STATE AND MUNICIPAL STRENGTHENING PROGRAM

(ME-0208)

EXECUTIVE SUMMARY

Borrower: Banco Nacional de Obras y Servicios Publicos, SNC (BANOBRAS).

Guarantor: United Mexican States.

Executing agencies: Fast-disbursing component: Ministry of Finance and Public Credit (SHCP).

Line of credit component: BANOBRAS

Amount and source:

IDB: (Fast-disbursing) (OC)	US$ 400.0
IDB: (Line of credit)	US$ 400.0
Local:	US$ 400.0
Total:	US$1,200.0

Financial terms and conditions:

	Fast-disbursing	Line of credit
Amortization period:	15 years	25 years
Grace period:	5 years	4 years
Disbursement period:	2 years	5 years
Interest rate:	variable	variable
Inspection and supervision:	1%	1%
Credit fee:	0.75% on undisbursed balance	0.75% on undisbursed balance
Currency:	US dollars from the Single-Currency Facility	

Objectives: The general objective of this program is to support the process of decentralization in Mexico. The specific objectives are: (i) to increase the autonomy of local governments (states and municipalities, hereinafter "subnational governments" or "GSNs") in the allocation of resources; (ii) to improve the performance of credit markets at the subnational level; and (iii) to strengthen the capacity of GSNs to manage public funds.

Description: The decentralization process in Mexico is intimately related with the country's evolving political situation. Reform efforts inspired by various political currents are today combining to transfer greater responsibility to the GSNs. Although this process has been underway for the last ten years, a number of major new initiatives affecting the

GSNs have been proposed and in some cases undertaken during the period 1998-1999.

The program presented in this document has been designed with the express purpose of supporting these measures, through three components. **Component I** consists of a two-tranche sector operation to support national policy reforms in two areas: the system for transferring federal funds to GSNs, and the credit market that provides financing for GSN investments. With respect to the transfer system, the component will support introduction of a new budgeting mechanism, *Ramo 33* ["Section 33"], with features that will strengthen the autonomy of the GSNs. *Ramo 33* will transfer greater resources to the GSNs, in line with a pre-established disbursement schedule, and will allow them autonomy in deciding how to use these resources. Implementation of these reforms, which have already been introduced by the government, will serve as the basis for disbursing the **first tranche** of Component I. The **second tranche** is based on reforming the credit market for GSNs. First, a series of actions will be undertaken to correct shortcomings in the performance of BANOBRAS as the public source of credit for GSNs. The aim is to better enable BANOBRAS to meet the needs of its customers, with modernized procedures and structures and a more sustainable financial position. Second, changes will be made in the legal framework for the guarantee system, under which the Ministry of Finance and Public Credit (SHCP) now withholds GSN shares under the federal revenue-sharing program. These amendments will seek to establish a more transparent and reliable system by setting objective debt limits and transferring a portion of the credit risk to the banks. The conditionality matrix (see Annex I and the supporting information in Annexes II and IV) summarizes the reforms anticipated under this component.

As a supplement to these measures, **Component II**, an investment operation, is designed to encourage GSNs to adopt sound practices in their financial management, through a line of credit administered by BANOBRAS. The critical issues to be addressed under this component include local regulation of *Ramo 33*, investment planning and auditing, budgeting and accounting systems. Special attention will be paid to enhancing the transparency of the GSNs' financial performance. To the extent that they achieve the agreed goals of sound practice, they will have access to the line of credit to finance a portion of their investment plans. This component will also include resources to finance technical assistance for implementing the reforms called for under this program, or to undertake other institutional strengthening efforts, in accordance with the limits and eligibility criteria established in the Credit Regulations.

Component III will provide support for the reform process within BANOBRAS: it will provide financing initially for the Institutional Modernization Program (PDMI), and subsequently for further

activities in pursuit of the organization's reform efforts. The PDMI will establish a strategy to ensure quality of service, efficiency and productivity, by rationalizing and optimizing BANOBRAS procedures with respect to costs, efficiency and risk.

Relationship of project in Bank's country and sector strategy: The proposed program is consistent with the Bank's strategy for Mexico, as reflected in the country document (GN-2045-1) recently approved by the Board of Executive Directors. The program in fact falls under the first objective of that strategy, which seeks to reinforce the process of structural change through decentralization, with a view to fostering social development, reducing poverty, and promoting more harmonious regional development that will be both socially equitable and geographically balanced.

Environmental and social review: The Environment and Social Impact Committee (CESI) approved the "Social and Environmental Report" on August 20, 1999, recommending that measures be taken to ensure that BANOBRAS has the institutional capacity to design an environmental management strategy and a program for monitoring and evaluation. The loan contract (Annex A) and the Program Operations Manual (MOP) for Component II will include recommendations for dealing with environmental issues.

Benefits: **Component I:** The introduction of untied funding through *Ramo 33* marks the beginning of a new stage in the development of federalism in Mexico. Through *Ramo 33*, GSNs, and in particular the municipalities, will be able to decide for themselves how to allocate a growing volume of budgetary resources. Three aspects warrant special attention in this context: (i) the volume of funding involved is substantial (roughly US$20 billion in 1999); (ii) these transfers are performed through a set of clearly established fiscal principles aimed at achieving greater efficiency of expenditure; and (iii) these reforms represent a precedent for a politically and technically viable method of progressively transferring autonomy over budgetary expenditure to the GSNs.

Upon completion of the programmed reforms, BANOBRAS will have acquired valuable experience that will allow it to focus its efforts on working more closely with the GSNs and providing them with better services and products. It will also have changed the way in which decisions are taken within the organization, by decentralizing powers and responsibilities. Eliminating functions that are peripheral to its main mission will significantly improve its level of efficiency.

The government's plan for reforming the guarantee system, based on federal transfers, will put an end to the uncertainty caused by changes introduced in the Fiscal Coordination Act of 1996, since which time the Ministry of Finance and Public Credit (SHCP) has been operating under a transitional article of that Act. In addition, withdrawal of the

federal government from operations under this scheme will reduce expectations that the Federation will intervene with its own funds to cover commitments and bail out the GSNs when they get into financial difficulty.

Component II. The line of credit will offer incentives to GSNs to strengthen aspects of their financial management, thereby complementing the decentralization measures undertaken by the federal government. In particular, the regulations for *Ramo 33* and the strengthening of the GSNs' investment management and their auditing, budgeting and accounting systems will allow them to meet the needs of their citizens in a more efficient and equitable manner. Strengthening the transparency of their operations will provide civil society, political forces and financial agents alike with better means for evaluating GSN performance.

Risks:

Component I. With respect to the mechanism for transferring additional resources to the GSNs, it is clear that there are great differences in the managerial capacity of GSNs to assume their new responsibilities, and this represents a high risk for the process of decentralization. Nevertheless, there are two factors that should help to mitigate this risk: (i) in the political sphere, the GSNs have recently become much more democratic; and (ii) Component II of this program is aimed at facilitating and implementing a process to strengthen GSN management so as to ensure greater transparency.

There is a risk that the BANOBRAS reform program will not be carried to completion, or that when it is completed a decision might be taken to halt or reverse the process of change. Nevertheless, once a program of this type is launched, it takes on a dynamic of its own, which will be difficult to derail arbitrarily. It should be noted that the SHCP, which is responsible for the development banking system, has expressed strong interest in the program as a means for achieving a thorough overhaul of the organization. Moreover, the program offers parallel but consistent incentives to all major players. If it fails to achieve the goals set out in the conditionality matrix, the SHCP will not have access to the second tranche of Component I, and BANOBRAS will not be able to access the line of credit.

With respect to the guarantee system, the government is proposing a system of incentives based on the functioning of the credit market. The effectiveness of these incentives will depend on whether the authorities amend the rules governing minimum levels of capitalization for financial intermediaries. The government has undertaken with the International Monetary Fund (IMF) to review the capital adequacy rules for the banks and to bring them more closely into line with international standards.

Component II. Although BANOBRAS has extensive experience in financing technical cooperation and institutional strengthening programs, it has no track record in executing policy-oriented

investment programs. BANOBRAS faces an ongoing conflict, common to most development banks, between policy objectives and the need to keep placing funds in new transactions. Despite this, it is clear that the senior administration of BANOBRAS has identified this as an area where BANOBRAS can play an important role, and one that could not readily be performed by the commercial banking system.

Special contractual clauses:

Component I (fast-disbursing): Disbursements will be made in two tranches of US$200 million each, and will be subject to fulfillment of the conditions precedent for each tranche shown in the matrix in Annex 1 of this document.

Six months after initiating the execution plan for the Institutional Modernization Program (PDMI), BANOBRAS and the Bank will hold a follow-up meeting to agree on any necessary adjustments to that plan (paragraph 3.3).

Component II (line of credit): The first disbursement under this component will be subject to compliance with the following conditions: (i) presentation of the funds transfer agreement signed between BANOBRAS and the guarantor (3.1); and (ii) entry into force of the MOP for Component II and the model contract that will be used for the subloans (3.22).

Other special conditions for Component II: Independent consultants will be hired to conduct: (i) evaluations of the first five GSN diagnoses and action plans; and (ii) annual evaluations of the quality of diagnoses and action plans, progress achieved in their implementation, and the use of resources from the component in accordance with the loan contract, on the basis of a 10% sample of participants, with a minimum of two per year (3.14; 3.44).

Independent external auditors will be responsible for examining a sample of the supporting documentation for disbursement requests (3.39).

Component III (Institutional Strengthening of BANOBRAS). Presentation of the plan of execution for the Institutional Modernization Program (PDMI) will be a condition precedent to the first disbursement.

Poverty-targeting and social sector classification:

Although the proposed program will support the process of decentralization and strengthen the management capacity of the GSNs, which will obviously help the government to improve equity, reduce levels of poverty and enhance public welfare, there are no specific activities or mechanisms targeted directly at alleviating poverty.

Procurement of goods, works, and consulting services:

Direct contracting of COINFIN Ltd. As an exception to the procedures for selecting consultants through public bidding, it is recommended that the firm Financial Institutions Consultants (COINFIN) be hired directly. COINFIN has technical and institutional advantages and competitive fees for advising BANOBRAS on the PDMI, and this approach is consistent with chapter GS-403 of the Procurement Manual (3.36).

International competitive bidding (ICB) for goods and services. It is proposed that international competitive bidding be required for project procurements in amounts above US$1 million for goods and US$10 million for works. These limits are justified in light of experience with other projects financed by the Bank in Mexico, where foreign bidders tend to participate in procurement opportunities above those limits. Moreover, the fact that many companies from Bank member countries are associated with Mexican companies will ensure a high level of participation and representation. Bidding for amounts below these limits will proceed in accordance with national legislation, which requires public bidding and in some cases calls for restricted invitations and/or direct awards, and these are compatible with Bank procedures (3.34). Detailed information is available in the project files in support of the request for this exception concerning the number and amounts of ICB contracts.

International competitive bidding (ICB) for the contracting of consultants. It is proposed that the limit be raised from US$200,000 to US$500,000. In the case of Mexico, where many foreign consulting firms from other member countries of the Bank are already associated with Mexican companies, the existing limits are not only costly in terms of advertising and time, but often present serious obstacles to the contracting of consultants, and this has resulted in unnecessary delays in the performance of studies or specific activities, thereby needlessly holding up disbursements and delaying execution of projects financed by the Bank (3.35). Details on recent consulting contracts above the proposed limits is available in the project files.

Recognition of expenditures:

It is recommended that retroactive financing with loan resources be authorized up to US$15 million, and that expenditures be recognized against the local counterpart contribution, up to US$10 million, for outlays during the preparation and initiation of activities under Component II (3.41).

I. BACKGROUND AND ISSUES ADDRESSED

A. Introduction

1.1 The general objective of this program is to support the process of decentralization in Mexico. Specific objectives are: (i) to increase the autonomy of local governments (states and municipalities, referred to hereafter as subnational governments or GSNs) in the allocation of resources; (ii) to improve the performance of credit markets at the subnational level; and (iii) to strengthen the capacity of the GSNs to manage public funds.

1.2 The process of decentralization in Mexico is intimately linked to the evolving political situation in the country. The stiff electoral competition that has characterized the voting process in recent years, the alternation of local government among different parties, and the growing strength of civic organizations, professional associations and regional newspapers are placing the quality of local management under increasingly close scrutiny. This situation is putting great pressure on state governors and municipal presidents to be more sensitive to the demands of voters. While local autonomy was initially promoted by the opposition parties, some of the state governors in the reform wing of the governing party have recently joined together to press the federal government to transfer greater responsibilities to the local level.

1.3 Although this complex process has been underway for the last ten years, during the period 1998-1999 a number of major initiatives for GSNs were approved and in some cases implemented. These reforms fall under three broad headings.

(i) The first of these reforms relates to the transfer of federal funds to local governments. The Budget Acts of 1998 and 1999 introduced and refined a new instrument (*Ramo 33*) which has significantly increased the volume of resources at the disposal of local governments, and particularly of the municipalities. This reform signifies a fundamental shift in the relationship between the GSNs and the federal government, and has opened the way to a progressive transfer of responsibilities and resources towards those entities.

(ii) The second of these reforms relates to the credit market. In financing their projects, particularly infrastructure projects, local governments need access to credit markets. Participation by the commercial banking system in this business has been based primarily on a system of guarantees administered by the Ministry of Finance and Public Credit (SHCP). That ministry has decided to reform the banking system by introducing incentives to influence its credit decisions, so that they will be based increasingly on market considerations. The National Bank for Public Works and Services, SNC (BANOBRAS), a public bank, is the principal supplier of credit to the GSNs. This bank will now need to

adapt itself to a changing role, consistent with the development of Mexico's financial markets. The authorities have proposed a wide-ranging modernization plan that seeks to prepare this institution to respond more effectively to market dynamics. Under this plan, BANOBRAS will become a more efficient, flexible body that is sensitive to the needs of its clients.

(iii) The third of these reforms refers to the capacity of the local GSNs to manage the responsibilities that have been assigned to them as part of the decentralization process. The elements referred to above have combined to make growing volumes of funding available to the GSNs to dispose of at their discretion. The fact that the federal government has been obliged to devote a significant volume of resources to rationalizing the finances of some states and municipalities in the wake of the 1994 crisis underlines the urgency of strengthening financial management in these entities. The first effort in this direction was undertaken by the SHCP through a series of financial reorganization programs agreed with the GSNs. This has been a slow and costly process, however, and there are still evident weaknesses in the basic management systems of many GSNs. Further efforts are needed in this direction, in light of the growing volume of resources that are handled at this level. The investments (which are relatively modest) needed to achieve greater efficiency in the handling of these resources (currently exceeding US$20 billion) will have a great impact on the efficiency of public spending in Mexico.

1.4 The program presented in this document has been designed expressly to support and carry forward reforms in these three aspects of decentralization. The program includes a fast-disbursing sector component intended to encourage national policy reforms relating to the fiscal transfer system and the credit market for GSNs. A second component will provide a line of credit to finance investments and technical assistance to support those states and municipalities interested in modernizing their management systems.

1.5 Chapter I explains the frame of reference for locating these interventions within the context of the evolving decentralization process in Mexico. It presents a summary of recent changes affecting the system of fiscal federalism, emphasizing the importance that these transfers have for the GSNs, and presenting a diagnosis of the principal management problems found at the state and municipal level. It next addresses the critical problems that are currently impeding the proper functioning of the credit market for GSNs. On one hand BANOBRAS, the public bank designated to serve the GSNs, suffers from severe operational and financial shortcomings. On the other hand, the commercial banking system, still reeling from the 1995 crisis, does not have an adequate scheme to continue channeling financial resources to the GSNs.

1.6 During the analysis stage of this program, the guidelines set out in Profile II approved on May 6, 1999 have been largely adhered to. In that profile it was proposed to combine a sector operation, in support of policy changes at the federal level, with a line of credit to support reforms at the GSN level. Two major changes have been introduced, as discussed below.

1.7 First, GSN access to credit resources has been recognized as a fundamental issue. In this context, two factors were identified that have had and will have a decisive influence on the development of capital markets at the GSN level. On one hand BANOBRAS, as the principal supplier of this service, suffers from serious weaknesses and on the other hand, the regulatory framework is inadequate for defining the rules under which the GSNs can offer guarantees on the basis of federal transfers to their creditors. In this respect, measures have been added to the reform program contained in the conditionality requirements, aimed at strengthening the management of BANOBRAS and introducing changes to the guarantee system based on federal transfers.

1.8 Secondly, with respect to the line of credit, it was decided to focus the objectives of this component on strengthening the overall administration of the GSNs, rather than addressing problems in the provision of specific local services. This focus will optimize the impact of resources under this program, since BANOBRAS already has lines of credit to support specific services. At the present time, there are no instruments other than those proposed in this program for effecting changes in the administration of the GSNs, the weakness of which has already been identified in Profile II.

B. The system of fiscal federalism in Mexico

1.9 The federal budgets for 1998 and 1999 represented a major turning point in the process of fiscal decentralization in Mexico. A new instrument was introduced, known as *Ramo 33* ["Section 33"], which allowed for a substantial increase in the untied resources available to GSNs. The impact on municipalities was especially significant: compared with the US$1.7 billion received through untied federal transfers in 1995, the municipalities will receive about US$5.5 billion in 1999. In order to explain the significance of this reform and its impact on the autonomy of GSNs, this section begins with a profile of the overall system of fiscal federalism in Mexico, and goes on to examine the operating characteristics of *Ramo 33*. The main problem that arises with the new fiscal provisions relates to the institutional capacity of the GSNs to manage these resources. The following section therefore analyzes their administrative performance.

Table I-1 Local revenues of GSNs

US$ billions	1991	1995	1999
States			
Own revenues	1.4	1.6	1.9[1]
Transfers	4.0	7.5	12.2
Debt	1.5	1.9	n/a
Others	1.7	1.6	1.5[1]
Total	8.6	12.7	15.7
Municipalities			
Own revenues	1.4	1.1	0.9[1]
Transfers	1.6	1.7	5.5
Debt	0.2	0.2	n/a
Others	0.3	0.2	0.1[1]
Total	3.4	3.2	6.6
Total GSN	**12.0**	**15.9**	**22.3**
Note: n/a. - not available [1] estimate			

1. State and municipal revenues

1.10 **Federal transfers.** The total revenues of the GSNs in 1999 amounted to approximately US$22 billion. As a point of reference, the federal budget in that year totaled US$108 billion (see Table 2). There are two principal channels for transferring resources from the federation to the GSNs. The first channel is through the system of "*participaciones*" [revenue sharing] in federal tax revenues.

Table I-2 Federal resource transfers to GSNs in Mexico

1999 Budget	US$ billions		Comments
Total federal revenues	108.2		
Transfers to parastatals	29.7		
Total revenue share to GSNs		**14.1**	= 21% of "sharable" federal revenues
Total contributions to GSNs	13.7		= Total *Ramo 33*
Tied contributions	10.1		= Funds 1 (education) and 2 (health)
Untied contributions		**3.6**	= Funds 3, 4, 5 (infrastructure etc.)
Untied transfers to GSNs		**17.7**	= Revenue sharing + Funds 3, 4 and 5

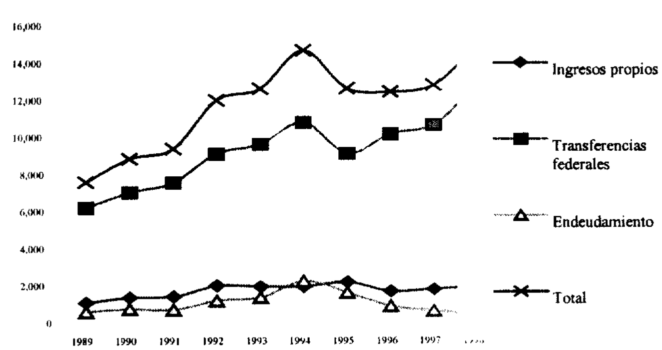
In return for suspending the collection of similar local taxes, the GSN receive a 21% share of "sharable" federal revenues[1] (5% for municipalities and 16% for the

[1] "Sharable" revenues, which account for about 85% of total federal revenues, represent all revenues received by the federal government less certain receipts derived from the exploitation of oil.

states), a proportion that implies a volume of some US$14.1 billion for 1999. These revenues are distributed among the GSNs by means of a formula that has not been amended for more than 20 years, and is based on their level of population and economic activity. The second channel consists of a system of grants, known as *Ramo 33*, which is handled through several funds, each with different rules for its use, and which will amount in 1999 to US$13.7 billion. The bulk of these revenues is earmarked for financing education and health programs through tied funds (Funds 1 and 2), the rules for which leave the states with little discretion in making decisions about their application. In contrast, about US$3.7 billion is transferred to the GSNs without any significant restrictions (Funds 3, 4 and 5), and the recipients have a fair degree of autonomy in deciding how to use them. Adding the freely available contributions to these revenue sharing arrangements, the federation will transfer some US$17.7 billion as untied resources to the GSNs in 1999.

1.11 **Introduction of *Ramo 33*.** *Ramo 33* marks a major turning point in Mexico's policy of fiscal federalism. It was introduced by way of 1998 budget legislation. In 1999, this innovation was consolidated through clarifications concerning the role of the municipalities as primary beneficiaries[2] and assigning responsibility for overseeing the use of *Ramo 33* resources to the GSNs. The impact of this policy derives from four key characteristics. First is the question of the amounts available. While it is the states that benefit from the bulk of revenue sharing, 70% of the untied funds under *Ramo 33* go to the municipalities. The municipalities will receive US$5.5 billion in transfers during 1999, compared with US$1.7 billion in 1995. Second, regarding the issue of autonomy, the federal government has various instruments for transferring resources to the GSNs, but they are always subject to conditions that leave little room for decision-making on the part of local government. On the other hand, Funds 3, 4 and 5 of *Ramo 33* establish the principle that the GSNs themselves are to decide the use of those resources. Third, regarding allocation by formula, while previous transfers allowed a significant degree of discretion on the part of the federal entity responsible for

Graph 1. Evolución de los Ingresos Estatales



[2] It was clarified that Mexico City (Federal District) was being treated as a state rather than a municipality for the purposes of the municipality apportionment formula.

distributing resources among the GSNs, under *Ramo 33* objective formulas have been published (at least for transfers from the federal to the state level; the distribution process from the state level to the municipalities requires greater transparency in some entities). The formulas are based on the size of population and on poverty indicators. Fourth, introduction of a monthly disbursement schedule by the federal government (compliance with which in the fiscal year 1998 was demonstrated during analysis of this program) allows the GSNs greater security in planning their resources, thereby enhancing the efficiency with which they are used.

1.12 **Own funds**. The GSNs also mobilize funds on their own account, although their taxing power is relatively limited. The states have the power to introduce a payroll tax (up to 5%) and a tax on hotels; municipalities have the power to levy property taxes. In addition, the municipalities receive a major portion of their revenues from the tariffs charged for use of public services (solid waste disposal, water supply, etc.), as well as a broad range of permits and licenses and registration fees. It is estimated that these locally generated resources will amount to some US$4.5 billion in 1999.

1.13 The increase in federal transfers has had the effect of discouraging the mobilization of local resources, at least in some GSNs. Between 1991 and 1995, self-generated municipal resources declined annually by 5% in real terms, and the states' own revenues increased annually by only 3%, on average. There is evidence that the fiscal behavior of local government results from strategic political decisions (some states have succeeded in raising their revenues dramatically, while others have consciously adopted a passive posture). Nevertheless, the low rate of revenue collections in the GSNs stands out as the weak link in the process of increasing their autonomy. A suitably pro-active program to provide greater incentives in this area could therefore have an important impact.

2. GSN responsibilities and performance

1.14 The basic responsibilities of the GSNs are defined in the national constitution of Mexico. Article 3 specifies that the states are sovereign entities and that their principal function is to provide education and health services. Similarly, article 115 (III) stipulates that municipalities are also sovereign entities, since they do not fall under the jurisdiction of the states, and their principal responsibilities are to provide services related to water supply, sanitation, solid waste management, urban roads, urban transit, and the planning and regulation of urban development.

1.15 Nevertheless, despite this *de jure* clarity as to their responsibilities, the *de facto* delineation between the three levels of government -- federal, state and municipal -- frequently leads to confusion. Laws governing specific sectors, and other types of regulatory instruments and expenditure programs controlled by the federal or state level, often imply modifications, at times substantial, to the essential constitutional provisions.

1.16 The institutional and financial capacity of the GSNs varies significantly from one entity to the next, depending on such factors as their size and their level of poverty. The Bank program files contain a detailed study on these issues; following is a summary of their major weaknesses.

1.17 **Financial standards of accounting and budgeting.** The most widespread deficiency of the GSNs lies in their financial standards of accounting and budgeting: (i) nearly all GSNs use some type of cash accounting; (ii) accounting, budgeting and cash management are generally performed without regard to each other; (iii) the classification of revenues and expenditures is inconsistent, not only between GSNs (which makes it difficult to compare their performance), but at times even within the same entity; and (iv) very few GSNs use a program-based budgeting system (or activity-based costing) - they are thus unaware of the real costs of specific services, and they are not in a position to establish appropriate tariffs or to take sound decisions on the allocation of resources. On this point, the Ministry of Finance and Public Credit has initiated a standardization program to set minimum accounting standards for the GSNs.

1.18 **Investment management.** Although the GSNs spend more than US$4 billion annually in capital outlays, they are for the most part lacking in systems to control the efficiency of such expenditures. Generally speaking, investment projects are not subjected to proper financial or technical analysis, nor do they undergo any systematic process for evaluating their environmental impact, and contracting regulations and laws are not consistently applied. As a result of these deficiencies, investment plans adopted by state governors and municipal presidents on the basis of their election platforms fall short of optimizing the impact of the resources employed.

1.19 **Tax administration.** Technical factors, combined with a lack of political motivation, help to explain the low rate of local resource mobilization in the GSNs. Generally, local governments have little technical expertise and lack the information systems to administer their tax base efficiently. Identification, rate setting, assessment and collection are all aspects in which local tax administration regularly falls short. The major municipal levy, the property tax, is very costly to administer. These factors have sparked a debate over the feasibility of replacing existing local taxes with a system of adding tax points to federal taxes for the exclusive use of the GSNs.

1.20 **Administration of *Ramo 33* resources.** As a counterpart to the transfer of *Ramo 33* funds to the GSNs, the federal government has imposed stricter requirements to ensure the transparent and efficient administration of those funds. Nevertheless, these requirements are still poorly defined, and compliance with them is generally weak, because the GSNs have not had sufficient time to prepare themselves for this change. One of the most critical legal issues relates to the allocation of state resources to the municipalities. In principal, the federal government has established

a formula governing this distribution, but in practice its application varies widely. Another important issue relates to the degree of control that the states may impose on the municipalities in making use of *Ramo 33* resources -- here again, things are quite different in practice.

1.21 **Transparency.** The requirements for financial information, audits and publicity have been defined in broad terms. According to federal law, the GSNs must secure approval of their budget by the state congress, and the budget must be published in the state's Official Gazette. The public accounts must be audited by the state auditor general (who reports to the state congress) before they are published in the Official Gazette. With few exceptions, the state auditors general are in urgent need of measures to strengthen their technical capacity. Some GSNs have decided to use independent auditors from the private sector in order to gain credibility with their taxpayers and with potential private lenders. In many cases, however, the budgetary information that is published is so unreliable as to be of little use. Timely publication of consistent and reliable financial data is thus one of the great challenges facing Mexico's GSNs.

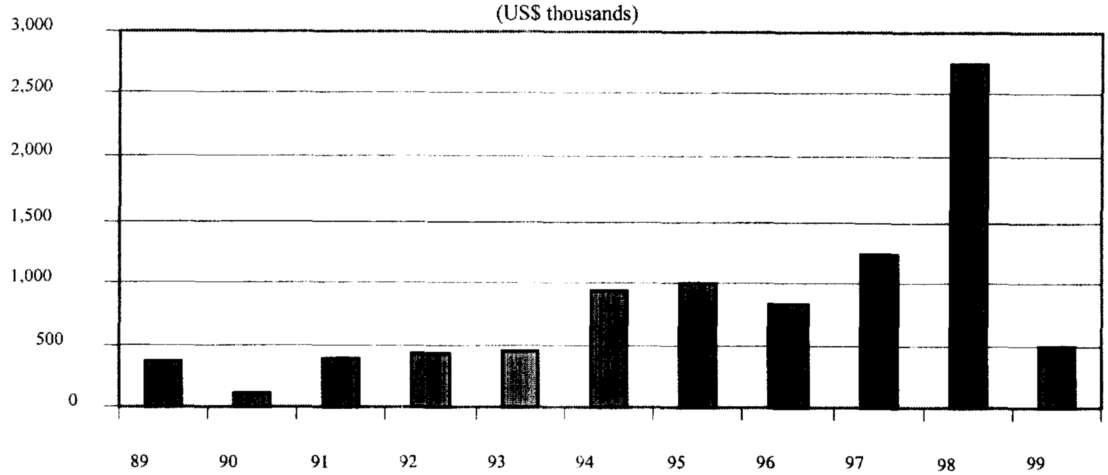
1.22 **The financial situation of the GSNs.** This has been very volatile over the past decade. The 1994 crisis left many states without the capacity to service their financial obligations, and the federal government was obliged to step in with special transfer programs to maintain their solvency. The cost of these programs, which exceeded US$2.5 billion in 1998 as shown in Graph 2, has reinforced the government's intention to strengthen the financial autonomy and managerial capacity of the GSNs, in order to ensure that they can meet their budgetary responsibilities ("hard budget constraints") without resorting to federal bailouts.

1.23 The issue of special transfers also led the SHCP to initiate a standardization program to improve the consistency and quality of the financial information provided by the GSNs. In addition, steps were taken to ensure that this information is published in a timely manner. The present program constitutes an instrument to carry forward these efforts towards correcting the deficiencies identified in the previous section.

1.24 In summary, recent years have produced very uneven results for the GSNs. Some now find themselves with sound finances and are in a position to take advantage of their greater autonomy, while others are still struggling under the burden of debt service or are constrained by their limited management capacity. Now that the federal government is less disposed to intervene with ad hoc solutions, local governments themselves will have to put their financial house in order if they are to optimize the impact of the current revenues they manage, and to improve their credit rating. On the other hand, there are a significant number of GSNs where investment programs have been held back as a result of the 1995 crisis. Given the growing demand for infrastructure projects, these GSNs have a clear interest in being able to finance these works through the credit markets.

Graph 2. Special transfers to GSNs

(US$ thousands)



C. The credit market for states and municipalities

1. Credit for GSNs.

1.25 Given the weakness of their own revenues and the volatility of public structures, efforts to turn the GSNs into creditworthy entities have had to rely on their most secure asset: the commitment of the federal government to share national revenues with them. This section describes the GSN credit market development mechanism, and traces its evolution in the wake of the 1995 banking crisis.

1.26 Towards the end of 1978, the federal government promulgated the Fiscal Coordination Act, according to which the states and municipalities were to be given a share of federal revenues. Article 9 of that Act established a system whereby debts that carried the approval of local legislatures and that had been registered with the SHCP upon petition of those bodies (municipal obligations may only be registered when they carry the full guarantee of the state and are assured a sufficient revenue share) could be guaranteed by having the Federal Government withhold funds under the revenue sharing arrangement. In the event of default by a state or municipality, the Treasury would make payment to the banks directly, as a charge to those funds, according to the order of registration of the claims.

1.27 This guarantee scheme gave rise to an active credit market, particularly at the state level. Nevertheless, the indiscriminate use of federal guarantees has reduced the process of innovation and has had negative effects on market discipline: (i) the risk assumed by the banks does not depend on the quality of the project financed, and only marginally on the financial situation of the borrower; (ii) the price (interest

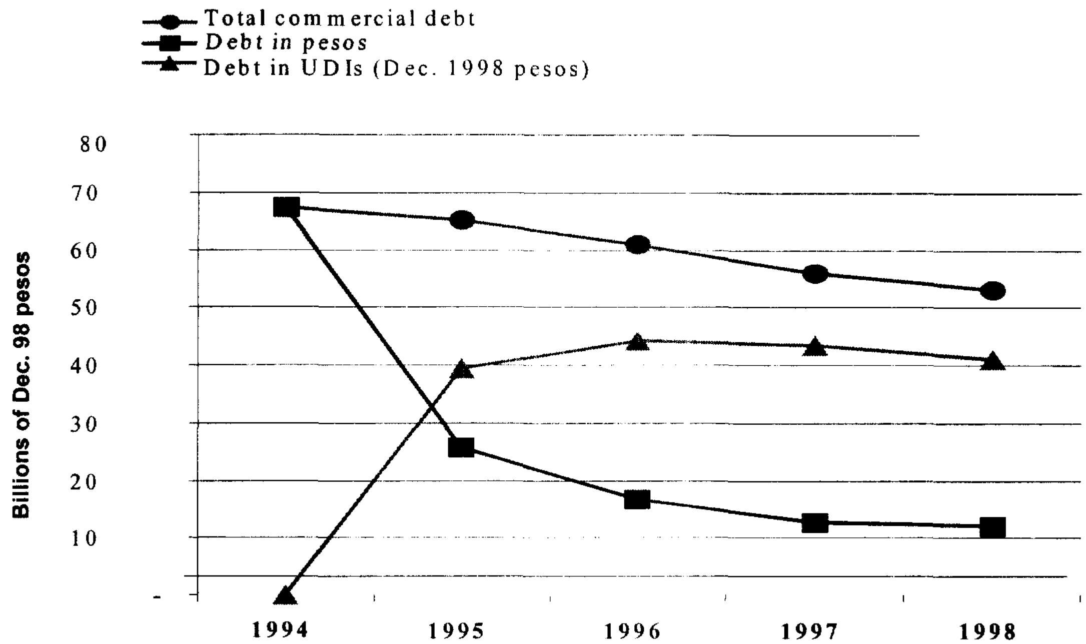
rate) on these transactions reflects more closely the negotiating skills of the borrower than the risks inherent in the transaction itself; and (iii) the calling of guarantees puts the borrower in a difficult liquidity situation, which in most cases is politically unsustainable, thereby rendering guarantees ineffective and creating pressures on the SHCP to cover the shortfall by one means or another (on several occasions, the SHCP has undertaken rescue operations for states in financial difficulty). This arrangement contains clear elements of "moral hazard", and it is not surprising that some states have ended up with high levels of indebtedness.

2. Effects of the economic crisis

1.28 The Mexican financial system was severely shaken by the 1995 crisis. Despite a series of government programs to forestall collapse of the financial system, the cost of which is estimated at 14% of GDP, and efforts to improve and strengthen the supervision of financial intermediaries, the system continues to exhibit shortcomings, among which are the lack of a solid capital base, the size of the nonperforming portfolio, reduced margins of intermediation (caused in part by restructuring programs) and a decline in the real value of its asset base. In real terms, credit from the system to the private sector declined by about 30% from its peak in December 1994, and has failed to recover over the last three years. In December 1998 the commercial banking sector's portfolio, measured in real terms, was unchanged from its 1992 level. In a complex scenario where there is little effective demand, despite the positive performance of the economy, net credit flows to the private sector have not recovered and have remained at very low levels.

1.29 **Credit to the GSNs**. The crisis also had a severe impact on the credit market for GSNs. The volatility of interest rates and the difficulties that many states and municipalities encountered in restructuring their debts have resulted in limitations on the effective demand for credit at the subnational level. In real terms, the outstanding debt of states and municipalities registered with the SHCP has declined by 21% over the last four years. An important part of this decline is due to restructuring agreements (in UDIs or "investment units") and to the purchase/transfer of a portion of the restructured debt to the federal government, as shown in Graph 3 below. A portion may also be regarded as a temporary reduction due to the increased volume of freely available resources for states and municipalities. Nevertheless, the total of transactions denominated in pesos, i.e. non-restructured debt and new debt, has tended to stabilize and has shown a certain recovery over the last two years. BANOBRAS, in particular, has recorded an increase in its loan portfolio of some 1.2 billion pesos in new credits during 1998, and expects to negotiate loans amounting to 2.5 billion pesos during 1999.

Graph 3. Total debt of states and municipalities



3. Changes in the guarantee system

1.30 At the beginning of 1995 the federal government decided to introduce amendments to the guarantee scheme. It proposed that each state should legislate the guarantee mechanisms it considered most appropriate, thereby effectively removing the SHCP from the scheme. This solution, however, made it impossible for creditors to gain access to transfers before they arrived in the hands of the states, and so tended to undermine confidence in this instrument. The possibility was explored of instituting a scheme based on trust accounts (one for each state, in which all federal revenue sharing transfers would be deposited), but this was discarded, partly because there was no basis for it in federal legislation and partly because of practical difficulties of implementation (over-guarantee of obligations, and unfair competitive advantages for the banks administering the trust accounts).

1.31 At the same time, as part of the program for restructuring and alleviating debt burdens (all credits to GSNs registered with the SHCP were covered by the State and Municipal Credit Support Program (PACEM), the SHCP began to insist that the GSNs undertake financial reorganization programs as a prerequisite for participating in those programs. Through these programs, the participating GSNs committed themselves to make improvements in critical areas, in exchange for federal assistance. In some cases, this assistance included the purchase of restructured loans by the federal government. In December 1998, about 65% of all

credits granted by the commercial banking system, and 88% of credits granted by BANOBRAS, had been restructured in UDIS, for terms of up to 18 years.

1.32 Similar programs to improve financial management have been initiated through agreements for the registration of debt and the constitution of guarantees. Through these agreements, local entities commit themselves to undertake reform programs and to strengthen their management, and the SHCP, reverting to the former scheme, registers the debt and assumes the responsibility of withholding federal funds for payment of bank debts in case of default. This procedure is based on a transitional article of the Fiscal Coordination Act of 1995, which has been extended year by year.

1.33 Although the existing arrangement has succeeded in motivating the GSNs to make substantial improvements to their management, they still suffer from the shortcomings of the old system as indicated above. Moreover, the arrangement does not have a solid legal basis nor is it transparent: it is not governed by any established rules, but relies in large part on the discretion of the SHCP. The difficulties arising from the debt restructuring process and the generalized uncertainty over the guarantee mechanisms based on federal transfers are now opening the way for introducing amendments to the rules of the game that until now have shaped the evolution of the debt market at the subnational level.

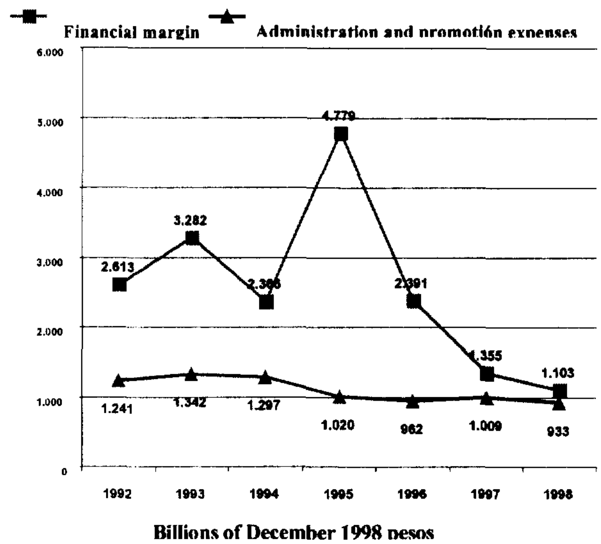
D. BANOBRAS: current situation

1.34 In addition to its role as financial agent of the federal government, BANOBRAS has been performing the functions of a public development bank, dedicated to financing infrastructure works, particularly in the areas of water and sanitation projects, transportation, housing and urban development. In addition, it provides technical assistance for the institutional strengthening of states and municipalities and for the analysis of infrastructure projects. More recently it has been participating in investment banking projects of the "Buy-own-transfer" (BOT) type, through its investment banking group. Despite its long tradition, the central role that it once played in financing the GSNs has been progressively eroded.

1.35 The activities of BANOBRAS have also been affected by the crisis. After declining by 23% in 1996 (in real terms), the total BANOBRAS portfolio has been recovering slightly, a trend that accelerated in 1998 when its own-account portfolio grew by 12% in real terms. In the last 18 months, while the flow of credit from the commercial banking system was drying up, BANOBRAS became the principal (and virtually the only) supplier of credit to the states and municipalities.

1.36 Nevertheless, the institution is still faced with serious internal structural difficulties. These difficulties are reflected in steadily shrinking financial margins over the last four years, in the face of operating costs that have declined only marginally over the same period. If this trend continues, BANOBRAS will begin to incur operating losses, and its capital will be eroded within two or three years.

Graph 4. Banobras, S.N.C.



1.37 The shrinking of financial margins results from a combination of several factors, including: (i) the financial conditions on the restructured credits; (ii) changes in the composition of the bank's liabilities; (iii) pressure on intermediation margins through competition from the commercial banks (the commercial banks do not incur any credit risk and can often reduce their transaction costs by using the analysis performed by BANOBRAS, and they can therefore offer better rates to the GSNs); (iv) the absence of any sustained strategy for raising funds in local and international markets; and (v) high operating costs.

1.38 The primary factor behind these high operating costs is the fact that BANOBRAS is essentially an organization focused on internal procedures and not on the provision of services. This can be appreciated from the fact that its employees devote only 20% of their time to meeting customer demands, while the remaining 80% is spent essentially on internal procedural matters. The bank is characterized by the centralization of credit and business decisions at the head office and the decentralization of operating activities, both of which run counter to modern banking practices, which call for precisely the opposite approach. The application of fragmented policies and procedures and the dilution of responsibility through a plethora of committees mean that procedures are haphazard and inefficient. Thus, despite the widely recognized technical capacity of its analysts and their deep knowledge of the institution's clients, BANOBRAS has been unable to turn these advantages into a growing volume of business. On the other hand, risk management in the credit area is based on a great variety of manuals and standards and has not been effectively integrated into the Bank's management and procedures. Moreover, BANOBRAS devotes substantial resources to functions that are peripheral to its central mission, such as housing loans and credits to transport carriers (involving many transactions of low value) and it engages in a number of internal functions that could be more efficiently contracted out to third parties, such as the provisions of medical care for its employees, payroll management and other

items. All of these factors have conspired to produce an organization that is over-dimensioned and burdened with time-consuming and costly operating procedures.

1.39 The managers of BANOBRAS and the authorities at the federal level are equally aware of the institution's difficulties and are prepared to introduce reforms that will allow it to continue playing an important role as the provider of technical assistance and financing to the GSNs, with particular attention to those entities that have limited access to private credit markets. The continuous shrinking of the intermediation margin in the face of operating costs that, while they have been reduced, are still out of proportion, means that the authorities will have to take decisive action in the near future, since if current trends continue the institution will not be viable over the medium term.

1.40 Considering the existing problems within BANOBRAS, and the commitment of its managers to undertake a comprehensive reform of the institution, the proposed program will support and finance an Institutional Modernization Program (PDMI) to begin the process of solving these problems, as detailed below in chapter II, The Program, Corporate Restructuring of BANOBRAS (paragraph 2.7).

E. Previous Bank programs and IBRD activities

1.41 In 1994 the Bank approved the Municipal Development Program (PDM), loan 837/OC-ME, for US$500 million, the principal component of which was to support the Municipal Social Development Fund in financing small infrastructure works in the areas of water supply, drainage, sanitation, paving and electrification. To data, some 40,000 works have been undertaken, involving a high degree of community participation, and 64% of the Bank's financing has been disbursed. These activities were conducted under *Ramo 26* ["Section 26"] and were coordinated and executed by the Ministry of Social Development (SEDESOL). With creation of *Ramo 33* in 1998, resources have been passed directly to the states and municipalities, and SEDESOL has ceased to function as the executing agency of the PDM. This change has hindered program execution, which until then was considered highly satisfactory. The Bank and the Mexican government will continue their search for alternative mechanisms to ensure complete execution of the PDM.

1.42 The World Bank is working closely with the government on the issue of decentralization. A series of studies on various aspects of the system of fiscal federalism has resulted in an agenda for medium and long-term reforms. The World Bank and the government are currently studying the possibility of a sector adjustment program that would include reforms aimed at broadening financial disclosure by the states, reducing sources of discretionary transfers in the federal budget, and making a start at studying the problem of unfunded pensions that many states are facing.

1.43 Thanks to the constant exchange of analyses and recommendations between the Bank and the World Bank, which has been underway now for more than a year, the reforms supported by this program will be complementary to any that may be undertaken in a future World Bank program.

F. Macroeconomic situation and justification for a sector operation.

1.44 As a result of the increasing volatility in world financial markets, Mexico's conditions of access to external credit have become much more difficult since mid 1998, and the country has experienced a flight of capital. The drastic drop in the international price of oil (from an average of US$17 a barrel in 1997 to an average of US$11 in 1998) has added to the fiscal pressure, since petroleum revenues account for one-third of the federal government's fiscal receipts. Thus, in 1998 federal revenues fell short of expectations by an amount equal to 1% of GDP. In the face of these trends, the federal government had to amend its 1998 expenditure budget three times, although it consistently protected social spending, which totaled 0.8% of GDP. As a result of these policies, the public sector deficit ended up at 1.24% of GDP, very close to projections at the beginning of the year, although the inflation rate exceeded 18%, compared with the official target of 12%. This fiscal prudence contributed to an economic recovery towards the end of 1998, which saw reductions in interest rates, inflation and the exchange rate, and a recovery in the securities market.

1.45 It was in the midst of this period of budgetary adjustments that the new *Ramo 33* was introduced (see paragraph 1.5). In fact, although the overall volume of budgetary expenditure declined, there was no change in the funding allocated to *Ramo 33*. The combination of fiscal pressures with a political commitment to decentralize expenditure has been accentuated in the course of the 1999 fiscal year. During the first quarter of 1999, federal revenues declined by 2.2% in real terms, compared with same period for 1998. As a result, the federal government showed a financial deficit of nearly US$800 million. At the same time, the funding allocated to *Ramo 33* rose from US$9.8 billion in 1998 to US$13.7 billion in 1999. The sector component of the proposed operation will thus make a modest contribution to financing a policy that has managed to maintain the level of decentralized spending, even in a time of fiscal pressure.

1.46 On July 7, 1999, the International Monetary Fund (IMF) approved a standby arrangement for Mexico for US$4.123 billion in support of the government's economic program over the coming two years, which will cover a portion of maturities on the remaining balance (US$7.3 billion equivalent) under the 1995 rescue package. The purpose of the program is to consolidate the reforms that were begun in the 1980s, as well as the progress that was achieved between 1996 and 1998 in the wake of the 1995 crisis, so as to maintain the economy on a higher and sustainable growth trajectory under conditions of low inflation and thereby enhance employment opportunities and improve living standards. The economic program

will also maintain strict surveillance over fiscal policies and at the same time will encourage structural reforms that are considered essential to improve the level of national savings, underwrite macroeconomic stability and reduce vulnerability to external shocks.

G. Program relationship with the Bank's strategy

1.47 The proposed program is consistent with the Bank's strategy for Mexico, as reflected in the Country Document (GN-2045-1) approved on June 3, 1999 by the Board of Executive Directors. The program in fact falls under the first objective of that strategy, which seeks to reinforce the process of structural change through decentralization, with a view to fostering social development, reducing poverty, and promoting a more harmonious regional development that will be both socially equitable and geographically balanced. In addition, the program will help to promote private sector participation, which is part of the second objective of the Bank's strategy for Mexico.

H. The GSNs and environmental management

1.48 Mexico has in place a sophisticated regulatory system of environmental protection, which has taken on an additional degree of complexity since 1996 when the Ministry of Environment and Natural Resources (SEMARNAP), in accordance with the decentralization guidelines described earlier, transferred to the states a large number of responsibilities in the environmental management area. Specifically, the obligation to conduct an environmental review of development projects is now clearly a state responsibility. A functional analysis of the current system reveals a wide variety of state institutional structures established to discharge this responsibility. More significant is the conclusion that, while standards and procedures are adequate in principle, their enforcement and application is very uneven. In some cases, environmental problems with development projects are detected at an early stage, and measures to mitigate their negative impacts can be undertaken successfully. In other cases, the environmental review is deficient, either for lack of human resources with the necessary training or because of weaknesses in giving institutional effect to the procedures. It is noteworthy that the obligation of municipalities to apply existing legal norms depends to a large extent on their own initiative and technical capacity.

1.49 Further details on this issue are to be found in the Environmental Report in the program files. The dynamics of the decentralization process and the objective of the program to contribute to those dynamics by encouraging sound management practices at the local level provide, in fact, an important opportunity. One of the key points in strengthening management relates to the planning of GSN investments, and ensuring that environmental issues are treated as part of an integral system for the comprehensive analysis and programming of public works.

The Environmental Report presents a more extensive version of the proposal and chapter III, Program Execution, provides a summary of that report.

I. Conclusions

1.50 Although the decentralization process in Mexico is dynamic and complex, the analysis presented in this chapter points to three important conclusions:

(i) The introduction of *Ramo 33* represents a substantial turning point in the system of fiscal federalism. Freely disposable resources of the GSNs will be rising during a period of pressure on the federal budget. Multipartisan support for the fiscal reforms suggests that this is part of a decentralization process that would be difficult to reverse. *Ramo 33* can be considered as a model or instrument for future adjustments in the direction of greater subnational government responsibility.

(ii) With respect to capital markets, the government has proposed significant reforms both in terms of the guarantee system required by the private banks and the efforts to modernize BANOBRAS, the public source of credit to the GSNs. These proposals warrant technical and financial support.

(iii) Finally, it is urgent to establish a systematic program for strengthening the management capacity of the GSNs. Given the magnitude of the resources they are handling and the weaknesses in their administration systems in many cases, there is room for significant improvement in the efficiency with which public funds are used.

1.51 The proposed program, as presented in the following chapter, has been structured to respond to each of the issues referred to above. To support policy reforms at the federal level (introduction of *Ramo 33*, strengthening the credit market) a fast-disbursing sector loan is proposed. To encourage the GSNs to adopt more efficient and transparent administrative and financial management systems, a line of credit is proposed to finance a portion of their investment programs.

II. THE PROGRAM

A. General objectives and overview

2.1 The general objective of this program is to support the process of decentralization in Mexico. The specific objectives are: (i) to increase the autonomy of local governments (states and municipalities, referred to hereafter as subnational governments or GSNs) in the allocation of resources; (ii) to improve the performance of credit markets at the subnational level; and (iii) to strengthen the capacity of the GSNs to manage public funds.

2.2 These goals are to be realized by means of three components. **Component I**, a sector operation with two tranches, is intended to achieve national policy reforms in two areas: in the system of transferring federal resources to the GSNs, and in the market that supplies credit to the GSNs to finance their investments. With respect to the system of transfers, the component will support introduction of a new budgeting mechanism, *Ramo 33*, the features of which will strengthen the autonomy of the GSNs. *Ramo 33* transfers greater resources to the GSNs, in accordance with a pre-established disbursement schedule, and allows those governments autonomy in deciding how to use the resources they receive. Introduction of these reforms, already implemented by the government, will serve as the basis for disbursing the first tranche of the component. The second tranche will be based on reforms to the credit market for states and municipalities. First, it proposes a series of actions to overcome deficiencies in the performance of BANOBRAS as the public source of credit for local government. It seeks to make BANOBRAS more customer-oriented in its operations, with modernized procedures and structures and a sustainable financial basis. Secondly, it is proposed to amend the legal framework governing the system of guarantees, whereby the SHCP withholds a portion of funding under the revenue sharing arrangements. These amendments are intended to establish a more transparent and reliable system, by setting objective debt limits and ensuring that banks pay attention to the specific risks presented by each GSN. The conditionality matrix (see Annex 1) summarizes the reforms anticipated under this component.

2.3 As a complement to these measures, **Component II** will seek to encourage the GSNs to adopt a set of sound practices in their administrative and financial management, by providing a line of credit to be administered by BANOBRAS. The component will deal with such critical issues as: local regulation of *Ramo 33*, investment planning and auditing, budgeting and accounting systems. Special attention will be paid to enhancing the transparency of the GSNs' financial performance. To the extent that they achieve the agreed goals of sound practice, they will have access to the line of credit to finance a portion of their investment plans. Funding under this component will also include technical assistance either

for implementing the reforms called for under this program, or to undertake other institutional strengthening efforts.

2.4 Finally, **Component III** will provide support for the reform process within BANOBRAS: initially it will provide financing for the reforms covered by the Institutional Modernization Plan (PDMI) and any further reforms defined on the basis of the medium-term plan that will be concluded over the next twelve months.

B. Component I: policy reforms (US$400 million)

1. Objectives

2.5 The sector component has the general objective of promoting a series of reforms that will bring about significant strengthening in the autonomy of local governments. The first specific objective is to support introduction of reforms to the system for transferring federal funds to local governments. These reforms will allow local governments to attend more effectively to the priorities and needs of their citizens, and to enhance their efficiency in using the funds received. The second specific objective is to support implementation of a series of reforms within BANOBRAS, so that it can meet the needs of local governments more promptly and on a sustainable basis. The third specific objective is to introduce changes to the guarantee system for loans to local governments, and enhance the efficiency with which the private banking system allocates resources to that sector.

2. Description

2.6 This will be a fast-disbursing component, and will support achievement of the objectives described above, through two tranches. The amount of US$400 million represents an estimate of Bank support for government efforts to continue the reform program and to maintain the level of transfers to the GSNs during a time of heavy fiscal pressures.

2.7 **Tranche 1**. This will support introduction of a new system for transferring resources from the federal to the local level. As discussed in chapter I, Background and Issues, *Ramo 33* has succeeded in introducing the following fiscal principles to the transfer system:

a. **Discretionality.** This means that the GSNs receiving these transfers will enjoy a high degree of autonomy in deciding how to use the resources received. This characteristic will allow the GSNs to allocate resources in accordance with local priorities (in contrast to funding that is tied to specific uses that necessarily reflect federal priorities).

b. **Distribution by formula.** Funds should be distributed among GSNs on the basis of a formula, with transparent and objective criteria. This characteristic will allow municipalities to make multiyear financial plans and will help avoid

back-room political negotiations between those entities and the federal government.

c. **Scheduled disbursements.** Publication of a disbursement calendar will allow each GSN to make rational plans for the use of resources during the fiscal year.

d. **Local responsibility**. The obligation and responsibility of seeing to the proper use of the resources received will fall clearly on the local authorities.

2.8 The elements discussed above represent good practice of a generally applicable type, with respect to fiscal transfers between different levels of government, and they are not specific to Mexico. In Mexico, the legal basis for establishing Funds 3, 4 and 5 of *Ramo 33* was the Federal Budget Acts for the fiscal years 1998 and 1999. (Details of this legislation may be found in the project files). In terms of the legislation, the conditions for disbursement of the first tranche have already been fulfilled. At the state level, however, much remains to be done in terms of regulating and implementing the additional responsibilities that have been transferred to the states. A further objective is to encourage the GSNs to acquire the necessary administrative instruments to carry out their new role.

2.9 **Tranche 2.** The reforms supported by the second fast-disbursing tranche relate to strengthening the credit market for state and municipal governments. As discussed in chapter I, Background and Issues, this market is divided in roughly equal proportions between the public development banking system (BANOBRAS) and the commercial banking system. The reforms to be supported under this tranche are therefore divided into two groups. In the first group, support will be provided for the corporate restructuring of BANOBRAS, and under the second, steps will be taken to reform the guarantee system to promote sustainable commercial banking participation in this market.

a. Corporate restructuring of BANOBRAS.

2.10 There is broad agreement with the senior management of BANOBRAS on the major problems confronting the institution. There is also agreement on the actions that must be taken to correct those shortcomings. Among those actions, senior management has decided to implement those that it feels can be completed within the next twelve months, since it fears that commitments extending beyond that time limit will run the risk of being obstructed or delayed by possible changes in the administration of BANOBRAS. The actions that are to be undertaken, and which have been included in the conditionality matrix (Annex II) are intended to: (i) improve the quality of service and products; (ii) instill a real "credit culture" through the adoption of uniform and decentralized processes and procedures; (iii) decentralize responsibilities and decision-making; (iv) move from a system of committees, where responsibility is diluted, to a system of individual accountability; and (v) reduce costs and increase efficiency by eliminating activities

that are peripheral to the organization's objectives. Moreover, during the next twelve months detailed plans will be prepared for the actions that must be taken to complete the reform process. These actions include the re-engineering of procedures, simplifying the administrative structure, and reforming human resource management. The actions to which the administration has committed itself are detailed in the Institutional Modernization Program (PDMI) which must be approved by the BANOBRAS Board of Directors. They can be summarized under six headings as follows:

(i) **Service to clients:** Four to six of the most important BANOBRAS branches, conducting the greatest numbers of transactions, will be selected around the country. Those offices will be reorganized under a new structure, their personnel will be given training, and new processes and procedures will be introduced to focus a greater portion of employees' working time on attending to their clients.

(ii) **Credit process:** uniform and simplified procedures and processes will be introduced for managing credit risk exposure, including adoption of a single procedural manual and a standard credit policy. In the selected offices, the processes of initiating and monitoring credit transactions will be re-engineered. This implies centralizing the approval of lines of credit and decentralizing the approval of projects and individual uses of those lines of credit, through a system of individual credit-granting authorities. Approved credits will be subject to constant monitoring, and special procedures will be introduced for tracking problem loans.

(iii) **Reviewing the functions and powers of committees:** committee functions and powers will be reviewed with the intent of rationalizing them. During this process the number of committees will be reduced and their functions will be limited so as to reinforce the individual allocation of decision-making powers and responsibilities.

(iv) **Product re-engineering:** the range of products will be reviewed and rationalized, and a standard procedure will be introduced for approving new products.

(v) **Eliminating peripheral activities within BANOBRAS:** activities that are not essential to the mission of BANOBRAS will be identified and eliminated, as well as those non-essential activities that could be contracted out.

(vi) **Continuity of the process**: a detailed plan will be prepared for actions that are to be undertaken within the three years following completion of the PDMI. This will provide a working instrument to guide activities of the new administration.

2.11 The specific actions required to achieve these changes (see Annex I and supplementary information in Annexes II and IV) and their execution will constitute the first element of conditionality for the second tranche of Component I. It is estimated that the progress benchmarks set for these activities in the matrix can be met within twelve months.

b. Guaranteeing the debt service of the GSNs

2.12 The SHCP has been working on a guarantee scheme to replace the registration of agreements currently in use. From the SHCP viewpoint, the new scheme must have the following characteristics: (i) administration and operation of the scheme must be performed by the private sector; and (ii) it must contain incentives so that the banks will differentiate between projects and borrowers on the basis of risk and price. The SHCP intends to implement the new scheme before the end of this year.

2.13 The proposed scheme will operate on the basis of trust arrangements with private banks, thereby correcting some of the deficiencies that were detected in the former scheme. In terms of incentives, changes are proposed to banking legislation, particularly in the rules governing bank capitalization, in the sense of introducing additional capitalization requirements for risky transactions and borrowers. In this way, the riskiest credits would be given a relatively higher weighting in the capital adequacy ratios. The scheme will call for the evaluation and qualification of risk by recognized Mexican risk assessors.

2.14 If this scheme is to be effective, however, changes will also have to be made to the manner in which the National Banking Securities Commission (CNBV) evaluates the capital adequacy of the banks. The CNBV's own figures would suggest that the banks are over-capitalized, according to current regulatory rules and definitions, while in the opinion of most analysts the situation is precisely the opposite. This contradiction will have to be resolved by the government as part of its broader sector policy, but it has serious and direct implications for the guarantee scheme proposed by the SHCP.

2.15 The Bank intends to maintain an ongoing dialogue with the Mexican authorities with respect to the guarantee system, given the key role that it plays in development of the subnational debt market. In this respect, whatever the system eventually adopted, it will have to include the following characteristics:

a. **Credit evaluation:** there must be clear incentives for the banks to perform a proper credit evaluation for each project or borrower, and to ensure that credits are allocated on the basis of such evaluations (evaluation of repayment capacity) and that loans are differentiated by price and risk.

b. **Prudential limits:** there must be incentives for credit providers to keep their level of risk exposure to individual GSNs within reasonable prudential limits.

These limits must be defined on the basis of the maximum indebtedness capacity of borrowers and their managerial ability to administer the resources properly and service the debt adequately.

c. **Transparency:** in order to provide full and timely information to all stakeholders, the SHCP will publish all information relevant to the guarantee scheme, such as, for example, a database with records for the last ten years showing indebtedness by state; debt service, with a breakdown for capital and interest due and paid; projections of obligations for the next five years; rates and operating conditions.

2.16 The matrix proposed for confirming implementation of these reforms is found in Annex I and in the supporting documentation in Annexes II and IV.

C. Component II: the line of credit (US$309 million)

1. Objectives

2.17 To provide funding for a line of credit to be administered by BANOBRAS for the purpose of strengthening administrative and financial management in the participating GSNs. Those GSNs that achieve defined goals in strengthening their major systems will enjoy prompt access to resources under the line of credit, for use in financing technical assistance and investments.

2.18 The objectives of the line of credit complement the federal reforms that are being supported under the first tranche of the sector component. These reforms have given new powers and responsibilities to the GSNs. The line of credit will serve to equip the states and municipalities with instruments to help them play a more independent and effective role. On one hand, these instruments will provide local governments with modernized systems for controlling and planning their resources, both in terms of financing and in terms of translating their development plans into a feasible and coherent investment plan. On the other hand, they will also make it possible to provide more complete, reliable and timely information to civil and political society. Thus, in addition to helping improve the quality of information produced at the local level, this component will promote measures to facilitate its public dissemination. Specific measures will ensure the prompt publication both of critical information on the distribution and application of *Ramo 33* funds and on the overall financial position of the GSNs themselves. These measures, taken as a whole, will allow communities, local groups and political parties to play a more active role in decision-making, and in the exercise of democratic surveillance.

2. Dimensioning

2.19 The dimensioning of the line of credit was determined in light of the GSNs' debt carrying capacity. The potential gross demand for long-term financing has been increasing as a result of contraction in the subnational government credit market

since the onset of the crisis. Net new credits to the GSNs declined from US$2.2 billion in 1994 to less than US$750 million in 1998. This abrupt drop in the volume of credit reflects in part the greater availability of untied resources, but also the postponement (unsustainable over the medium-term) of new and economically feasible infrastructure projects, and the continued deterioration of existing infrastructure.

2.20 In this volatile climate, it is very difficult to estimate real GSN demand for credit with any degree of precision. If demand does not exceed the 1998 credit increase during the five years of program execution, a line of credit of US$309 million will represent less than 15% of the amount required. In that sense, a lower line of credit provides a mechanism for the Bank and executing agency to make the necessary verifications needed to encourage an innovative process of modernization among the GSNs.

2.21 Within this context of limited supply and excess potential demand, administration of the line of credit will have to be oriented towards regulating effective demand for these resources, by establishing strict eligibility requirements. In this context, the responsiveness and flexibility of this line of credit should be sufficient incentive to induce the GSNs to pay what might be called the "price of access" to resources under the program.

3. Description

2.22 Any GSN seeking to participate in the program will need to undergo a diagnosis of the current situation in its principal management systems. On the basis of this diagnosis, it will prepare an action plan to design and implement the changes required to achieve standards of good practice in each of those systems. To the extent that the GSN meets these goals, BANOBRAS will provide it with funding from the line of credit.

2.23 Following are the reform criteria to be used in measuring performance improvements in GSN functions and activities (see also annex III):

(i) **Auditing.** There must be independent annual audits of financial statements. For the larger GSNs, the auditors will have to be drawn from the private sector.

(ii) **Investment planning.** Investment planning will be conducted through four subsystems: technical analysis, financial analysis, environmental analysis, and procurement. The **technical analysis subsystem** must be able to ensure that an investment proposed by a GSN is evaluated and certified by the regulatory agency responsible for the sector concerned. Water projects, for example, must be certified by the state water board. The quality of the regulatory and institutional framework for the GSN's

services will also be checked. The **financial evaluation subsystem** will be used to ensure the feasibility of the financing plan, in terms of investment costs and related recurring costs. The system must establish two levels of analysis: an individual project level and an overall multiyear investment program level. This will make it possible to establish the feasibility of covering the investment costs with the combined total of the GSN's own savings, commercial bank loans, and loans under the proposed program, ensuring that prudential standards are maintained (the current revenue/debt service ratio, for instance). With respect to current costs it will be possible to determine the feasibility of covering operating and maintenance costs, in addition to debt servicing, under the proposed financial plan. In other words, it will have to be determined how the GSNs will mobilize the taxes, special fees, and tariffs needed to finance the additional costs associated with the new investments. The **environmental analysis subsystem** is discussed below in paragraphs 3.24 to 3.27. The **procurement system** will ensure the transparency, competitiveness, and efficiency of the GSN's process for procuring works, goods, and services.

(iii) ***Ramo 33* regulations.** Each participating GSN will have to adopt legal provisions defining rules for managing resources under *Ramo 33*, Funds 3, 4 and 5. The system of transfers under *Ramo 33* has two weaknesses that must be addressed immediately. First, the formula for distributing funding from the state level to the municipalities is not always announced publicly, with the amounts allocated at the beginning of the fiscal year. Secondly, the municipalities frequently fail to publish a statement at the end of the year showing how they used those resources. These two steps are required by federal law, but their implementation at the local level needs to be strengthened.

(iv) **Transparency**. Participants must ensure timely and systematic publication, through a suitable medium, of audited statements of their financial position and their credit obligations, in accordance with standard formats.

(v) **Budgeting.** There must be a program budgeting system, complete with cost centers and revenue centers.

(vi) **Tax administration.** Improvements to the tax administration system, including an expanded tax base and a reduced percentage of uncollected revenues, must be successfully put into effect.

(vii) **Accounting.** There must be a modernized accounting system in place.

2.24 The technical standards expected for each of these elements will depend on the category of the participating GSN. In general, those GSNs with populations exceeding 200,000 will have to comply with the strictest standards. The proposed standards are shown in annex III.

2.25 On the basis of prudential rules to be developed as part of the Institutional Modernization Program (PDMI), BANOBRAS will establish a credit ceiling for each participating GSN. In each case, the credit will be used exclusively to finance a percentage of the GSN's investment program. In order to access these resources, the GSN will have to present evidence of progress in reforming its management systems. A 12% drawing against the ceiling will be available (essentially to finance technical assistance) once the GSN has agreed to the reform plan and demonstrated that it has an adequate accounting system. This tranche will have two functions: (i) it will enable the GSN to finance the activities (technical assistance, equipment purchases, training) required to carry out the plan and thus meet the established criteria; and (ii) it will provide an incentive for entering the program by reducing any institutional friction that might result from the managerial changes required. Once BANOBRAS has verified that the GSN has met the investment planning criterion, as well as the three other criteria, the GSN will have access to 48% of the ceiling amount. The remaining 40% will be available once the goals for all of the strengthening criteria have been met. The participating GSN will be able to use the resources received either to finance technical assistance for implementing the action plan or to finance a portion of its investment plan.

D. Component III. Institutional strengthening of BANOBRAS (US$4 million)

2.26 Given the need to make BANOBRAS more responsive and efficient (see section A, Corporate Restructuring of BANOBRAS, paragraph 2.9), the program will finance the Institutional Modernization Plan (PDMI). That Plan consists of a series of measures to establish a strategy for ensuring quality of service, efficiency and productivity, by rationalizing and optimizing procedures with respect to cost, efficiency and risk consistent with the basic mission of BANOBRAS, which is to provide its clients with long-term funds and technical assistance for investment projects in basic infrastructure, urban development and services.

2.27 **Interest rate on loans to the GSNs**. BANOBRAS will receive funds for financing the line of credit in pesos, at an interest rate between Cetes[3] and Cetes + 1. The rate that BANOBRAS will charge its clients will cover all of its financial and administrative costs but will be maintained at levels to avoid any market distortions that might discourage private bank participation in the GSN credit market..

[3] The Cetes rate is the rate on local market placements of Federal Government bonds.

E. Program costs and financing.

2.28 The total cost of the program is estimated at US$1.2 billion, as shown in detail in Table II-1, divided as follows: (i) US$800 million from the Bank, through the Single Currency Facility, with resources of its Ordinary Capital (OC), in U.S. dollars; and (ii) US$400 million from the government of Mexico.

Table II-1 Cost and financing (in US$ millions)

Categories	IDB	Mexico	Total	%
1. Component 1. Reforms	**396**	**0**	**396**	**33.0**
1.1 First tranche	198	0	198	
1.2 Second tranche	198	0	198	
2. Component 2. Line of credit	**309**	**394**	**703**	**58.6**
3. Component 3. Institutional Strengthening of BANOBRAS	**4**	**0**	**4**	**0.3**
4. Audits	**1**	**0**	**1**	**0.1**
5. Financing costs	**90**	**6**	**96**	**8.0**
5.1 FIV	8	0	8	
5.2 Interest	82	0	82	
5.3 Credit fee	0	6	6	
Total	**800**	**400**	**1,200**	**100.0**

F. Sources, terms and conditions of Bank financing

2.29 Bank financing for the proposed program will amount to US$800 million, in U.S. dollars, drawn from the Single Currency Facility, financed with Ordinary Capital resources. The loan terms and conditions are shown below.

Terms and conditions	Fast-disbursing	Line of credit
Amortization period:	15 years	25 years
Grace period:	5 years	4 years
Disbursement period:	2 years	5 years
Interest rate:	variable	Variable
Inspection and supervision:	1%	1%
Credit fee:	0.75% annually on undisbursed balance	0.75% annually on undisbursed balance
Currency:	US dollars from the Single-Currency Facility	

III. PROGRAM EXECUTION

A. The borrower, guarantor and executing agencies

3.1 The borrower will be the National Bank for Public Works and Services, SNC (BANOBRAS), which serves as the financial agent for the government of Mexico. The guarantor will be the United Mexican States. The executing agencies will be the following: (i) the Ministry of Finance and Public Credit (SHCP) for Component I, and (ii) BANOBRAS for Component II. BANOBRAS and the government will sign a funding agreement setting out the obligations and responsibilities of each party and the mechanisms to be used for channeling funds from the loan to the executing agencies. The first disbursement under Component II will be conditional upon presentation of this agreement to the Bank.

3.2 Despite the distribution of responsibilities indicated above, satisfactory progress under the program will require close coordination between the SHCP and BANOBRAS. Mechanisms to ensure such coordination are discussed below.

B. Execution of Component I: Reforms

3.3 **Institutional responsibilities**. The SHCP is responsible for the sector reforms to be introduced, in accordance with the conditions proposed for the fast-disbursing component. The SHCP will submit evidence to the Bank that the conditionality as shown in the attached matrices has been met. With respect to the first tranche, the Bank already has an initial list of documents showing that the changes called for in the transfer system were made during fiscal years 1998 and 1999 (see Annex II). With respect to the second tranche, BANOBRAS will report to the SHCP on progress under the Institutional Modernization Plan (PDMI), while the SHCP will be responsible for confirming compliance with the corresponding matrix, and will inform the IDB to this effect. The Bank has already received from BANOBRAS a draft of the PDMI, detailing the activities required over the next twelve months to achieve the goals indicated in the preceding chapter. Before submitting this program to the IDB Board of Executor Directors, confirmation will be required that BANOBRAS has contracted a firm to assist with execution of the plan. Within six months after execution begins, BANOBRAS and the Bank will hold a follow-up meeting to verify fulfillment of the PDMI and to make any necessary adjustments. If the results are found to be unsatisfactory, the IDB and BANOBRAS will agree on a program of measures to rectify the situation.

3.4 With respect to reforms to the guarantee system, as described in Chapter II, The Program, Section B, Debt Service Guarantees for the GSNs, the Bank and the SHCP have agreed to maintain a close and steady dialogue on this issue, given its key importance in the development of the subnational debt market. In addition, it has been agreed that any system to be implemented must be governed in

accordance with the following criteria: (i) credit evaluation; (ii) prudential limits; and (iii) transparency.

C. Execution of Component II. Line of credit

1. Initiation and participation

3.5 To initiate execution, BANOBRAS will send a letter to the GSNs indicating the objectives and procedures of the program, and inviting interested entities to submit proposals for participation. A draft of this letter is contained in the project files.

3.6 No participant may contract loans under the line of credit for a total amount succeeding US$100 million. The total for any GSN may not exceed 50% of the cost of its investment plan (see section on counterpart funding, below).

3.7 Initiation of the line of credit will not be dependent on BANOBRAS' progress with the PDMI. When the follow-up meeting for the program is held, however, if the IDB finds that progress with the PDMI is not satisfactory, it will suspend the commitment of funding under the line and no further agreements will be signed with GSNs until an action plan is in place, acceptable to the Bank, to rectify the situation with the PDMI. Notwithstanding this provision, disbursements pursuant to commitments based on agreements signed with participants before the date of that meeting will be honored.

2. Operation of the component

3.8 **Subjects of attention**. (i) The state governments and the government of the Federal District; (ii) municipal governments seeking to modernize their financial management; and (iii) independent operators of local public services under guarantees between the corresponding government and BANOBRAS.

3.9 **Functioning.** A simple system has been designed to measure the quality of financial management in the GSNs, applying seven criteria (see Chapter II, The Program, paragraph 2.23). Any GSN seeking to participate must commit itself to undertake an institutional and financial reform plan, prepared on the basis of an initial diagnosis. As the participant complies with those criteria, BANOBRAS will give it access to a predetermined amount of long-term funding as cofinancing for its investment plan. The use of resources will also depend on compliance with the criteria established in the Program Operations Manual.

3.10 **Rules of access**. The amount that any participant may draw under the line of credit will be determined in light of criteria established by BANOBRAS for determining

the Indebtedness Ceiling (TEB)[4]. These resources will be made available in three stages, according to the following scheme:

a. The first 12% of the TEB will be available upon signature of an agreement with BANOBRAS, whereby the participant undertakes to execute the institutional and financial reform plan agreed. It is expected that a substantial portion of this first disbursement will be used for technical assistance in executing the reform plan. The remainder will be devoted to financing a portion of the participant's investments. The total amount of resources at the disposal of all participating GSNs, as a sole result of signing these agreements, will not exceed 20% of the total amount of the line of credit.

b. Upon compliance with the first four criteria in the agreed plan, a further 48% of the TEB will be available to finance other portions of the GSNs investment plan or to pay for technical assistance.

c. Upon compliance with the remaining three of these seven criteria, the balance of funding will become available for financing further portions of the participant's investment plan or to pay for technical assistance.

d. Notwithstanding the foregoing, the amount disbursed by BANOBRAS during any year to any one GSN may not exceed 50% of the GSN's authorized investment expenditure for that year.

e. Program resources will be used exclusively to finance technical assistance activities or investments authorized by the GSN.

f. Advance disbursements under the preceding scheme may not exceed 5% of the financing granted to the GSN.

3.11 **Operating incentives**. The operating rules governing the component will be key to ensuring that the proposed mechanism is attractive to GSNs and that it will provide an incentive to them to absorb the cost of the needed reforms. The proposed rules are as follows:

a. Funds will be disbursed to participants in tranches, to finance investments identified in the annual investment plans agreed with each GSN; this will not involve approval of specific projects by BANOBRAS. The principal restriction to be observed is that imposed by the Constitution, which stipulate that GSNs may incur debt only for the purpose of financing productive works.

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[4] The TEB does not represent the total possible indebtedness of the state or municipality, but rather the proportion thereof that BANOBRAS is prepared to assume on the basis of prudential risk criteria.

b. All controls and verification with respect to use of the resources and compliance with program procurement procedures will be done on an ex-post sampling basis (see paragraph 3.33).

3.12 If a participant cannot meet any of the seven criteria initially, but is prepared to make a concerted effort at reform, it should be able to fulfill indicators 1, 2, 3 and 4 within six months, and indicators 5, 6 and 7 within a period ranging from 12 to 24 months.

3. GSN eligibility

3.13 As described in chapter II, an applicant must first undergo a diagnosis of its performance against the seven Program criteria, in order to be eligible for access to funding under the line of credit. This diagnosis may be conducted by BANOBRAS directly or by independent consultants. Subsequently, funding will be accessible once the applicant has taken the actions indicated to rectify its identified weaknesses. It is the responsibility of BANOBRAS to verify that these technical goals have been achieved before it makes any disbursement.

3.14 To ensure transparency in the process, and to detect and correct promptly any deviation, it is been agreed that independent consultants will be hired each year to conduct an evaluation of a 10% sample of participants (numbering at least two per year). The consultants will examine compliance with program criteria by evaluating the initial diagnosis, the corresponding action plan, the performance of actions called for under the plan, and the technical quality of the results. When shortcomings are detected, they will make the corresponding recommendations in their report, which will be discussed at annual administration meetings between the Bank and BANOBRAS. In addition to these annual evaluations, BANOBRAS will use resources from the program to contract consultants at the outset of the program for an evaluation of the first five diagnoses/action plans prepared. The evaluation report will be submitted to the Bank for consideration.

D. Execution of Component III. Institutional strengthening of BANOBRAS

3.15 As indicated in the preceding chapters, and in light of the need to make BANOBRAS more responsive and efficient in its relationship with the GSNs, it has been agreed to implement an Institutional Modernization Program (PDMI), the presentation of which will be a condition precedent to the first disbursement. Six months after start-up, the Bank and BANOBRAS will meet to evaluate progress relative to the indicators agreed upon for each PDMI module. It has been agreed that prior to the aforementioned meeting, BANOBRAS shall not commit more than 25% of the resources under Component II. This will allow work on Components II and III to begin without delay, with the assurance that successful use of the line of credit will not be jeopardized should the PDMI advances be diverted. To that effect, the Bank's senior management will receive a report on the consistency of the

advance for the two components. Each year thereafter, BANOBRAS and the IDB will review the plan for the previous year, the problems detected, progress achieved, and the plan for the following year.

E. The sustainability of investments and the promotion of public service policy

3.16 The central objective of the line of credit is to improve the GSNs' capacity to administer the US$22 billion in untied resources that they disburse annually. In particular, the procedure established for the program (upon initial contact with a GSN, a diagnostic assessment of its current management systems is conducted and a strengthening plan is prepared afterwards) provide several opportunities to ensure the feasibility of the GSN's investments and improve its delivery of public services.

3.17 The first opportunity relates to the improvements that will be expected in accounting, budgeting, audit, and information management systems. These measures tend to generate the reliable and timely information needed to improve the quality of decision-making and strengthen civil society supervisory capacity. This represents the first step in determining the actual cost of services.

3.18 The second opportunity relates to strengthening of the investment planning system, and in particular the subsystems that will determine the quality of the technical and financial analyses to be received for each proposed investment. The technical analysis subsystem must in any event be capable of ensuring that an investment proposed by a GSN has been evaluated and certified by the regulatory agency for the sector concerned. The diagnostic assessment will also cover the quality of the regulatory and institutional framework for the GSN's services. It will in particular examine the regulatory agency's degree of independence and the degree of autonomy between the supplier and the GSN responsible for the service.

3.19 The financial evaluation subsystem will be used to ensure the feasibility of the financing plan, in terms of investment costs and related recurring costs. The system must establish two levels of analysis: an individual project level and an overall multiyear investment program level. This will make it possible to establish the feasibility of covering the investment costs with the combined total of the GSN's own savings, commercial bank loans, and loans under the proposed program, ensuring that prudential standards are maintained (the current revenue/debt service ratio, for instance). With respect to current costs it will be possible to determine the feasibility of covering operating and maintenance costs, in addition to debt servicing, under the proposed financial plan. In other words, it will have to be determined how the GSNs will mobilize the taxes, special fees, and tariffs needed to finance the additional costs associated with the new investments.

3.20 The third opportunity will be provided when a substantial part of the funding is allocated to investments in a service suitable for financing on a user-fee basis. In

these cases,[5] the strengthening plan must include actions to safeguard the autonomy of the regulatory agency, promote separation between the operator and the GSN, and establish a system of fees to cover the long-term cost of providing the service. The section on evaluation describes how independent consultants will be used to evaluate the initial diagnostic assessments as well as an annual sample of strengthening programs carried out by the participating GSNs. On the basis of the evaluation reports, completion of the steps required to strengthen the delivery of public services will constitute an item on the agenda of regular meetings to be held between the Bank and the executing agency to ensure proper implementation of the program. If the borrower is not a GSN but a service operator, this evaluation will include a report from independent auditors evaluating its financial statements.

F. Program Operations Manual

3.21 Prior to the first disbursement under Component II, Line of Credit, BANOBRAS must present to the Bank the MOP that will govern the use of funds from this component, including the technical, financial and environmental eligibility criteria for participation by GSNs. A draft MOP (the general lines of which are summarized in the previous sections) may be consulted in the project files. The MOP will include the following: (i) eligibility criteria; (ii) a limit for each participant of US$100 million or 50% of its investment plan, whichever is less; (iii) funds may not be used in subloans for the purchase of real estate, financing debts or buying equity shares; (iv) funds must be used exclusively for executing an agreed annual investment plan; (v) contracting and procurement procedures; (vi) information, accounting and monitoring requirements; (vii) limits and eligibility criteria for technical assistance; and (viii) a model subloan agreement.

G. Counterpart

3.22 The required counterpart is 50% of the total credit component, i.e. 100% of the Bank loan for the line of credit (US$400 million). This requirement will apply to each participating GSN on the basis of its investment plan. Any contribution to the participant's investment plan that does not come from the program will be recognized as part of the counterpart. Program promotion and administration costs incurred by BANOBRAS can also be recognized as part of the counterpart. The proportion of a GSN's investment plan financed with resources from the line of credit must not exceed 50%.

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[5] This requirement will be stipulated in the Program Operations Manual when the service represents 20% or more of the multiyear investment program, or when the cost of works exceeds US$5 million, or when the borrower is not a GSN but a service operator (private, state semipublic, or municipal semipublic).

H. Operation of the line of credit and environmental review

3.23 The matrix of criteria and goals for the line of credit (see Annex III) indicates an investment planning system as one of the key requirements for improving the management of participating GSNs. Such a system should have, as its four principal elements, procedures for ensuring: (i) that each project proposed is subjected to a proper technical analysis; (ii) that its financial consequences have been forecast; (iii) that the contracting procedure is consistent with the rules of transparency and competition; and (iv) a satisfactory environmental review process.

3.24 In the case of environmental reviews, it is important to note that the objective of the program goes beyond ensuring that specific projects financed under it are subject to such a review. The intention is that, once a participating GSN is declared eligible for access to program resources, it will have a functioning system to ensure that all of its projects, regardless of their source of financing, will be subject to such a review. In order to comply with this requirement, the entity must demonstrate the following points, among others:

(i) The entity responsible for environmental review must be independent of the entities sponsoring the projects, and must have the technical and budgetary capacity to carry out its duties on a sustainable basis.

(ii) There must be a procedure for ensuring that any project has the necessary environmental license before implementation begins.

(iii) There must be procedures for public consultation and the publication of information, and other systems to ensure that the agencies are accountable for their performance.

3.25 The responsibility for ensuring that a GSN has an adequate environmental review system, and for supervising plans to strengthen that system if it is found to be deficient, will fall to BANOBRAS, in the course of conducting the initial diagnosis of the applicant GSN. Subsequently, BANOBRAS will be responsible for monitoring the quality of the corrective actions taken. If BANOBRAS does not have the technical resources to fulfill these responsibilities, it will contract them as a charge against program resources, where appropriate.

3.26 The program calls for a system of independent auditing of operations under the line of credit in general, and in particular for auditing compliance by participants with the eligibility criteria and goals. At the outset of the program, the first five diagnoses will be assessed by independent experts with experience in the four areas of technical analysis, contracting procedures, financial analysis, and environmental protection. Every year, independent experts will evaluate at least two diagnoses or action plans, and the degree of progress. This ongoing evaluation procedure will make it possible to identify and undertake any adjustments needed to ensure that the

objective of strengthening GSN management is being met and, in particular, that the management of environmental aspects is being improved.

I. Disbursement procedures

3.27 Documentation in support of disbursements will be reviewed on an ex-post basis, in light of the fact that BANOBRAS has been performing very efficiently in its financial administration of the Sub-Program for the Institutional Strengthening of Intermediate Municipalities (FIMI) under the Municipal Development Program (PDM), currently in execution (loan 837/OC-ME). As the executing agency for Component II of this program, BANOBRAS will merely have to submit disbursement requests to the Bank's Country Office in Mexico, accompanied by payment details based on the transmission forms used in the Expanded Use Electronic Payment System (SPEUA), in accordance with specifications agreed with the Bank for controlling disbursements and local counterpart funding, while the state offices of the executing agency will retain the original of all corresponding support documentation.

3.28 BANOBRAS must ensure that the information contained in the SPEUA is duly supported by the kind of evidence normally required, as agreed with the Bank. Similarly, BANOBRAS and the states participating in Component II must maintain supporting documentation (contracts, orders, invoices, receipts, evidence of payment, supplier certificates, certificates of origin or other documents to back up the information provided in the SPEUA), properly filed and available for review by authorized Bank officials and by the external auditors.

3.29 The Bank's Country Office in Mexico will use technical or financial inspection visits to ensure, on a sampling basis, that the executor is maintaining files with supporting documentation for disbursement requests, and that the resources have been used in the manner indicated in the loan contract.

J. Revolving fund

3.30 Disbursements of 5% for constituting and replenishing the revolving fund will be made in accordance with Bank rules and provisions. The fund may be replenished upon submission of a request by BANOBRAS, justified by the accompanying detailed payment information.

K. Procurement of goods and services

3.31 The procedures proposed have been designed, in the context of a decentralized program, to allow goods and services to be procured promptly and flexibly, while at the same time respecting Bank policies with regard to principles of economy, competition, efficiency and due process in all bidding procedures associated with the program. The publication/notification of procurement will be consistent with the following principles:

a. The General Procurement Notice (GPN) for the Program, which will be published in *Development Business*, will describe the program's structure and the obligations of states and municipalities with respect to procurement (points b and c below).

b. A participating state or municipality will be deemed to have complied with the Bank's rules by publishing the following information over the Internet: (i) upon joining the program, a general description of the planned use of resources to be obtained under the program; and (ii) for each procurement, prior notice of at least two months, stating the purpose of the procurement and the name and telephone number of the person responsible.

c. Contracts establishing sub-lines of credit (between BANOBRAS and the participating entities) will include the principles listed above. The efficiency and transparency of procurement procedures will be ensured by the second of the financial management criteria (see above), which requires participating states and municipalities to have an acceptable procurement law (similar for example to the Federal Act). BANOBRAS will maintain a page on the Internet for posting advance notice of contracts under sub-lines of credit, and providing access to the individual pages of participating entities, with their procurement plans.

3.32 Finally, it has been agreed with the Country Office in Mexico that for amounts below the threshold for international bidding, all control and verification by the IDB will be done on an ex-post sampling basis.

L. Limits for international competitive bidding (ICB)

3.33 The purchases of goods and the contracting of works will be done in accordance with the procedures stipulated in Annex B of the loan contract. On an exceptional basis, it is recommended to the Bank's Executive Board that ICB be mandatory for purchases exceeding US$1 million for goods and US$10 million for works. These limits are justified in light of experience with other projects financed by the Bank in Mexico, where foreign bidders tend to participate in procurement opportunities above those limits. Moreover, the fact that many companies from Bank member countries are associated with Mexican companies will ensure a high degree of participation and representation. Although the Board of Executive Directors agreed on September 21, 1994 to raise the ICB threshold from US$1 million to US$5 million for civil works, and from US$250,000 to US$350,000 for the procurement of goods (using the arguments for loans 652/OC-ME and 670/OC-ME), there still appear to be no realistic prospects of obtaining proposals from suppliers in other member countries of the Bank. Yet the country is obliged to comply with the publicity and timing requirements, which generally result in unnecessary delays and backlogs in project execution. Bidding for amounts below these limits will proceed in accordance with national legislation, which requires public bidding and in some

cases calls for restricted invitations and/or direct awards, and these are compatible with Bank procedures. Information justifying this request for an exception concerning the number and amounts for ICB are available in the project files.

3.34 Similarly, it is proposed to the Board that, on an exceptional basis, the ICB limit for the contracting of consultants be raised from US$200,000 to US$500,000. In the case of Mexico, where many foreign consulting firms from other member countries of the Bank are already associated with Mexican companies, the existing limits are not only costly in terms of advertising and time, but often present serious obstacles to the contracting of consultants, and this has resulted in unnecessary delays in the performance of studies or specific activities, thereby needlessly holding up disbursements and delaying execution of projects financed by the Bank. Details on recent consulting contracts exceeding the proposed limits are available in the project files.

M. Direct contracting of COINFIN

3.35 As an exception to the procedures for selecting consultants through public bidding, it is recommended that the firm Financial Institutions Consultants (COINFIN) be hired directly. COINFIN has technical and institutional advantages and competitive fees for advising BANOBRAS on its Institutional Modernization Program (PDMI). COINFIN was originally hired by the Bank to prepare a diagnostic assessment and the modernization plan. Its work will be confined solely to advising BANOBRAS on execution and fulfillment of the goals of the PDMI according to the timetable of activities agreed upon by Mexico and the Bank. This approach is consistent with chapter GS-403 of the Procurement Manual.

3.36 It should be noted that the Bank's Office of Procurement Policy and Coordination has expressed its support and nonobjection to the thresholds proposed by the project team for ICB, the consulting contracts, and the direct contract with COINFIN.

N. Disbursement period

3.37 Loan funds will be disbursed over two years for Component I and over five years for Component II. Eligibility will become effective as soon as the conditions prior to the first disbursement have been fulfilled. The preliminary disbursement schedule (Table III-1) is compatible with the execution capacity and the availability of local counterpart resources.

Table III-1

Source	Year 1	Year 2	Year 3	Year 4	Year 5	Total
IDB/OC	200	300	100	100	100	800
Mexico	0	100	100	100	100	400
Total	200	400	200	200	200	1,200
%	16.7	33.3	16.7	16.7	16.7	100

O. Auditing

3.38 This will be done by independent external auditors, in addition to the annual auditing of the program's financial statements. The external auditors will also examine, on a sampling basis, the supporting documentation for disbursement requests, and they will present a separate report on that documentation.

3.39 Given the features of the proposed program, and the volume of work to be performed by the independent auditing firms, the cost of these services (US$1 million) will be financed by the Bank loan.

P. Retroactive financing and recognition of expenditures

3.40 It is recommended that retroactive financing be approved for up to US$15 million, and that expenditures for Component II be recognized as a charge to the local counterpart contribution for up to US$10 million, with respect to: (i) preparation of diagnoses; (ii) development of action plans on the basis of those diagnoses; (iii) program promotion, in accordance with procedures substantially similar to those of the Bank; and (iv) implementation of the PDMI by BANOBRAS.

Q. Program evaluation and Bank supervision

3.41 There will be a permanent monitoring system to determine and evaluate the effectiveness and efficiency of activities conducted under the program. Annual reviews will pay special attention to execution of the entire program, and to identifying any changes necessary to ensure optimum execution.

3.42 Within the first three months of each calendar year, the executing agency will submit an operating plan for execution of Component II during that year. At the time of the annual supervision and evaluation meetings, the progress of execution will be analyzed in accordance with the program's monitoring indicators and goals. In addition, a joint monitoring meeting will be held six months after the beginning of implementation of the PDMI in BANOBRAS, in order to verify its progress.

3.43 The Bank's Country Office in Mexico (COF/CME), with technical support from the Social Programs Division (SO2) and the Infrastructure and Finance Division (FI2), will be responsible for supervising program performance. All controls and

verifications will be done on an ex-post basis. Once a year, BANOBRAS will use program resources to hire independent consultants to evaluate: (i) compliance with GSN eligibility criteria under Component II; (ii) use of resources from the line of credit; (iii) compliance with procurement procedures; and (iv) compliance with the *pari passu* rules for the local counterpart contribution. The audit will be based on the participating state or municipality as the unit of analysis. Ten percent of participants, numbering no fewer than two, will be audited each year. The auditors' report will constitute the basis for the annual meetings to be held by the Bank with the SHCP and BANOBRAS for monitoring the program and making any necessary adjustments.

3.44 To establish a suitable technical level from the outset, BANOBRAS will hire independent consultants with program resources to evaluate the first five diagnostic assessments and strengthening plans prepared for the program. It is expected that the resulting reports can be reviewed as part of the follow-up meetings six months after program startup.

IV. BENEFITS AND RISKS

4.1 Following is an analysis of the risks and benefits as they relate to the principal elements of the proposed program. Separate consideration is given to the federal reforms supported under Component I, such as introduction of *Ramo 33*, modernization of BANOBRAS and amendments to the GSN credit guarantee scheme. Finally, the benefits and risks associated with the line of credit proposed under Component II are analyzed.

A. Introduction of *Ramo 33*

4.2 The introduction of untied funding through *Ramo 33* marks the beginning of a new stage in the development of federalism in Mexico. While federal transfers have played a predominant role in local finances since the current system was first created by the Fiscal Coordination Act of 1978, the federal executive has retained the power of decision-making with respect to resources earmarked for the GSNs. Thanks to *Ramo 33*, the GSNs will acquire the power to decide for themselves how to allocate a growing volume of budgetary resources. Three aspects warrant special attention in this context:

a. **The volume of resources involved**. The GSNs will receive about US$22 billion in 1999, compared with about US$15.99 billion in 1995, by way of transfers (representing an annual growth rate of 8.3%). The municipalities, and especially those with major urban centers, have benefited in particular from this reform in the sense that they are now able to finance more ambitious infrastructure investment programs.

b. **The guiding principles for implementing these transfers**. Perhaps even more important is the fact that these transfers have been accomplished by means of a set of clearly established fiscal principles aimed at achieving greater expenditure efficiency: local discretion over their application; allocation by objective formula; scheduled disbursements; and transfer of responsibility to the local level for making proper use of these resources. These principles are intended to ensure that resources can be used flexibly to respond to the real priorities of the local population, and they will therefore contribute to enhancing efficiency in the use of Mexico's public resources.

c. **The precedent represented for the future evolution of the fiscal transfers system**. These reforms constitute a precedent in the sense that the programs they cover belong to the GSNs, and not to the federal government. With introduction of *Ramo 33*, it is now politically and technically feasible to transfer increasing autonomy over budgetary expenditures to the GSNs. Future amendments to the transfers system will undoubtedly be made within the parameters set out by this

instrument. This process is already evident in the 1999 budget, where a new program (public safety) was added to *Ramo 33*.

4.3 On the other hand, the most glaring weakness in the instrument is the fact that Funds 1 and 2 under *Ramo 33*, dedicated to education and health, do not show these characteristics. In those funds, local autonomy is severely constrained by the continued centralization of key decisions at the federal level. It is clear that political problems continue to affect the pace of decentralization in Mexico. There is a consensus, however, that this process is irreversible, and that the system of transfers must continue to be adapted so as to broaden the scope of budgetary freedom for the GSNs.

4.4 It is clear that if these federal reforms are to have the expected impact, the GSNs must have the institutional capacity to cope adequately with their new responsibilities. In a country with such great diversity as Mexico, there are major differences of institutional capacity among the GSNs. The lack of capacity, particularly (but by no means exclusively) among the poorer GSNs, represents a high risk to the decentralization process. Yet there are two factors that should help to mitigate this risk:

(i) In the political arena, the GSNs have recently become much more democratic, as is reflected in the electoral battles between the official party and the opposition. Thanks to the efforts of political parties and citizens groups and other associations, local government is coming under increasing public scrutiny. This in turn has generated noticeable political pressure to improve the performance of local administration.

(ii) Component II, the line of credit, is aimed at strengthening the management tools for exerting proper control over resources at the disposal of the GSNs, and generating financial information that will allow the citizenry to oversee the performance of local administrations. In this respect, efforts to ensure greater transparency in those administrations are essential to the success of the program. The program will therefore promote measures to enhance the quantity and quality of information available at the local level on the budgetary process and its management.

B. Corporate reform of BANOBRAS

4.5 Introduction of the Institutional Modernization Program (PDMI) in BANOBRAS is an important step forward in the process of modernizing that institution. This plan was developed by BANOBRAS management with the advice of specialized consultants, and it enjoys the full support of the institution's senior management and its Board of Directors. Now that there is a consensus on the issues facing the bank and on the measures that must be taken, there are much better prospects for success

with this complex process of institutional transformation that is being launched with the PDMI. It includes measures that should have a great impact, and that can be completed in less than 12 months, before the next round of elections gets underway. Nevertheless, there is always a serious risk of resistance to change in undertakings of this kind, and BANOBRAS will be no exception in this respect. To deal with these difficulties, senior management has agreed to set up a working group composed of high-level officials who are well known within the institution, through which, with the help of specialized consultants, they can manage the process of institutional change.

4.6 Once the PDMI is completed, Mexico will have an institution that can draw upon its valuable experience to provide better service and products to the GSNs. The manner of decision-making within the organization will also have changed, by decentralizating powers and responsibilities. To this end, it will be essential to move away from the current system of committees, where responsibility is diluted, to a system based on individual accountability. Substantial changes will also have to be made to the way the organization evaluates and manages credit risk, by implementing uniform and decentralized processes and procedures. Moreover, during the next twelve months, a detailed action plan will be developed for the years following completion of the PDMI, in order to consolidate the process of change. These are fundamental changes that, once introduced, will have an effect on other areas of the bank, and are expected to place BANOBRAS in an excellent position to consolidate the process of institutional transformation over the coming years.

4.7 There is a risk that the BANOBRAS reform program will not be carried to completion, or that when it is completed a decision might be taken to halt or reverse the process of change. Nevertheless, once a program of this type is launched, and if it enjoys the decisive support of senior management from the outset, it takes on a dynamic of its own, which will be difficult to derail arbitrarily. It should be noted that within the SHCP, which is responsible for the development banking system, there is a strong current of opinion to the effect that BANOBRAS has not performed as well as it could, and that a thorough overhaul of the organization is in order. Moreover, the program offers parallel but consistent incentives to all major players. If it fails to achieve the goals set out in the conditionality matrix, the SHCP will not have access to the second tranche of Component I, and BANOBRAS will not be able to access the line of credit.

4.8 The PDMI will not in itself solve the basic problem of the continually narrowing spread for BANOBRAS intermediation. Over the medium-term, this problem could erode the institution's capital base. A basic solution to this structural problem will require a combination of measures designed to lower operating costs while raising value added and the spread for GSN operations. Various components of the PDMI will contribute significantly to this process: the elimination of non-essential activities – particularly large volume operations in small amounts, which have a

strong impact on the Bank's cost base; the customer oriented approach to BANOBRAS activities; and the introduction of better mechanisms for measuring and controlling the risk and profitability of operations. BANOBRAS has also launched an information campaign for potential investors, stressing its role in reducing the cost of establishment in local markets. The measures proposed in the PDMI provide a basis for reversing the negative trend in financial spreads. Module 11, medium-term economic planning, can be expected to result in other complementary measures as part of a comprehensive and substantive response to the financial and structural problems facing BANOBRAS over the medium-term and beyond the context of this operation.

4.9 It is appropriate to ask what should be the role of an institution like BANOBRAS in the continuing development of Mexico's financial markets. The recent history of those markets has been highlighted by the fact that the banking system has been unable to overcome the financial crisis of 1995. Although government actions succeeded in containing the crisis and re-establishing an atmosphere of stability and confidence, the banks within the system have continued to suffer from inadequate capitalization, high levels of nonperforming loans, and a lack of liquidity in much of their asset base. In real terms, bank lending has been dropping at an accelerating pace over the last four years (almost 40% in real terms). The government has launched a new effort to consolidate the process of rationalizing the banks and stimulating banking activity. Yet the banks are only now beginning to recover, and this process is likely to take many years. In such circumstances, BANOBRAS will continue to play an essential role as the principal supplier of credit to the GSNs, at least in the near future (two to three years).

4.10 In the short run, then, the program will allow BANOBRAS to offer greater efficiency in its services. Over the medium term, however, it is expected that, with recovery of the financial sector generally, commercial sources of financing will take on an increasingly important role in funding public infrastructure at the local level, for two basic reasons:

(i) Mexico's public development banks face the same cost structure as the private banking system when it comes to funding themselves in financial markets (essentially through bonds), but they do not have access to the same diversity of funding sources (through public deposits); and

(ii) The process of banking disintermediation, although it is just beginning, can already be seen in the number of GSN issues placed directly on the

capital markets[6], a trend that is expected to be accentuated in coming years.

4.11 It is expected that this trend will be more evident initially among those GSNs that are in a relatively strong financial position. BANOBRAS will gradually have to specialize in meeting the needs of municipalities that require assistance in gaining access to financial markets. Over the medium term, then, it is expected that the reform supported here will help provide BANOBRAS with the elements for responding appropriately to changes in the market.

C. Reform of the guarantee system based on federal transfers

4.12 The government's proposed scheme will put an end to the uncertainty that has arisen in light of the changes that were made to the Fiscal Coordination Act in 1996, since which time the Ministry of Finance and Public Credit (SHCP) has been operating under a transitional article of that Act. In addition, withdrawal of the federal government from operations under this scheme will reduce expectations that the Federal Government will intervene with its own funds to cover commitments and to bail out GSNs in financial difficulty. These two aspects should help to revive commercial lending to municipalities and to encourage the development of new alternatives for the banks and the GSNs to restructure their financial operations.

4.13 When it comes to encouraging suppliers of credit to differentiate in their transactions according to risk, the incentives contained in that scheme operate only indirectly, through the capital adequacy index of the banks. If those incentives are to be effective, the authorities will have to amend the rules governing the minimum level of capitalization for financial intermediaries. The banks' shortage of equity capital is a topic of wide discussion in the Mexican media, as is the need to restrict the inclusion of certain items such as deferred taxes in the capital base. The authorities have undertaken with the IMF to revise the capital adequacy rules for the banking system, to bring them more closely into line with international standards. Nevertheless, this process must be regarded as a medium-term undertaking, given the current weakness of Mexican bank capitalization. Under the circumstances, the IDB intends to maintain an ongoing dialogue with the authorities in order to assess the effectiveness of the incentives system implied in the government's proposals.

4.14 Overall, the two groups of reforms will help to correct two major shortcomings in the credit market for GSNs. On one hand, the reforms proposed for BANOBRAS will transform that public sector institution from a high-cost operation into an entity

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[6] This process will also depend on the capacity of the GSNs to present themselves as creditworthy borrowers. The line of credit under this operation will help GSNs to improve their management and enhance the quantity and quality of the information they provide to markets.

that is more effective and better prepared to fill the gaps that are still not being covered in a satisfactory manner by the commercial banking system.

D. The line of credit

4.15 Recent years have seen the transfer of major responsibilities from the federal level to the GSNs. Yet the capacity of the GSNs to respond to this challenge is very uneven, and the analytical stage of the present program identified seven factors that are of great importance to the sound performance of the GSNs. Strengthening these factors will have a significant effect on the quality of GSN management in two principal areas: management and internal controls, and the generation of relevant and timely public information. Thanks to the incentives contained in this component, the GSNs should be motivated to participate in the program, and to generate a modernization plan for tackling the areas of weakness detected. To the extent that they succeed in meeting the parameters of good practice, funds will be made available to them for financing their investment budgets. The main attraction of these resources is that each individual investment project will not have to be subjected to scrutiny by BANOBRAS. The direct link between improved management capacity and access to financing resources is expected to constitute a powerful incentive.

4.16 There are currently no other programs in Mexico to foster improvements in GSN management systems, as Component II of this program is expected to do[7]. The volume of freely allocable resources that they will be managing is considerable, in excess of US$20 billion. The returns from improved management of these resources are potentially very high.

4.17 Despite the risks inherent in Component II, it should be noted that while BANOBRAS has extensive experience in financing technical cooperation and institutional strengthening programs, it has none when it comes to executing policy oriented investment programs. BANOBRAS faces an ongoing conflict, common to most development banks, between policy objectives and the need to keep placing funds in new operations. Despite this, it is clear that the senior administration of BANOBRAS has identified this as an area where BANOBRAS can play an important role, and one that could not readily be performed by the commercial banking system. The performance of BANOBRAS in identifying weaknesses in GSN management systems and in conditioning disbursements to real progress in these areas will be monitored closely through evaluations by independent consultants.

[7] For the last four years, the SHCP has been managing a program to coordinate efforts to restructure the debt of the GSNs. Although this scheme represented a strong incentive to comply with rules and regulations, the SHCP has indicated that it will not allocate any special budget transfers to continue financing the program, and hence it is expected to have no funding for the year 2000.

STATE AND MUNICIPAL REFORM PROGRAM ME-0208

POLICY MATRIX

As guidance to the borrower with respect to specific actions required to comply with conditionality, a more detailed list is found in the annexes following this matrix

Areas and objectives	First tranche conditionality and Conditions prior to Board submission[1]	Second tranche conditionalit
ing the system of fiscal federalism		
ting expenditure decentralization anism for federal transfers to the GSNs that use of resources.	Introduce a mechanism with the following characteristics[2] 1. Autonomy for the GSNs in the use of resources. 2. Allocation of resources through an objective formula. 3. Prior and assured scheduling of disbursements. 4. Make the GSNs responsible for the proper use of resources	Retain the mechanism
ng the credit market for GSNs		
thening the performance of BANOBRAS s in BANOBRAS to correct the principal approach, procedures and structure, and its on.[3]	Conditions prior to presentation to the IDB Board: 1. Submission of the Institutional Modernization Plan (PDMI), after approval by the BANOBRAS board. 2 Selection of pilot local offices. 3. Submit plan of products, functions and portfolios to be phased out, specifying the first group of functions and portfolios to be phased out.	Achieve PDMI goals in the following areas:[3] 1. **Service to clients**. Select 4 to 6 offices and re their structure so that staff devote more of thei serving clients. 2. **Credit process**. Uniform credit policy and m introduced. In the pilot offices, new procedur initiating and managing credit have been impl 3. **Committees**. Rationalize the number and pov committees. 4. **Re-engineering products**. Rationalize the ra existing products and introduce a standard pro approving new products. 5. **Peripheral activities**. Identify non-essential a portfolios, and products to be phased out. 6. **Continuity**. Prepare an action plan for contin implementation of PDMI as an aide memoire f following administration.

Areas and objectives	First tranche conditionality and Conditions prior to Board submission[1]	Second tranche conditionality
ket for GSNs (continued)		
e guarantee scheme for GSN debt service Debt scheme based on guarantees in the form		The subnational debt scheme has been amended to 1. **Credit evaluation**. Effective incentives for ba conduct credit evaluations and differentiate loa and risk. 2. **Prudential limits**. Effective incentives for ler avoid excessive risk exposure beyond reasonal prudential limits in extending credit to GSNs. 3. **Transparency**. Measures to ensure publicatio (or agencies it designates) of a database for ea with historical data on debt, outstanding balan amounts and financial conditions.

prior to Board submission are indicated in italics in this column
ovides greater detail on the elements required to meet this condition
resents specific benchmarks for the PDMI

MEXICO

STATE AND MUNICIPAL REFORM PROGRAM (ME-0208)

Area/Objective	First tranche conditionality for Component I	Documentary support
liture decentralization		
nism and system for transfers to the GSNs that following areas:	Government of Mexico, through the Ministry of Finance and Public Credit (SHCP) will present evidence to the Bank that legal measures have been taken relating to:	
ty over resources	• Direction of funding, objectives of decentralization and medium-term prospects (General and by fund)	• Fiscal Coordination Act, Chapter V, 1999 • Decree approving the PEF, 1999, DOF [Officia 12/31/98
of funds by formula	• Determine technical ceilings for *Ramo 33* funds. distribution criteria and mechanisms for supervision, control and evaluation of decentralized resources (by fund)	• Fiscal Coordination Act, Chapter V, 1999 • Decree approving the PEF, 1999, DOF 12/31/9
eduling of resources	• Provide an efficient mechanism for distributing *Ramo 33* funds for 1998 and 1999, and publish an advance schedule	• DOF 01/30/98; DOF 01/20/99; and 01/29/99
responsible for control and supervision over nagement	• Determine that *Ramo 33* resources will be administered and executed by the GSNs	• Decree approving the PEF, 1998 • Fiscal Coordination Act, Chapter V, 1998 DOF • DOF 12/31/98

nal Government
xpenditures Budget
Gazette

ME-0208/BANOBRAS LINE OF CREDIT
MATRIX OF CRITERIA AND GOALS

	Category 1 GSNs	Category 2 GSNs
Classification criteria	Municipalities with more than 200,000 inhabitants State governments	Municipalities with more than 200,000 inhabitants
Number of states	32	
Number of municipalities	66	> 2,000

Eligibility criteria (Group for 2nd disbursement)	Goals for Cat. 1 GSNs Category 1		Goals for Cat. 2 GSNs Category 2
1. Audited financial statements	Auditing by an independent firm		Auditing by the State Auditor General
2. Establish an investment planning system with procedures	Technical:	Multi-sector and multi-year system for selecting works on basis of a development plan	List of projects based on sector development plans (water supply and sanitation, transportation)
	Financial:	Financing plan that indicates the source of financing for each project (current savings, commercial credit, BANOBRAS credit, private sector)	No requirements
	Contracting:	**States**: contracting law that assures transparency and efficiency in procurement of goods and services. **Municipalities:** compliance with state law. Quarterly publication of list of contracts granted, on Internet site.	Compliance with state law. Quarterly publication of list of contracts granted, on Internet site
	Environment:	**States:** separation of functions between entities responsible for sponsoring projects and entity responsible for environmental licensing. Process of environmental review and enforcement. **Municipalities**: environmental office responsible for defining and reviewing environmental studies before submitting them to the regulatory entity.	Environmental engineering available for defining and reviewing environmental studies before submitting them to the regulatory entity

3.	Transparency	Publish quarterly reports using basic BANOBRAS formats, with financial statements and debt profile (outstanding balances, original amount, date of contracting, interest rate, amortization date)	Publish quarterly reports using basic BANOBRAS formats, with financial statements and debt profile (outstanding balances, original amount, date of contracting, interest rate, amortization date)
4.	*Ramo 33* management	States: 1. Establish, through the appropriate legal instrument, a mechanism to ensure transparency in the use of *Ramo 33* resources earmarked for the state itself, stipulating clear rules for publication of ex-ante information, audits and publication of ex-post information as appropriate.[1] 2. Establish, through the appropriate legal instrument, a mechanism to ensure transparency in the allocation of *Ramo 33* resources that the state will pass on to its municipalities, stipulating clear rules for reporting, auditing and publication of corresponding information.[2] Municipalities: Establish, through the appropriate legal instrument, a mechanism to ensure transparency in the use of *Ramo 33* resources earmarked for the municipality, stipulating clear rules for the publication of ex-ante information, audits and publication of ex-post information as appropriate.[3]	Establish, through the appropriate legal instrument, a mechanism to ensure transparency in the use of *Ramo 33* resources earmarked for the municipality, stipulating clear rules for the publication of ex-ante information, audits and publication of ex-post information as appropriate.[4]

[1] In particular, the state must demonstrate that it is complying with the requirements of article 33 (I to IV), of the Fiscal Coordination Act (Official Gazette of 31 December 1998) with respect to the Social Infrastructure Contribution Fund.

[2] In particular, the state must demonstrate that it has complied with the requirements of article 35 (penultimate paragraph) of the Fiscal Coordination Act (Official Gazette of 31 December 1998) with respect to the Social Infrastructure Contribution Fund.

[3] In particular, the municipality must demonstrate that it has complied with the requirements of (a) Article 33 (I to IV) of the Fiscal Coordination Act (Official Gazette of 31 December 1998) with respect to the Social Infrastructure Contribution Fund, and (b) Article 37 of that Act with respect to the Municipal Strengthening Contributions Fund.

[4] In particular, the municipality must demonstrate that it is compliant with the requirements of (a) Article 33 (I to IV) of the Fiscal Coordination Act (Official Gazette of 31 December 1998) with respect to the Social Infrastructure Contribution Fund, and (b) Article 37 of that Act with respect to the Municipal Strengthening Contributions Fund.

Eligibility criteria (Group for 3rd disbursement)	Goals for Cat. 1 GSNs Category 1 (State governments and municipalities with more than 500,000 inhabitants)	Goals for Cat. 2 GSNs Category 2
5. Budgeting	Budgeting by program and by activity, with cost and revenue centers, integrated into the accounting system	Budgeting system by program and activity
6. Tax administration	6-month collections equal to 85% of potential collections. Expansion of the tax base.	6-month collections equal to 70% of potential collections
7. Accounting	Double-entry, cause-based accounting system linked to payment and budgeting system	Accounting system for tracking financial obligations (acquisition, expiry, payment)

<u>Disbursement sequence</u>:
1st Disbursement: eligible upon signature of reform agreement and action plan with the specific GSN.
2nd disbursement: eligible when GSN meets goals for criteria 1, 2, 3 and 4.
3rd disbursement: eligible when GSN meets goals for criteria 5, 6 and 7.

Component II – Line of Credit
Strengthening GSN administration systems
Annual performance indicators

Issue/Year	Year 1	Year 2	Year 3	Year 4	
Agreements signed with GSNs					
States	10	12	3		Total: 25 states
Municipalities	5	5	5		Total: 15 municipalities
Diagnoses performed	15	17	8		Total: 40 GSNs
Systems to be strengthened			8		
1. Auditing	15	17	8		
2. Investment planning	15	17	8		
3. *Ramo 33*	15	17	8		
4. Transparency	15	17	8		
5. Budgeting		15	17	8	
6. Tax administration		15	17	8	
7 Accounting		15	17	8	
Annual evaluations performed	2	2	2	2	Total: 8 GSNs
Initial evaluations	5				

MEXICO
STATE AND MUNICIPAL REFORM PROGRAM (ME-0208)
WORK PLAN FOR THE INSTITUTIONAL MODERNIZATION PLAN (PDMI) OF BANOBRAS

Modules	Sub-modules	Goals (no trad. Del traductor)
pilot offices [*Delegaciones*]	1.1 Determine characteristics of pilot offices	- Define criteria for an office to qualify and guarantee s PDMI
	1.2 Select pilot candidates	- Reduce number of candidates to between 8 and 10 off
	1.3 Interview office chief and staff	- Examine offices in detail to select final pilot offices (I
nal adaptation of pilot offices	2.1 Adapt organization of pilot offices	- Define a suitable organization for the DPs
	2.2 Determine expected work loads	- Define personnel requirements for each DP.
	2.3 Training and skills upgrading	- Provide training for DP personnel
	2.4 Management information system	- Implement pilot system of management information a temporary information system
of client focus	3.1 Prepare client matrices in pilot offices	- Coverage matrix for 1 year completed for DPs.
	3.2 Prepare accounting plans in pilot offices	- Accounts plan for 1 year completed for each DP.
	3.3 Prepare credit plans in pilot offices	- Credit plan for 1 year completed for each DP.
	3.4 Approval of Central Credit Committee	- Plans for each DP approved.
	3.5 Analysis and approval of individual projects	- Portfolio of projects in progress according to new plai
on of credit risk management	4.1 Credit policy manual	- Credit Policies Manual prepared.
	4.2 Procedure for implementing the credit policy manual	- Credit policies manual implemented throughout the o
ing the credit initiation process	5.1 Establish credit granting powers	- Matrix of credit granting authorities for DPs prepared
	5.2 Requirements and documentation for credit applications	- Easier for DP clients to apply for credit, requirements minimum.
	5.3 Risk analysis for proposed credits	- DPs have project analysis form for Technical Credit C
	5.4 Set structure and pricing	- Matrix of terms, conditions and prices applicable to tl prepared.
	5.5 Implement Technical Credit Committees	- Operating standards for Technical Credit Committees prepared.
	5.6 Re-engineering the records and files system	- New records system introduced in DPs.
	5.7 Documentation and disbursement	- New system for documentation and disbursement syst prepared.
	5.8 Training program for the new credit initiation process	- New process for initiating credit functioning in DPs.

Modules	Sub-modules	Goals (no trad. Del traductor)
ing the credit monitoring	6.1 Annual review of lines of credit and project approvals	- New global line and program review process impleme
	6.2 Function for reviewing credit process and portfolio	- Review function implemented in DPs.
	6.3 Monitoring and control of projects in progress	- New process implemented in DPs.
	6.4 Early warning system for problem loans	- New process implemented in DPs.
	6.5 Managing problem loans	- New process implemented in DPs.
	6.6 Functions in support of risk management	- New functions implemented in DPs.
	6.7 Training program for new credit monitoring process	- DP training program completed.
ing committees	7.1 Diagnosis of current situation	- Details available on how committees operate.
	7.2 Characteristics of committee system	- General features of committees defined.
	7.3 Design of committee system	- New committees system and manual in place.
	7.4 Institutional committee	- Committee functioning.
	7.5 Central Credit Committee	- Committee functioning.
	7.6 Technical Credit Committee	- Committee functioning.
	7.7 Committee on Asset and Liability Positions	- Committee functioning.
	7.8 Committee on Technology and Informatics	- Committee functioning.
	7.9 Products Committee	- Committee functioning.
	7.10 Control and Auditing Committee	- Committee functioning.
ing products	8.1 Analysis of current products	- Details available on existing products.
	8.2 Analysis of client needs	- Market analysis for institution's products available.
	8.3 Design families of credit and fiduciary products	- Products manual approved and operating.
	8.4 Process for design of new products	- Procedures in place for developing, designing, approv introducing new products.
	8.5 Training program for new product system	- Training in new product creation process and in new r completed.
d portfolio to be phased out	9.1 Selection of portfolio and products to be phased out	- Portfolio selected.
	9.2 Selection of working team	- Team selected.
	9.3 Analysis of alternative courses of action and phase-out of portfolio	- Portfolio removed from balance sheet.
be phased out	10.1 Selection of functions to be phased out	- List of functions for phase-out completed.
	10.2 Analysis of alternative courses of action and phase-out of functions	- Non-essential functions eliminated from internal Banl
	10.3 Review of impact and results	- Report on results of phase-out of functions completed
n planning	11.1 Medium-term objectives of the Modernization Plan	- Medium-term objectives of the modernization project
	11.2 Key areas for attention and proposed work plan	- Key areas for attention and action plan defined.
	11.3 Development of the medium-term plan	- Medium-term plan developed with an aide-memoire f administrations

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Original: Spanish

PROPOSED RESOLUTION

MEXICO. LOAN ___/OC-ME TO THE BANCO NACIONAL DE OBRAS Y SERVICIOS PUBLICOS, S.N.C.

States and Municipalities Strengthening Program
(Fast Disbursement Component)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Banco Nacional de Obras y Servicios Públicos, S.N.C., as Borrower, and the Estados Unidos Mexicanos, as Guarantor, for the purpose of granting the former a financing to cooperate in the execution of the Fast Disbursement Component of a State and Municipalities Strengthening Program. Such financing will be for the amount of up to US$400,000,000, from the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the "Financial Terms and Conditions" and to the "Special Contractual Conditions" of the Executive Summary of the Loan Proposal.

PROPOSED RESOLUTION

MEXICO. LOAN ___/OC-ME TO THE BANCO NACIONAL DE OBRAS Y SERVICIOS PUBLICOS, S.N.C.

States and Municipalities Strengthening Program
(Investment Component)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Banco Nacional de Obras y Servicios Públicos, S.N.C., as Borrower, and the Estados Unidos Mexicanos, as Guarantor, for the purpose of granting the former a financing to cooperate in the execution of the Investment Component of a State and Municipalities Strengthening Program. Such financing will be for the amount of up to US$400,000,000, from the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the "Financial Terms and Conditions" and to the "Special Contractual Conditions" of the Executive Summary of the Loan Proposal.