data given above is shown below.

LGU BUDGET FOR 2009 (in million pesos)

Part I: General Fund Proper

Income estimates:		
I_P	500	
Expenditures:		
PS_P	200	
$MOOE_P$	155	
CO_P	100	
S_{PL}	45	
Total expd for GFP		500

Part II: LEE

Income estimates:	
I_L	75
S_{PL}	45
Total income	120
Expenditures:	
PS_L	50
$MOOE_L$	70
Total expd for LEE	120

Part III: General Fund (Consolidated)

Income estimates:	
Total income	575
Expenditures:	
Total expenditures	575

Box 3. Con't (4)

Assessment. This presentation is consistent with one fund-principle. It is also the most transparent of the three options considered. Although PS expenditure for the LEE is shown explicitly in the budget, it is not difficult to exclude it from the computation to check compliance from the PS cap.

During budget execution, this presentation is able to build a firewall of sorts between the General Fund Proper and the LEE. For instance, if actual collections of I_P were to fall short of the estimate in the course of the budget year, then it is likely that only expenditure items in GF proper will be affected. In like manner, if actual collections of I_L were to fall short of the estimate in the course of the budget year, then it is likely that only expenditures items for the LEE will be affected. However, if actual collections of IL

were to exceed the estimate, the LEE can automatically increase their spending beyond what has already been appropriated without first enacting a supplemental budget.

This presentation defines an unambiguous demarcation line that separate the LEE from the GF proper. It also fosters greater transparency and provides clearer signals/ incentives for efficient use of resources.

In both cases, the COA audit reports rendered an unfavorable opinion and argued that as a result of the way the LEE income and expenditures are treated in budget preparation and budget execution, the financial position of the LGUs' LEEs, the results of the LEEs' operations and cash flows for the reference year cannot not be ascertained. As such, the lack of financial information rendered difficult the measurement and evaluation of the financial performance and viability of the LEEs.

It should also be pointed out that the way LEEs are treated in the budget when Option 2 is used is not consistent with the "one fund" principle. Under this principle, the government's budget should in principle cover all transactions financed with public financial resources. Schiavo-Campo (2007) asserts that "it is impossible for the government budget to reflect the preferences and choices of society and to incorporate the principles of good governance if it includes only a small proportion of revenues and expenditures. If the budget excludes major expenditures, there can be no assurance that scarce resources are appropriately allocated to priority programs and that legal control and public accountability are properly enforced. Only if all proposed expenditures are on the table at the same time does it become possible to review them in relation to one another and to choose those that have higher relative benefits for the community."

It should be stressed that one-fund principle applies to LEE expenditures because LEEs do not have a separate legal persona since they do not partake of the corporate form under the existing legal framework. Instead under the Local Government Code, LEEs are still part of the General Fund but special accounts within the General Fund should be maintained for each LEE.

Of course, it would have been an altogether different story if LEEs are established as a corporation with separate legal personality and full operational autonomy. Note that expenditures and revenues of government corporations are not submitted to the same scrutiny and approval mechanisms as the government budget. Rather, the government's

budget should only include the net transfers between the government and the government corporation (i.e., subsidies, equity contributions).

Recommendation. Some LGU officials and some analysts argue in favor of Option 2. They assert that government entities which provide quasi-private goods and services and which charge for said goods/ services should be allowed to retain at least a significant portion of it. Otherwise, these government entities would have no incentive to improve their efficiency if they could not use freely some of the revenues they earn from selling their services. For instance, these officials refer to the increase in income of DOH retained hospital after the income retention policy was put in place to illustrate their point.

In order to take this concern into account, at least partially, while at the same time putting emphasis on transparency and accountability, it is recommended that LEE income and spending be treated following Option 3 in **Box 3**. In this presentation, the budget is divided into three parts. Part 1 shows the income estimates and spending proposals (including subsidy to LEE) for the General Fund Proper. Part 2 shows the income estimate and spending proposal for the LEE. This implies that Sanggunian authorization for LEE spending is required. Part 3 shows the consolidation of Parts 1 and 2. This budget format is not only more transparent than current practice, it also provides incentives for LEE managers to improve their collections since they are better able to isolate their earnings from the rest of the General Fund Proper.

3.2.2. LGC provision on personal services spending of LEEs creates perverse incentives

The LGC also provides that:

> "The total appropriations, whether annual or supplemental, for personal services of a local government unit for one fiscal year shall not exceed 45% in the case of first to third class provinces, cities, and municipalities, and 55% in the case of fourth class or lower, of the total annual income from regular sources realized in the next preceding fiscal year. The allowances of officials and employees of public utilities and economic enterprises owned, operated and maintained by the local government unit shall not be included in the annual budget or in the computation of the maximum amount for personal services. The appropriations for the personal services of such economic enterprises shall be charged to their respective budgets" (Section 325 - a).

The preferential treatment given to personal services expenditures of LEEs by exempting the same in the computation of compliance with the PS cap has given rise to perverse incentives. Said preferential treatment of LEEs may be justified on the grounds that LEEs being self-sustaining deserves some flexibility in their staffing. However, interviews with LGU officials during the field visits affirm that many LGUs abuse this provision and use it as a means to feign compliance with the PS cap.

Recommendation. It is recommended that the favorable treatment given to the personal services spending of LEEs as provided under under Section 325 (a) be retained but that

its application be limited to LEEs which are created by ordinance and which have well articulated policy on cost recovery.

3.3. Need to Strengthen LGU Capability Relative LEE Creation and Operation

The discussion so far highlights the need to capacitate LGUs in the following areas:

- evaluating alternative modes of public-private partnerships
- evaluating when to create new LEEs or when to continue operations of existing ones
- drafting of ordinances for the creation of new LEEs including formulation of subvention policy
- improving LEE operations
    - development/ evaluation of feasibility studies, especially forecasting of demand
    - tariff setting
    - collection procedures and systems
    - evaluating alternative organizational structures for the management and monitoring of LEEs
- conduct of periodic review of existing LEEs
- evaluating alternative divestment modes.

At the same time, there is a need to information dissemination/ advocacy campaign targeting LGU and oversight agencies officials to generate better appreciation and understanding of the new policy framework for LEEs.

4. SUMMARY AND CONCLUSION

An unambiguous definition of term “economic enterprise” is key the formulation of a clear policy framework for the creation and continued operation of local economic enterprises. In this regard, we that the oversight agencies (DBM, DOF/ BLGF, DILG, NEDA) adopt a common definition of the term “local economic enterprise” emphasizing enterprise dimension: *LEEs are local government owned economic entities that generate the bulk of their revenues from selling goods and services.*

The guidance on LEEs found in the LGC, the NGAS and the UBOM is generally consistent with conceptual framework found in the international literature. Perhaps by being silent on what the alternative options are, the existing policy framework appears to lean more heavily towards the public ownership model. Also, the existing policy framework does not provide cautionary statement on potential government failures that may arise with the establishment and continued operation of LEEs.

Given this perspective, the need to establish a clearer and more comprehensive policy framework to govern the creation of new LEEs and continued operation of existing ones is critical. Many of the elements of the existing framework will still be part of the new framework but a number of new features will have to be put in place.

The new policy framework should be anchored on the basic principle that LGUs need to focus on their core functions. It should also be premised on the superiority of private-sector led development unless a strong case can be made for government intervention. The framework should thus establish guidelines when government provision of marketable output is justified, taking into account the tradeoffs between market failures and government failures.

The new policy framework should also recognize that some marketable goods/ services are better delivered by the government central and that the LEE modality is but one of a number of alternative service delivery modes. After considering the different alternatives, if an LGU deems it best to create an LEE, the new policy framework should provide explicit guidance in doing so. This guidance should specify that LEEs should be established by enacting an ordinance that specifies in unequivocal terms: (i) LGU policy on degree of cost-recovery of LEE up front in terms of what percent of cost will be recovered from user charges, (ii) tariff rates or user charges that will be charged for goods/ services provided by LEE, and (iii) who will be subsidized and by how much;[7] including schedule of rates by income bracket of clients where applicable.

The new policy framework should then distinguish between LEEs created by ordinance with well articulated policy on cost recovery as described above and "LEE-like" activities (i.e., activities that are commercial in nature but from which LGU has little or no intent to recover cost). Subsequently, the policy framework should provide for the differential treatment of these two groups of activities in terms of budgeting and need for the maintenance of special accounts. The proposed treatment of the chartered LEEs, LEEs in the General Fund, and regular LGU units delivering "LEE-like" services with respect to budgeting, use of income and PS spending is summarized in **Figure 2**.

[7] This means that subsidy given to LEEs is an ex-ante conscious decision on the part of the LGU rather than an ex-post item that finances whatever the resulting gap between revenue and expenditure is. The La Union Medical Center provides a good example of how a well articulated policy on providing subsidy to the poor contributes to the efficient operation of the LEE.

Figure 2. Chartered LEEs, LEEs in the General Fund and Regular LGU Unit Delivering "LEE-like" Services

Form/ Modality	Nature of Service	Extent of Cost Recovery as per Statement of Policy	Legal Basis for Creation	Treatment in the Budget	Treatment of PS Spending Relative to PS Cap	Need for Special Account in General Fund	Use of Income
Chartered LEEs (GOCC-like) e.g., LUMC, PLM & QCGH	Commercial with intent to recover cost fully or partially	Variable but significant; extent depends on social service orientation	Act of Congress	LGU appropriations for GOCC shown as subsidy/ equity/ transfers/ net lending	Not applicable	Not applicable	Yes
LEE	Commercial with intent to recover cost fully or partially	Variable but significant; extent depends on social service orientation	Act of Sanggunian	Option 1: Three part presentation of GF budget – GF proper and LEEs – more transparent but some kind of firewall between the two Option 2: : LEE essentially treated off-budget. Only subsidy to LEEs is part of spending proposal/ appropriations.	PS spending of LEE not included in computation of compliance to PS cap.	Yes	Option 1: No Option2: Yes
Regular office/ unit delivering LEE-like service	Commercial with little or no intent to recover cost	Nil	None	Treated just like any other LGU department/ office in the budget; appropriation for unit shown as PS, MOOE, CO in LGU annual budget	PS of LEE-like activities included in computation of compliance with PS cap	Yes	No

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