MULTIPHASE PROGRAM FOR INVESTMENT AND FINANCIAL AND INSTITUTIONAL STRENGTHENING OF STATES AND MUNICIPIOS. PHASE I

(ME-0231)

EXECUTIVE SUMMARY

Borrower: Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS)

Guarantor: United Mexican States

Executing agency: BANOBRAS

Amount and source:

	Phase I (three years)	Phase II (three years)	Phase III (three years)
IDB: (OC)	US$300 million	US$300 million	US$400 million
Local:	US$300 million	US$300 million	US$400 million
Total:	US$600 million	US$600 million	US$800 million

Financial terms and conditions:

Amortization period:	25 years
Grace period:	3 years
Disbursement period:	3 years
Interest rate:	variable
Inspection and supervision:	1%
Credit fee:	0.75% on the undisbursed balance
Currency:	U.S. dollar drawn on the Single Currency Facility

Objectives: The general objective of the program is to support the decentralization process in Mexico by enhancing the management capacity and financial situation of subnational governments.

The specific objectives are to: (i) introduce best practices geared towards strengthening the management of public funds by subnational governments; (ii) strengthen these governments' financial situation; and (iii) finance investment projects with high social return and technical assistance to expand these governments' capacity to deliver public services.

Rationale for a multiphase program: Unlike other projects that seek to solve a specific problem, this program will support the decentralization process that has been stepped up since 1998 and will continue beyond the program's nine-year implementation period at various levels and with various actors

(federal, state, and municipal). In addition to providing financing for infrastructure and public, financial, and social services projects, the Bank will support: (i) the administrative and financial modernization of subnational governments; (ii) preparations to help these governments improve their access to credit; and (iii) compliance with Bank policies on economic, financial, and environmental viability, sector criteria, and public utilities.

It is proposed that the multiphase modality be used, which has been adopted satisfactorily in other operations in Mexico, and holds important advantages inasmuch as it will allow the Bank to adjust its support for subnational governments and BANOBRAS in accordance with the changing economic, legal, political, financial, and social context of the decentralization process. The first phase will focus on verifying the effectiveness of the new eligibility criteria, especially in the financial sphere, and on testing BANOBRAS's capacity to absorb the allocated resources effectively and its institutional strengthening and modernization. During the second phase, any necessary changes will be made in order to adjust, enhance, and consolidate the new criteria, mechanisms, and products. During the third phase, adjustments will continue to be made and program coverage will be expanded. The present proposal is to approve the format of a multiphase program and a loan for the first phase.

Description: The credit line (US$297 million for phase I) will be administered by BANOBRAS so as to encourage the subnational governments to adopt a series of best practices in their financial and institutional management. As the agreed best-practice targets are attained, the subnational governments will gain access to program resources to finance part of their investment plans on a gradual basis. Financing will be provided for up to 50% of the investment plans presented by the subnational governments (up to a maximum of US$100 million per accredited entity).

The credit line will also be used to finance, on a pilot basis, up to 50% of the investment plans (up to US$1 million) of approximately 10 municipios classified in the category of medium to high marginality, some of which are located in the country's 250 microregions with highest marginality.

This credit line will make it possible to continue and expand the financial and institutional strengthening launched under the State and Municipio Strengthening Program (FORTEM, loan 1214/OC-ME) and meet the growing demand for this type of operation. It will operate along the same lines as the FORTEM program, with the function performed by the seven criteria being expanded through a manual on financial and institutional best practices, an institutional and financial analysis manual, and a core action plan. A new structure

will give greater flexibility for adapting program actions to the requirements of each subnational government. All Bank criteria concerning economic, financial, and environmental viability, sustainability of investments, and the public utilities policy will be observed.

The Bank's country and sector strategy: The proposed program is consistent with the 2001-2006 National Development Plan and the Bank's strategy for Mexico. Specifically, it seeks to strengthen structural reforms for decentralization with an eye to effecting greater social change, reducing poverty, and fostering more harmonious regional development that is both socially equitable and geographically balanced. The program is also consistent with the Bank's subnational development strategy, which includes among its proposed areas of intervention building institutional capacity among subnational governments and developing financing vehicles for subnational entities.

Environmental and social review: Pursuant to the recommendations made at the 31 August 2001 meeting of the Committee on Environment and Social Impact, it was decided that the instruments contained in the program—i.e., its operations manual, the financial and institutional best practices manual, and the financial and institutional analysis manual—will include an environmental component as a core element of subnational government management. Details on the program's environmental strategy can be found in chapter IV and Annex II.

Benefits: Mexico currently has no programs that focus on enhancing subnational government management systems. The proposed program's activities will encourage subnational governments to strengthen their financial management as a complement to the decentralization measures taken by the federal government, and the mechanisms to be implemented will yield important benefits for subnational governments. The adoption of financial best practices will make for more efficient use of public funds and prevent the overcommitment of these resources.

The financial and institutional analysis manual will provide a more complete description of the desirable features of a subnational government and ensure greater rationality and coherence in the actions taken by those governments under the program. Likewise, the program will identify best practices and benchmarks against which the governments can measure their performance and against which the public can assess how well their government is working. The manual is also expected to become a tool for disseminating best practices. For instance, proper regulation of Ramo 33 (one of the mechanisms used by the federal government to transfer resources to subnational governments) and better management of investments and audit, budgeting, and accounting systems would allow subnational

governments to meet citizens' needs more efficiently and with greater equity. Similarly, making operations more transparent will give financial agents as well as the general public better criteria for assessing subnational government performance.

Risks:

There is a risk that the activities to prepare diagnostic studies and approve financing could generate a conflict of interest within BANOBRAS during program execution. In this connection, BANOBRAS's recent reorganization established a clear and transparent separation of the processes of promotion, approval, lending, and monitoring for financed operations of subnational governments. A key consideration is that the process will include the Center for Studies on the Economic Evaluation of Projects (CEPEP), an agency that operates within BANOBRAS as a select group of professionals with recognized experience in project analysis who will be responsible for the projects' socioeconomic appraisal and will check that the individual projects to be funded meet the economic, financial, and environmental viability and sustainability criteria.

Special contractual clauses:

The first disbursement of program funds will be released upon fulfillment of the following conditions and approval by the Bank:

(i) Adoption of the program's operations manual, prepared in accordance with terms previously agreed with the Bank (paragraph. 3.13)

(ii) Adoption of the manual on financial and institutional best practices, prepared in accordance with terms previously agreed with the Bank, which will be used by BANOBRAS to prepare the action plans for the subnational governments (paragraph 3.17)

(iii) Adoption of the financial and institutional analysis manual, prepared in accordance with terms previously agreed with the Bank, which will be used by BANOBRAS to produce a financial and institutional analysis of the subnational governments participating in the program (paragraph. 3.18)

(iv) Presentation of the model agreement that BANOBRAS will use with each of the participating subnational governments (paragraph. 3.28)

Condition for execution

During execution of the program, BANOBRAS is to: (i) ensure institutional separation between its area of promotion, technical assistance, and planning; and (ii) keep the necessary technical capacity in order to ensure application of the viability and sustainability criteria for projects to be financed.

Prior to approval of this operation, BANOBRAS fulfilled the condition of adopting an ex ante review system for the procurement of works, goods, and consulting services by subnational governments (paragraph 3.40).

Poverty-targeting and social sector classification: This operation qualifies as a social equity enhancing project as described in the key objectives for the Bank's activity set forth in the report on the Eighth General Increase in Resources (document AB-1704). The experience gained under the FORTEM operation in the states of Quintana Roo, Oaxaca, and Veracruz indicates that there is an unmet demand for programs to provide institutional and financial strengthening in subnational governments in whose territory a high percentage of the population is poor. This demand was taken into account in the design of the proposed program, which expects to secure greater participation in the lower-income states, such as Campeche, Puebla, and Yucatán. The program also includes a pilot project to strengthen the governments of municipios classified in the category of medium to high marginality, with the objective of supporting BANOBRAS in designing and implementing new intervention methodologies that could be replicated on a larger scale during a second phase of the program. The operation does not qualify as a poverty-targeted investment (PTI).

Exceptions to Bank policy: None

Procurement: Bank policies and procedures will be followed for the procurement of all goods, services, and works.

International competitive bidding will be used whenever the estimated value of the goods or related services being procured is US$350,000 or more, with a threshold of US$5 million for works procurement. International open calls for proposals will be used for consulting services estimated at US$200,000 or more.

Consulting services estimated at less than US$200,000 will be procured in accordance with the provisions of Annex D to the loan contract.

Recognition of expenses: Not applicable

I. BACKGROUND

A. Introduction

1.1 In 1999, the Bank approved the Program to Strengthen the States and Municipios (FORTEM), the objective of which was to support the decentralization process in Mexico. The program consisted of a fast-disbursing component and a line of credit, in the amount of US$400 million each. The fast-disbursing component (loan 1213/OC-ME) has been fully disbursed, and the line of credit (loan 1214/OC-ME) shows an advanced level of execution (35%) and of committed resources (100%). The line of credit has proven an effective instrument for promoting change in the participating states and municipios toward modern and transparent management practices and toward greater solidity in their finances. The Mexican government has requested a new Bank program that incorporates the lessons learned from the FORTEM. Inasmuch as the decentralization process in Mexico is well under way but requires significant adjustments, and the use of credit as a tool to support that process must adapt to these changes and to the evolution of the financial markets, this operation has been structured in three phases, for a total of US$1 billion. The new operation will seek to motivate states and municipios to commit to introducing significant reforms to strengthen their financial structure and institutional capacity for change in order to obtain program resources to finance part of their investment plans. These reforms are of fundamental importance because these institutions are achieving growing autonomy over a very significant portion of public expenditure in Mexico. However, the federal government is increasingly reluctant to implement support programs for local governments in financial difficulty, making it all the more urgent and necessary to provide good financial management at the level of subnational governments.

B. Decentralization in Mexico

1.2 The decentralization process in Mexico has been characterized by a slow but steady transfer of resources to subnational governments, primarily through the reforms introduced into the Sistema Nacional de Coordinación Fiscal [National Fiscal Coordination System] (SNCF). This system centralizes the collection of the principal taxes at the national level, and transfers them to subnational governments through three mechanisms: (i) revenue sharing; (ii) administrative cooperation agreements; and (iii) contribution funds. The SNCF has a major impact on resource redistribution among subnational governments, while also affecting their fiscal efforts. In addition to resources from the SNCF, subnational governments enjoy significant autonomy in contracting financial obligations.

1. The fiscal coordination system

1.3 **Federal revenue sharing.** The SNCF was established in 1980 to harmonize taxation at the national level. To offset the suspension of charges through their membership in the SNCF, subnational governments received a portion of the

revenue share-out funds[1] established through the Fiscal Coordination Act. This arrangement enabled subnational governments to receive increasing amounts of transferred untied resources as a result of the increase in collections and the proportion of the pool of funds available for federal share-outs (RFPs). The RFPs consist of federal revenues including all federal government tax revenues, the regular tax on oil extraction, and the regular mining tax net of drawbacks and direct sharing arrangements. The General Share-out Fund is the largest of these, accounting for 21.3% of the RFPs. In 1995, major reforms were made in the General Share-out Fund to: (i) increase it to 21% of the RFPs; (ii) initiate a distribution formula that incorporates such variables as population, the collection of federal revenues, and relative wealth; and (iii) establish the states' commitment to transfer at least 20% of the amounts they receive to the municipal governments. Other major share-out funds are the *impuesto especial sobre producción y servicios* [special tax on production and services] (IEPS) (0.56%) and the Municipal Development Fund (1% of the RFPs). In 2000, transfers through the various share-out funds totaled approximately US$15 billion (2.3% of GDP), and accounted for 23.3% of the RFPs. The states received 17% of these resources, while municipios received 4%. Share-outs account for a significant portion of revenues for states (40% to 90%) and municipios (60% to 70%), and are their major source of untied resources.

Table I. 1. Overall distribution of share-out funds as a percentage of the pool of funds available for federal share-outs (RFPs)

	1980	1985	1990	1995	2000
General Revenue Sharing Fund/1	16.89%	16.82%	19.19%	19.73%	21.30%
Municipal Development Fund/2	-	0.60%	0.39%	1.00%	1.00%
Other/3	0.37%	1.63%	0.12%	0.39%	0.95
Total (% RFP)	17.26%	19.05%	19.70%	21.72%	25.23%
Total (millions of 2000 pesos)	76,527.5	93,955.5	99,897.8	101,044,5	148,304.5

1/ Includes the contingency reserve established temporarily from 1988 to 1990.

2/ In 1995, includes the Fund for Urban Adjustment.

3/ Includes IEPS share-outs, contingency reserves, foreign trade, oil share-outs, and the Complementary Financial Fund.

1.4 **Contribution funds (Ramo 33).** The National Budget Expenditure Act for fiscal 1999 is vital to the decentralization process in Mexico. The introduction of a new instrument, Ramo 33, laid the foundation for a significant increase in the resources that the federal government transfers to subnational governments. Ramo 33 was introduced in the 1999 budget, and was adjusted and refined in the 2000 and 2001

[1] Share-outs to states come from the General Share-out Fund, direct share-outs in revenues collected on beer, drinks, alcoholic beverages, and tobacco (IEPS), and the contingency reserve. Share-outs to municipios come from the Municipal Development Fund, share-outs to border municipios, and share-outs from the 3.17% surtax on oil extraction and toll bridges.

budgets. It established and consolidated a mechanism through which the federal government contributes resources for specific purposes (mainly education and health). The introduction of Ramo 33 involved a basic change in the relationships between the subnational governments and the federal government, in that it: (i) significantly increases transfers to subnational governments, particularly to municipios; (ii) establishes transparent formulas for resource distribution that largely eliminate excessively broad federal discretionary powers over transfers; and (iii) facilitates financial planning because the available funds and the transfer schedule of those funds are known. Most of these resources have a counterpart expenditure, and the subnational governments cannot use the funds for purposes other than those established by law. However, since the funds are administered by the subnational governments, these contributions have meant a significant increase in the resources available to subnational governments.

Table I. 2. Ramo 33 federal-state resource sharing (in millions of 2000 pesos)

Funds	1998	1999	2000	Change 1999-98	Change 2000-99
Contributions for basic education and teacher training (FAEB)	115,329.6	118,484.3	128,203.3	2.7	8.2
Contributions for health services (FASSA)	17,171.38	19,674.8	21,713.2	11.1	10.4
State social infrastructure (FISE)	1,613.3	1,864.1	1,927.9	15.5	3.4
Public security contributions (FASP)	2,552.5	5,187.9	5,179.0	103.2	(0.3)
Contributions for technical and adult education (FAETA)	-	1,976.9	2,044.7	N/A	3.4
Multiple contributions (FAM)	4,698.8	5,030.3	5,179.2	7.1	3.0
Municipal social infrastructure (FISM)	11,695.8	13,515.9	13,978.7	15.6	3.4
Contributions for strengthening municipios (FORTAMUN)*	8,612.4	14,457.1	14,952.1	67.9	3.4
Total	162,216.2	180,767.6	193,169.0	11.4	6.9

* This is the only fund without a counterpart expenditure. Local authorities administer and control all these resources from the moment the funds are received.

1.5 **Conclusions.** The SNCF is a complex mechanism for transferring resources. This makes it difficult to achieve the system's objectives and to adjust the system to the country's changing realities. It also makes it difficult to establish a clear scheme of incentives to pursue these objectives. On the other hand, the SNCF has been successful in transferring increasing amounts of resources to subnational governments while decentralizing responsibility for administration of these funds (see Table I. 3). This situation has created a vast opportunity to improve the use of the transferred funds, which will be possible only if the management capacity for public expenditure increases even as access to the funds grows, to reflect local

preferences adequately. These capacities vary greatly and are insufficient in most instances.

Table I. 3. Total transfers to state and municipal entities (in millions of 2000 pesos)

Revenue source	1980	1985	1990	1995	2000	%RFP
Revenue share-out fund	76,527.5	93,955.5	99,897.8	101,044.5	148,304.5	23.25%
Contribution fund	-	-	-	-	179,505.9	28.15%
Incentives for administrative cooperation	835.2	2,142.9	5,375.4	9,839.9	13,663.4	2.14%
Decentralization agreements	-	-	10,513.6	107,033.2	38,295.6	6.00%
Support for Strengthening State Agencies (PAFEF)	-	-	-	-	6,870.0	1.08%
TOTAL	**77,362.8**	**96,098.4**	**115,786.9**	**217,917.6**	**386,639.4**	**60.62%**

2. Generating local revenues

1.6 When the subnational governments enrolled in the SNCF, they waived their right to exercise a significant portion of their autonomy with regard to revenue generation. The states' ability to impose taxes is limited to the payroll tax (the most important) and other less significant taxes and duties. Municipios have the estate tax and other sources that enable them to generate a significant part of their revenues. In June 1999, the Mexican Congress approved a series of reforms to Article 115 of the Constitution, giving local authorities greater power to set property values, which had historically been one of the states' powers. This means that local authorities now have the ability to set, control, and supervise regulations pertaining to land-use planning and urban development plans. The national government has been returning certain other taxation faculties that it had taken on, such as the lodging tax, licenses for drinking establishments and alcoholic beverages, notices and posters (starting in 1996), and car taxes (starting in 1997). In addition, the proposed fiscal reform now under discussion would make possible a significant increase in the pool of tax revenues available for share-outs deriving from the value-added tax and the corporate and personal income tax.[2]

1.7 The reforms of the SNCF have had an impact on the amount and composition of state and municipal revenues. Among states, the fastest growing source of revenue has been federal transfers, while locally generated revenues have increased at a slower pace. The revenue autonomy of states has decreased from 11.2% in 1997 to

[2] One proposal under consideration in the tax reform relates to reducing the income tax ceiling for legal entites from 40% to 30%. The federal income tax would account for 10%, the state income tax for 10%, and the municipal income tax for the final 10%. The national government would handle all collections at the national level, and would divide these revenues as follows: (i) 33% for the national government; (ii) 33% of the amount collected in each state would be earmarked for the state in which the funds were collected; and (iii) 33% for each municipio in which the revenue was collected. According to this formula, 10% would remain for distribution among the most underdeveloped and marginal states and municipios.

8.2% in 2000. Among municipios, the reform of the SNCF has allowed for a substantial expansion in freely available resources, while local resource generation has remained relatively steady (see Table I. 4). The reassessment of property values, and the related increase in the estate tax, contributed to the uptick in municipal revenues.

Table I. 4. Subnational government revenue structure (in billions of pesos)

Category	1997	1998	1999	2000	2001
STATES/1	169.9	235.4	292.8	369.8	405.2
State revenues	19.0	19.9	23.0	30.1	28.2
Federal revenues	150.9	211	266.9	336.0	373.1
Other revenues	ND	4.5	2.9	3.6	3.9
Revenue autonomy	11.2%	8.5%	7.9%	8.2%	7.0%
MUNICIPIOS/2	46.5	70.9	81.0	85.4	106.2
Local revenues	20.9	21.7	23.0	24.3	29.8
Revenue sharing	25.6	26.4	28.1	29.6	36.4
Contributions	-	22.8	29.9	31.5	40.0
Revenue autonomy	-	30.6%	28.4%	28.4%	28.1%

1/ In current pesos.
2/ In 1999 pesos.

3. Government expenditure in states and municipios

1.8 The reform of the SNCF produced a substantial decentralization of responsibility for expenditure and investment to subnational governments. With the exception of contributions from the Fondo de Aportaciones para Educación Básica [Contribution Fund for Basic Education] (FAEB) and the Fondo de Aportaciones para Servicios de Salud [Contribution Fund for Health Services] (FASSA)–the objective of which is to cover the operating costs for these services–all the other resources transferred to subnational governments are administered by those governments. This means that the subnational governments are responsible for allocating approximately 40% of the RFPs in addition to their own resources.

1.9 The structure of state expenditure indicates that, in keeping with the allocation of responsibilities, the main categories of state spending are current expenditures and federal-state outlays, accounting for 23% and 46.7% of the total, respectively. The state investment rate is approximately 10%. In the structure of municipal expenditures, 28% is allocated to construction, 50% to administrative expenses, and the remainder to smaller categories such as transfers (7.1%), debt service (2.3%), and other payments.

Table I 5. Structure of government expenditure (in billions of pesos)[3]

Expenditure category	1998	1999	2000
Current expenditures	34.9	51.9	65.2
Investments	20.6	26.6	29.2
Federal-state outlays	87.7	102.9	132.1
State transfers	39.1	46.3	55.8
Total	182.3	227.6	282.3

4. Autonomy to acquire financial obligations and the debt situation

1.10 The states have broad autonomy to acquire financial obligations at the local level, but the Constitution prohibits them from contracting debts with foreign entities. Municipios must obtain authorization from their respective state assembly in order to borrow. Given the limited availability and reliability of information, and the limited enforceability of financial contracts, the vehicle that has allowed for the rise of a subnational debt market has been guarantees based on revenue share-outs. The financial crisis in 1994 and 1995 sharply reduced the capacity of many subnational governments to meet their credit obligations, which caused the federal government, as on past occasions, to intervene with special financial support programs. Although the indebtedness of subnational governments in Mexico is not as high as in other countries, this experience underscored the need to review the system of guarantees based on federal revenue share-outs. The new system aims to eliminate the perception that there is an implicit federal guarantee for subnational funds, and to strengthen market mechanisms to ration and place credit. The main decisions taken include: (i) modification of the system of guarantees based on revenue share-outs; (ii) introduction of risk ratings by leading rating agencies as a fundamental element in the credit process; and (iii) modification of banking regulations, particularly with regard to rules for calculating the capitalization level of banks (subnational governments with higher risk ratings require higher levels of capital allocation). At present, most states have received a risk rating from two rating agencies, and the national government, the banks, and the subnational governments are completing work on structuring a master trust that will enable subnational governments to commit their share-outs as a guarantee of their credit obligations.

1.11 In aggregate, the indebtedness of states and municipios is moderate in comparison with countries such as Colombia. The three states with the highest levels of indebtedness are: the state of Mexico (23.3 billion pesos), Nuevo León (8.7 billion), and Jalisco (5.1 billion). By contrast, the three least indebted states are: Campeche (0.1 billion), Nayarit (0.1 billion), and Zacatecas (0.03 billion), excluding the state of Tlaxcala, which has no outstanding debt. The total balance of state debt for 2000 is 89.4 billion pesos, or 2.1% of state GDP. A partial estimate of states' pension-related contingent debt is 167 billion pesos for 1997 (approximately 6% of

[3] Does not include the states of Chihuahua, Durango, Jalisco, Michoacán, or Nuevo León.

Mexico's GDP). Most state governments view pension liabilities as the legacy of pre-1990 practices, when state governments were, in practice, under the financial control of the federal government. Consequently, state governments view pensions as an implicit obligation of the federal government, and do not record it in their debt stock.

5. Conclusion

1.12 The most salient features of the financial situation of subnational governments are that: (i) owing to the reform of the SNCF, more resources are freely available to subnational governments, which can generate significant benefits only if they are accompanied by an increase in public management capacity; (ii) although the increase in intergovernmental transfers has not had a negative impact on the level of subnational revenue collections–particularly at the municipal level–tax proceeds are rising at a slower pace than overall revenues, which implies that corrective steps may be taken to maintain and, subsequently, to improve the subnational fiscal effort; (iii) the administrative expenditures of the states have expanded at a much higher rate than overall spending and investments, likely indicating a need to make adjustments in the resource allocation process; (iv) the public investment rate of municipios is 28%, and its significance for citizens can be guaranteed only if these investments are accompanied by mechanisms to improve their efficiency; and (v) in general, the level of indebtedness of states and municipios is moderate, which indicates that although the reforms made in the system of guarantees have been successful in avoiding overindebtedness, much remains to be done to develop a system of subnational financing.

C. Institutional situation of subnational governments

1.13 Various institutional studies of the subnational governments[4] have indicated that the main weaknesses of these governments are in the following areas: development planning and investment management; human resources management; financial and tax administration; environmental management; and mechanisms to ensure transparency and citizen monitoring of public-sector decisions.

1. Development planning and investment management

1.14 In order for decentralization to produce the expected benefits, investment decisions must correspond to local priorities, and tools must be in place to ensure that the projects will actually generate greater socioeconomic cost efficiency. At present, few states and municipios have investment systems, and even those that took part in the FORTEM (loan 1214/OC-ME) had to make an enormous institutional effort to

[4] In preparation of this section, the following reports were reviewed: Standard & Poor's study of the institutional variables that influence ratings; the FORTEM evaluation report; and the study of management indicators performed by DEXIA for the FORTEM.

set them up. The reason for this is that setting up an investment planning and management system requires strong political support and sufficient technical capacity to provide appropriate financial, economic, and environmental evaluations of projects. Additionally, weaknesses have been identified in the municipal and state development processes, making it impossible to guarantee that investments effectively correspond to citizens' demands.

2. Human resources management

1.15 One persistent problem in Mexican public administration, and particularly in the administration of subnational governments, is a lack of continuity in public policies and in job security for civil servants. Although this is a problem that must involve passage of a civil service act or regulation, from the perspective of institutional strengthening, incentives must be put in place to encourage subnational governments to implement transparent hiring procedures that ensure that highly competent individuals will join the civil service; performance evaluation systems must be implemented; merit-based pay scales must be used; and an institutional training program must be in place. At present, very few subnational governments have such comprehensive human resources management tools available.

3. Financial management

1.16 The experience gained through the FORTEM now in execution indicates that one of the aspects of institutional strengthening that requires greater effort is establishing financial management tools that guarantee the transparency and quality of decisions relating to public housing. In a way similar to the establishment of integrated financial management systems, policies and budget controls must be improved. Great progress has been made in this respect (as illustrated by the fact that an increasing number of states and municipios have external audits and credit ratings, and by the existence of the Accounting Systems Modernization Program), but much remains to be done, particularly in the municipios.

4. Tax administration systems

1.17 In general, the municipios have the most significant weaknesses in terms of tax administration. These weaknesses relate to the failure to update land registers, and a lack of administration systems for taxes and fees. Specifically, administration of the estate tax must be improved, given its importance for municipal finances.

5. Mechanisms to ensure transparency

1.18 The experience of the FORTEM shows that many states and municipalities do not have the mechanisms in place to promote citizen oversight and involvement. These mechanisms are extremely important in the context of the decentralization process, because it is through these mechanisms that citizens can have access (using tools such as web pages, gazettes, bulletins, etc.) to information about state and

municipal development plans, the subnational government's budget, its investment program, debt, and financial statements, and the procurements and purchases made by the subnational government.

D. The role of risk rating agencies

1.19 In the government's strategy, risk rating agencies play a fundamental role in organizing the credit markets. As previously noted, current regulations for banking establishments stipulate that if a subnational government does not have two risk ratings, its operations will be penalized with additional capital requirements. For qualified entities, these requirements vary in accordance with the credit rating issued by the rating agencies.

1.20 Beyond capital requirements, the rating agencies require high-quality information and have become important centers for the analysis and dissemination of that information. Consequently, the subnational governments have had to improve the quality and quantity of the information they disclose to the markets and to the public, thereby allowing for more effective controls of management by government officials.

1.21 The reforms supported by the proposed program aim to improve the management and financial situation of subnational governments. This will certainly have a positive impact on their ratings, and consequently on improving their conditions for access to commercial credit markets.

E. The experience of the FORTEM[5]

1.22 In 1999, the Bank approved the Program to Strengthen the States and Municipios (FORTEM), the objective of which was to support the decentralization process in Mexico through actions aimed at: (i) increasing the autonomy of subnational governments in decisions relating to resource allocation; (ii) improving the performance of credit markets at the subnational level; and (iii) increasing subnational governments' financial management capacity regarding public resources. The FORTEM was structured as a fast-disbursing component to support sector reforms, and a line of credit for the subnational governments.

1.23 The objective of the fast-disbursing component (loan 1213/OC-ME), which has been fully disbursed, was to support three major reforms: (i) introduction and regulation of Ramo 33; (ii) modification of the systems of guarantees for credits to subnational governments; and (iii) implementation of a series of actions aimed at correcting shortcomings in the institutional performance of BANOBRAS. All the actions planned in this component have been implemented, with very positive

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[5] This section is based on an independent evaluation of the FORTEM program performed in May 2001.

effects on the conditions in which the decentralization process is moving forward in Mexico.

1.24 The credit line (loan 1214/OC-ME), which is still in execution with a disbursement level of 37% and a commitment level of 100%, aims to motivate subnational governments to adopt a series of best management practices, through technical cooperation operations and financing conditional upon gradual compliance with seven eligibility criteria, which were designed to prompt the subnational governments to adopt a series of best practices. Considering the importance of having the subnational governments adopt these best practices, the operation in execution seeks to motivate and support them in gradually improving the following aspects:

(i) **Auditing.** Annual financial statements must undergo an independent audit. For larger subnational governments, the auditors must come from the private sector.

(ii) **Investment planning**. A system must be in place to ensure that each project in the investment plans undergoes a project analysis and selection process in accordance with technical criteria (economic, financial, environmental, and social), and that an adequate system is provided to manage procurements in accordance with the laws of Mexico and the policies and procedures of the Bank.

(iii) **Regulation of Ramo 33**. The participating subnational government must have a legal framework that sets the rules for managing Ramo 33 resources so that municipios know in advance how much has been allocated at the start of the fiscal year; mechanisms must be in place to control the use of these resources.

(iv) **Transparency**. Participants must publish their audited financial results and credit obligations in a timely and systematic manner, in a readily accessible medium and in keeping with standard formats.

(v) **Budgeting**. Each program must have a budgeting system, including cost and revenue centers.

(vi) **Tax administration**. Subnational governments must have successfully implemented a plan to improve their tax administration systems, allowing for an increase in collection efficiency of up to 80%.

(vii) **Accounting**. Subnational governments must have an accounting system integrated with the budget and standardized with the federal accounts.

1.25 The line of credit component has enabled five states and four municipios to make significant progress in adopting best practices for financial and institutional

management based on an initial diagnostic analysis of their compliance with the seven eligibility criteria and their implementation of the resulting institutional strengthening plans. None of the participating subnational governments complied with the seven mandatory criteria, and as of October 2001, only one state and one municipio had met all the criteria. The following table shows the state of compliance with the criteria referenced above.

Table I. 6. Administrative and Financial Management Criteria as of 29 October 2001

Client	Criteria met		External Audit		Investment Planning		Ramo 33		Transparency		Budget		Tax Administration		Accounting	
	As of diagnostic analysis	Oct. 2001	C	P	C	P	C	P	C	P	C	P	C	P	C	P
States																
Durango	4	5	C			P	C		C		C		C			P
Jalisco	4	5	C			P	C		C		C		C			P
Oaxaca	2	4	C			P	C		C		C			P		P
Q. Roo	5	5	C			P	C		C		C		C			P
Veracruz	4	7	C		C		C		C		C		C		C	
Municipios																
Morelia	5	5	C			P	C		C		C		C			P
N. Laredo	4	6	C			P	C		C		C		C		C	
Ixtapán, State of México	5	7	C		C		C		C		C		C		C	
Tlanepantla, State of México	4	4	C			P	C		C			P	C			P

Key: C: Criterion approved P: Pending for second or third disbursements

Source: Office of Institutional Strengthening. Division of Infrastructure and Technical Assistance, BANOBRAS

1.26 All subnational governments have begun major strengthening processes in the context of the FORTEM, by means of significant modernization plans. During program execution, the subnational governments have demonstrated a serious commitment to meeting the FORTEM requirements. The most significant weaknesses, and thus the criteria that are hardest to meet, relate to the investment planning system of subnational governments and their accounting systems, which are coordinated with the federal chart of accounts and are integrated with the Investment Planning System and the Budget System.

1.27 The current distribution of investments by sector indicates that approximately 52% of investments relate to transportation projects; 12.3% to water and sewer projects; 5.4% to health projects; 5.4% to municipal infrastructure; and the remainder (approximately 25%) to other projects such as institutional strengthening

operations, preinvestment analyses, managing municipal solid waste, ecology, and electrification.

1.28 The line of credit was intended as a pilot project to test potential demand for resources and the effectiveness of the tools needed to motivate subnational governments to adopt best practices for financial management. The level of demand was much higher than expected. The FORTEM, which was scheduled for execution over five years, committed all its resources in less than two years. There is now a waiting list of 12 states and 30 municipios to access the program, including some that have already been rated by rating agencies. In the new operation, the subnational governments are not required to have a rating from a risk rating agency. However, if they do not have a rating, the financial cost to the subnational government will be higher than for those that have been rated.

1.29 The preliminary conclusions of the FORTEM evaluation are that:

(i) The FORTEM has been a successful instrument to motivate subnational governments to implement institutional and financial strengthening measures.

(ii) BANOBRAS has played a fundamental role in promoting the FORTEM, reaching agreements with the subnational governments on institutional strengthening actions to meet the seven criteria, and monitoring compliance with the agreed actions.

(iii) BANOBRAS must play a much more active role in the processes of analysis and negotiation with the subnational governments. It must also expand its capacity to provide ongoing technical advice to subnational governments with regard to implementing strengthening plans.

(iv) The eligibility criteria have made it possible to undertake major institutional strengthening processes within subnational governments, and in general the level of effort required of subnational governments to comply with the criteria was deemed adequate. Nonetheless, the criteria have shown limitations in that the required actions are one-time operations, and are not part of a comprehensive, coherent institutional strengthening plan. Additionally, the criteria must be strengthened and deepened in order to promote the long-term financial stability of the subnational governments.

(v) The subnational governments are continuing to indicate considerable interest in participating in programs that, like the FORTEM now in execution, are directed toward strengthening them institutionally and financially.

1.30 To ensure compliance with the Bank's sector policy with regard to services, the FORTEM provides for two types of activities when the investment plan of a subnational government allocates 20% or more than US$5 million from the line of credit to a single project: (i) a series of actions to modernize the sector in accordance with the Bank's public utilities policy; and (ii) an ex ante review of the technical, financial, economic, and environmental viability by the Bank's Country Office in accordance with the corresponding policies of the Bank for projects that exceed US$5 million or 20% of the subnational government's annual investment plan. So far, the Bank has reviewed three projects in the water sector that account for 30% of overall investments in the sector. The reviews indicate that control mechanisms are in place to ensure that the financed projects comply with the Bank's sector policy.

F. Program rationale and strategy

1.31 The proposed program builds on the lessons learned from the FORTEM and the dynamic that the FORTEM program has generated among the subnational governments. The program will make it possible to support subnational governments that have not yet participated in the FORTEM (27 states and 2,424 municipios). Subnational governments that participated in the previous FORTEM program (loan 1214/OC-ME) will also be able to participate, provided that the total amount of resources received under the first operation and under this operation does not exceed US$100 million. The same intervention methodology will be used, in which access to investment resources is conditional upon the adoption of best practices in financial and institutional management, broadening the seven criteria in two ways. On the one hand, the content of the methodology will be expanded to include a performance indicator and a series of best practices related to it, which will be structured into a manual of best practices. On the other hand, a series of criteria relating to the financial structure of the subnational governments and the medium-term viability of public finances will be established and included in the manual.

1.32 The functions of BANOBRAS in execution of the program will increase, as it will be required to promote the program, negotiate with the subnational governments concerning their conditions for gaining access to the program, and monitor the agreements reached. To that end, the program will build on the progress made in the institutional strengthening process of BANOBRAS, which the present administration has continued and intensified, in order to expand its capacity to conduct and/or coordinate institutional and financial analyses, advise the subnational governments with regard to structuring strengthening plans, and providing monitoring and technical support during implementation.

1.33 In awareness of its role as a development bank, BANOBRAS will take steps to strengthen municipal governments classified in the category of medium to very high marginality, some of which are located in the 250 marginal microregions of

Mexico in phase I. Using program resources, BANOBRAS will implement a pilot project to strengthen the capacity of this type of municipal government, through which BANOBRAS will be supported in designing and implementing new intervention methodologies that may be replicated on a larger scale during the second phase of the program. The program will thus promote decentralization from an additional perspective: that of reducing regional imbalances. The experience gained through the FORTEM program in the states of Quintana Roo, Oaxaca, and Veracruz indicates that there is unmet demand for financial and institutional strengthening programs among subnational governments that represent a considerable percentage of the poor population. This demand has been taken into consideration in the design of the proposed program, which expects to attract greater participation from lower-income states such as Campeche, Puebla, and Yucatán.

G. Rationale for a multiphase program

1.34 Unlike other projects that aim to solve a specific problem, the program will support a decentralization process that has been under way since 1998 and will continue beyond the nine-year period of the program. This process will take place at various levels and will involve a variety of players (federal, state, and municipal). The multiphase modality is recommended in light of the special nature of this program, in which the Bank, in addition to providing financing for infrastructure, public services, and social services projects, will support: (i) an administrative and financial modernization process for the subnational governments; (ii) preparation so that subnational governments may have better access to credit; and (iii) compliance with the Bank's economic, financial, and environmental viability policies, sector criteria, and public utilities policy. This modality, which has been used successfully for other operations in Mexico (loans ME-983/OC-ME and 1256/OC-ME), offers significant advantages, since it will enable the Bank to adjust its support for subnational governments to reflect changes in the economic, legal, political, financial, and social context of the decentralization process. Phase I will focus on verifying the effectiveness of the new eligibility criteria, particularly financial criteria, and on testing the capacity of BANOBRAS to absorb the level of allocated resources effectively, as well as its modernization and institutional strengthening process. In the second phase, the necessary changes will be made to adjust, improve, and consolidate the new criteria, mechanisms, and products. Finally, the third phase will allow for consolidation and expansion of program coverage, while necessary adjustments may be made based on the execution of phase II.

H. Mexico's strategy

1.35 The consolidation of federal-state share-outs is a priority for the Government of Mexico, and is in keeping with its political and economic reforms. The 2001-2006 national development plan states that the strategies to meet needs and to create the conditions for development in each locality must be the responsibility of the states

and the municipios. The executive branch of the federal government is committed to accelerating the decentralization process, fair redistribution of expenditure, the capacity to generate high revenues, and giving local governments the authority to make decisions and execute construction projects and provide services.

I. The Bank's strategy

1.36 The proposed program is consistent with the national development plan mentioned above, and with the Bank's strategy for Mexico, which is reflected in the Country Paper (GN-2045) approved on 3 June 1999 and ratified in the Country Paper now in preparation. Specifically, this program is consistent with the first objective of the strategy, which seeks to strengthen the decentralization process of structural change in order to achieve greater social change, reduce poverty, and promote more harmonious regional development that is socially equitable and geographically balanced. Additionally, the program is consistent with the Bank's subnational development strategy, which identifies, among the proposed areas of intervention, strengthening the institutional capacity of subnational governments and the development of financing mechanisms of subnational agencies.

J. The Bank's public utilities policy and the environmental variable

1. Compliance with the public utilities policy

1.37 The proposed program will comply strictly with the Bank's policies and regulations, and will include ex ante verification of compliance with sector policies and their coherence with the Bank's criteria for economic, financial, and environmental feasibility and sustainability, and with the public utilities policy, if applicable. As discussed in chapter III below, the mechanisms to be used in executing the proposed program (operations manual, financial and institutional diagnostic analysis, and manual on best practices, among others) place special emphasis on compliance with the Bank's policies and regulations.

2. Environmental considerations

1.38 Compliance with environmental regulations will be verified in a similar manner. The diagnostic analysis and the strengthening plan will be reviewed to ensure that the subnational government is complying with and implementing all the regulations contained in the Mexican government's Environmental Protection Act [Ley General del Equilibrio Ecológico y la Protección al Ambiente]. If any discrepancy is detected, the strengthening plan must include relevant measures and actions to correct it. For example, criterion 2 ("Investment Plans") of the FORTEM program now in execution incorporates the environmental variable as a planning tool within the context of sustainable development, and makes resources available to subnational governments for institutional strengthening with regard to implementing environmental regulations. Mexico has a sophisticated system of

environmental protection regulations. The system became even more complex in 1996, when the Environment and Natural Resources Secretariat (SEMARNAT), following the guidelines of the decentralization process outlined above, transferred a significant number of environmental management responsibilities to the states. The proposed program will include specific provisions in the operations manual that are consistent with the environmental act referenced above, to help subnational governments comply with national environmental legislation. Similarly, the regulatory instruments of the proposed program, as specified in Chapter III, include the environmental variable in the manual on financial and institutional best practices and in the manual on financial and institutional analysis. Finally, since a multiphase program is being proposed, the final evaluation of the program will include an analysis and review from the financial, economic, and environmental perspective.

K. Conclusions

1.39 The results of the decentralization process in Mexico have been uneven for the subnational governments. While all subnational governments clearly have greater managerial autonomy, and this autonomy is increasing, the institutional and financial capacity to use this increased freedom successfully is quite uneven. Some subnational governments are already in a solid financial position, and are able to take advantage of this greater level of autonomy. The positions of other subnational governments are compromised by the burden of debt service or by limited management capacity. Since the federal government is less disposed to intervene with ad hoc solutions, the local governments will have to put their financial management in order, to optimize the impact of the current resources they manage, and to become more viable as potential borrowers. In this context, this program has the potential to become an important tool for facilitating the decentralization process in Mexico.

II. THE PROGRAM

A. Objectives

2.1 The general objective of the program is to support the decentralization process in Mexico by enhancing the management capacity of subnational governments and strengthening their financial situation.

2.2 The specific objectives are to: (i) introduce best practices aimed at strengthening the management of public resources by subnational governments; (ii) strengthen the financial situation of those governments; and (iii) finance investment projects with high social return and technical assistance to build capacity among subnational governments to provide public services.

B. Description

2.3 To attain these objectives, the program has been structured as a credit line that will be administered by BANOBRAS in an effort to encourage subnational governments to adopt a set of best practices for their institutional and financial management. As they attain the agreed best-practice targets, subnational governments will be afforded access to program resources to finance a portion of their investment plans. Resources will be made available to the governments in three tranches disbursed as advances. The first will be used mainly to finance technical assistance under the program. The second and third advances will be intended for investment and technical assistance and will be disbursed to the governments as they complete the financial and institutional strengthening actions agreed in the core action plans, as described below. Financing will be provided for up to 50% (with a maximum of US$100 million per participating government) of the investment plans the governments present.

2.4 This credit line will make it possible to continue and expand the financial and institutional strengthening launched under the FORTEM operation and meet the growing demand for this type of operation. It will operate along similar lines as the FORTEM operation, with the function performed by the seven criteria being expanded by means of a manual on financial and institutional best practices, a manual of financial and institutional analysis, and a core action plan. This new structure will allow greater flexibility in adapting program actions to the needs of each subnational government. At the same time, sector criteria for economic, financial, and environmental viability and the sustainability of the investments, as well as the Bank's public utilities policy will all be observed (see paragraph 3.14).

2.5 The credit line will also finance, on a pilot basis, up to 50% of the investment plans (up to US$1 million) of a maximum of 10 municipios classified in the category of medium to high marginality by the Social Development Secretariat (SEDESOL).

Some of these municipios are located in the country's most marginalized 250 regions. As with the other subnational governments, the resources channeled to these municipios will be disbursed apace with progress in implementing the agreed reforms. As explained in chapter III (on program execution), the activities to be financed under the program will be defined on a case-by-case basis, using the manuals for financial and institutional best practices and for financial and institutional analysis. The use of these methodologies will ensure that municipios in marginalized regions have customized plans.

2.6 There is an understanding between the Bank and BANOBRAS that this new operation will make every effort to reach the 27 states and 2,424 municipios that are not part of the current FORTEM operation (loan 1214/OC-ME). FORTEM participants will be subject to a cumulative ceiling of US$100 million for that program and the present operation, with the expanded conditionality as reflected in the manual on financial and institutional best practices.

C. Financing

2.7 The program has a total cost of US$2 billion and is structured in three phases: phase I for US$600 million; phase II for US$600 million; and phase III for US$800 million. Phase I will receive financing from the Bank in the form of an Ordinary Capital loan for US$300 million (see Table II.1).

Table II. 1
Cost and financing
(in millions of U.S. dollars)

	Phase I		
	IDB	Mexico	Total
1. Credit line	297	300	597
2. Financial costs	3	0	3
Total	300	300	600

D. Financial costs

2.8 This consists of US$3 million for the inspection and supervision charge for phase I.

E. Terms and conditions of the Bank's loan

2.9 The following terms and conditions would apply to the loan for phase I:

Amortization period	25 years
Grace period	3 years
Disbursement period	3 years
Interest rate	Variable
Credit fee	0.75 per annum on the undisbursed balance
Currency	U.S. dollars drawn on the Single Currency Facility

III. PROGRAM EXECUTION

A. The borrower and executing agency and the guarantor

3.1 The borrower and executing agency will be Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS), acting as financial agent of the Government of the United Mexican States. The guarantor will be the United Mexican States.

1. Institutional development

3.2 BANOBRAS's new management has decided to continue and deepen the internal reforms launched under the Institutional Modernization Plan with funding from the current FORTEM operation (loan 1214/OC-ME). The reforms seek to focus the agency's activity on its stated mission "to promote development of the country in the areas of infrastructure and public services, with a high social return". Against this backdrop, a process of structural change was launched with a view to separating out policy functions from business functions, enhancing efficiency, and paring back costs. The past year saw a significant decrease in staff (22%) and a restructuring of all branch offices, including a cutback in operations and a strong focus on client service using the model piloted at branch offices as part of the FORTEM operation. The risk analysis and credit processes were reviewed and strengthened, and an aggressive plan was launched to address the bank's main weaknesses in the systems and human-resources management areas. Management has embarked on an ongoing process to upgrade business processes by adopting a quality management model that will entail, on the one hand, updating the organizational structure and internal procedures by setting clear objectives, functions, and responsibilities in the various areas, introducing management benchmarks, and redefining core human-resource profiles and, on the other, documenting, reengineering, and certifying the processes. Improved productivity is expected to yield greater increases in efficiency and reductions in operating costs over the coming years.

3.3 An important change vis-à-vis execution of the present program is the transfer of the Center for Studies on Economic Evaluation of Projects [Centro de Estudios de Evaluación Económica de Proyectos] (CEPEP) from the promotion area to the policy planning area, directly under the Strategic Planning and Economic Studies Department [Dirección de Planificación Estratégica y Estudios Económicos] (DPEEE). The CEPEP, which was established in 1995 to form a body of professionals trained in analytical techniques and socioeconomic evaluation of projects, now has a group of professionals with recognized experience in the analysis of infrastructure projects. This unit will verify the technical, financial, and environmental viability and sustainability of individual projects presented for funding. The tools to be used in conducting socioeconomic analyses of projects will be reviewed and strengthened, thus making for a more objective evaluation of

projects to be funded under the proposed operation. In addition, a unit will be set up to examine and assess local public finances and governmental management; this unit will receive training in the use of methodologies for evaluating and providing advisory services to subnational governments.

2. Financial situation

3.4 Like other government-run banks in Mexico, BANOBRAS acts both as financial agent of the federal government and as a development bank. As at December 2000, it had assets of approximately US$13.6 billion and US$1,323 million in capital. However, since the bulk of its portfolio is guaranteed by the federal government, its capital ratio stood at around 50% as of that date. As a consequence of this overcapitalization, BANOBRAS returned US$280 million of its capital to the federal government, which brought its capital ratio to 34% as of September 2000. Financial projections run by BANOBRAS show that this reduction in capital has not had any substantial negative impact on the institution.

3.5 Transactions for which BANOBRAS acts as financial agent account for roughly 50% of its portfolio; for these transactions, it has a small intermediation margin of around 1.5 per mil. Most of its revenue comes from its own intermediation activities, for which its policy is to maintain a spread of 2%. It has been able to maintain this margin in the past, and the financial projections provided by BANOBRAS indicate that it would be possible to maintain it in the future. BANOBRAS has posted losses in recent years owing in part to high operating costs and in part to pressure exerted on its margins by financial market conditions and the impact of operations restructured under the government's programs. As a result, the two main recommendations emanating from the analysis conducted in conjunction with preparation of the FORTEM operation (1214/OC-ME) are that BANOBRAS should reduce its operating costs substantially and increase its intermediation margin by adding greater value to its products and improving its strategy for attracting funds. As mentioned above, BANOBRAS is in the process of introducing fundamental changes to pare back its operating costs and increase the added value of its services.

3.6 As of September 2001, BANOBRAS's portfolio had an arrears rate of 1.3%, which reflects, on the one hand, the fact that most of its own lending is guaranteed by federal government revenue-sharing and, on the other, the impact of the restructuring of problem loans under federal relief arrangements following the 1995 crisis. BANOBRAS is now pursuing a strategy to diversify its sources of funding. Its current strategy is to bring technical enhancements to its asset-and-liability management, to improve maturity transformation and keep liquidity risks under control.

3.7 BANOBRAS has introduced a number of key measures in an effort to reverse the negative trend in its financial situation. These weaknesses were detected during the

in-depth studies carried out in conjunction with the FORTEM operation by an independent consulting firm. Many of these measures were taken as part of that program and have already had—or will very soon have—an impact, e.g., the 41% reduction in staff over the past four years will have a major impact on the organization's cost base. Others, such as the strengthening of the risk analysis and credit process and the certification of processes, will yield results in the medium term. All these measures, however, point towards the commitment of the bank's board of directors to strengthen the institution financially and institutionally to help it face changing circumstances in credit markets at the subnational level.

3. Interest rates

3.8 The rates applied by BANOBRAS to credit operations financed with the proposed program's proceeds will be based on the foreign-exchange hedge cost of the Fondo de Apoyo a Estados y Municipios [State and Municipio Support Fund] (FOAEM). The FOAEM, a fund operated by the Ministry of Finance, provides foreign-exchange hedging for some operations that originate abroad and are directed at projects to support states and municipios in Mexico. The cost to BANOBRAS of funds in local currency (including the exchange hedge) is equal to the federal government's cost of borrowing on the local market with various maturities (1-10 years). The FOAEM has not required any budgetary support, inasmuch as domestic real borrowing rates have thus far consistently exceeded external real borrowing rates. As a result, the FOAEM has generally carried a surplus. Since national government borrowing rates in Mexico reflect market conditions, any distortions in the rate differential have been rapidly corrected by arbitrage operations, which in turn has prevented subsidy elements from being introduced into the scheme.

3.9 As mentioned above, the FOAEM's rates reflect the federal government's 1-to-10-year borrowing rates, giving the requesting subnational government the option of choosing the period during which the interest rate will be fixed (ranging as well from one to ten years). The resulting rates are fixed for the agreed period and can be stated in nominal or in real terms vis-à-vis the UDI inflation index. Accordingly, at the borrower's choice, the loan can bear a nominal rate based on 1, 3 or 10-year bonds or a real rate based on 5 or 10-year UDIBONOS. BANOBRAS applies a spread of 1.5% to 3.5% over the FOAEM's rates, depending on the borrower's risk as represented by the two risk ratings assigned by the accredited rating agencies in accordance with applicable standards.

3.10 The resulting rates are comparable and sometimes higher than those charged by commercial banks. For instance, the rates charged by commercial banks for this type of operation range from the interbank equilibrium interest rate (*tasa de interés interbancaria de equilibrio,* or TIIE) +1% to TIIE +5%, depending on the risk and their appetite for this type of operation. By way of example, 1-year CETES rates were set at the last auction at 10.96 while the 90-day TIIE rate was fixed at 10.45%. For such sales and for this option, BANOBRAS's rates would fall between 12.44%

and 15.44%, while commercial bank rates would be between 11.45% and 16.45%. This is a normal rate structure and reflects the fact that BANOBRAS's rates are comparable to those charged by commercial banks and do not introduce distortions in the financial markets.

B. Program guidelines and instruments

3.11 Based on experience with the current FORTEM operation (loan 1214/OC-ME) and, mainly, on the new objectives set for the operation proposed here, there is agreement that the instruments described below will be used to strengthen subnational governments financially and institutionally.

1. Operations manual

3.12 As a condition precedent to the first disbursement of program resources, the Bank must have approved the program's operations manual presented by BANOBRAS, which should include the economic, financial, and environmental eligibility criteria for subnational governments to participate in the program. The manual is to stipulate: (i) the eligibility criteria; (ii) a ceiling of US$100 million per participant and the condition that up to 50% of the annual investment plan can be financed; (iii) that the loan proceeds may not be used for onlending to purchase real property (except for property directly related to and essential for implementation of an investment project, in the event the required counterpart funding from the subnational government is insufficient to cover that cost), to finance debt, or to purchase stock; (iv) that the loan proceeds shall be used exclusively to carry out the agreed annual or multiyear investment plan; (v) the procurement and hiring plan; (vi) information, accounting, and monitoring requirements; (vii) ceilings and eligibility criteria for technical assistance; (viii) model agreement for onlending operations; (ix) the obligation of the subnational governments to open and maintain separate accounts and accounting records for program resources and for the counterpart contribution and that clear, easily auditable accounting procedures be used; and (x) specific procedures to ensure compliance with the public utilities policy.[6]

3.13 This manual will be the most important tool for the Bank to be able to verify compliance with its public utilities policy under the new program. The following arrangements are in place to make sure that only those projects that comply with the Bank's public utilities policy are financed with program resources:

(i) Preparation of the manual on financial and institutional analysis will include a detailed analysis of the investment planning tools used by subnational governments. It is at this stage that projects are subjected to

[6] By way of example, the minimum criteria for drinking water and sanitation will require that the rates charged cover the costs for operation and maintenance.

a socioeconomic analysis in order to establish if they are to be included in the investment plan. The manual outlines how to conduct this analysis, especially the use of technical, financial, environmental, and social criteria to select investments. If any problems are detected, the subnational government is to commit to an action plan to remedy them by way of the core action plan.

(ii) The investment plan prepared by the subnational government, which contains a list of projects for possible financing under the program, must include the respective socioeconomic studies that justify including those projects. The socioeconomic study analyzes the projects' technical, financial, environmental, and social viability. The investment plan is to be presented for the Bank's no objection.

(iii) Agreement has been reached on a set of minimum sector criteria that all projects must meet, as well as a set of actions aimed at improving the conditions for delivery of those services. For projects costing less than US$2 million and representing less than 10% of the subnational government's annual investment plan, BANOBRAS will verify fulfillment of the criteria in advance, and the Bank may conduct an ex post review. For projects over that amount, the Bank will conduct an ex ante review in all cases.

(iv) If a subnational government is found not to meet the minimum criteria, investments and technical assistance may be financed to remedy the shortcomings detected. In such cases, the subnational government must pledge to carry out a plan of sector improvements, which will be included in the commitments reflected in the core action plan.

3.14 The agreed sector criteria are intended mainly to ensure the presence of a suitable regulatory framework as well as the economic sustainability of the projects.

2. Manual on institutional and financial best practices

3.15 This manual, which is being prepared with assistance from a prominent rating agency, will compile national and international best practices for a set of areas that are the responsibility of the state and municipal governments. The manual will be divided into two areas of work: finance and institutional considerations. Each area will be broken down into modules and submodules for the units to be strengthened. Each submodule will contain a recommendation vis-à-vis specific practices that have been successfully implemented at the national and international levels. For each recommended practice, a performance benchmark will be indicated in order to verify objectively the progress made by subnational governments in adopting the recommended practices. Tables III-1 and III-2 summarize the financial and institutional considerations to be included in the manual.

Table III.1
Financial and Institutional Best Practices Manual
Financial Considerations

Module	End objective	Submodule
Revenue	Strengthen revenue and decrease dependence on federal transfers	**Own revenue** Revenue from local levies *Taxes* *Fees* *Betterment levies* *Products and services* *Fines and surcharges* *Revenue other than local levies* Administration cooperation agreements Revenue from decentralized agencies and companies with State participation
		Transfers *Untied* Share-outs Support Program to Strengthen Federal Entities Other special transfers
		Tied Ramo 33 Decentralization agreements
		Total operating revenue Own revenue Revenue from transfers
Non-operations revenue	Identify nonrecurrent revenue	Revenue from financing Special contributions
Outlays	Maximize efficiency in the breakdown and allocation of spending	Operating expenses (divided between current expenses and capital expenditures) *Administration of the Executive Branch* *Social welfare* *Production development* *Other agencies and branches* *Decentralized agencies and companies with State participation*

Table III.2
Financial and Institutional Best Practices Manual
Institutional Considerations

Module	End objective	Submodule
Investment planning	Improve the quality and management of public investments by adopting a multisector, multiyear investment planning system	Technical module Financial module Social impact and environment module Procurement module
Human resources management	Have a human resources management system that supports the strengthening plan recommended in the core action plan	Payroll Performance evaluation Merit-based remuneration Training plan, based on evaluation Civil service career path
Accounting	Improve the quality of financial information by means of an accrual-based accounting system that produces financial statements and public accounts	Revenue Outlays Public debt Cash Fixed assets Inventory Suppliers
Audit	Monitor proper use of public resources and information to taxpayers	Government audit External audit by certified public accountant
Programming and budget	Have a program-budget system	Revenue Outlays Capital programming (debt) Performance benchmarks for public management
Environmental management	Improve environmental management at the state, regional, or municipal level	Environmental licensing of projects Environmental services
Disclosure of information (transparency)	Establish mechanisms to facilitate monitoring and participation by citizens	Development plan Budget Investment program Debt Financial statements Procurement

3. Manual on financial and institutional analysis

3.16 This manual will include the same areas, modules, and submodules as the best practices manual, compiling the specific techniques and methodologies needed to assess the progress made by a subnational government vis-à-vis the recommended practices, in particular with regard to the performance benchmarks identified in the best practices manual. The financial and institutional analysis manual will make it possible to define a comparative profile of each subnational government for each submodule with regard to the recommended practices and the respective benchmarks. This initial profile will be used to measure progress made by each participating subnational government in the respective submodules of the program.

C. Preparation and execution cycle for core action plans and investment plans

1. Promotion

3.17 BANOBRAS will launch program execution by sending a notice to the subnational governments stating the program's strategy, objectives, and procedures. Promotion of the program among these governments will be the responsibility of BANOBRAS's Promotion Department, with support from its regional branches. The department will carry out a special promotion campaign for municipal governments.

3.18 Program eligibility is open to state governments, the government of the Federal District, and the municipal governments. No subnational government may have access to credit line resources in excess of US$100 million. Program proceeds may be used to finance up to 50% of the total cost of the government's annual investment budget.

2. Preparation and review of the financial and institutional analyses

3.19 BANOBRAS will conduct financial and institutional analyses of subnational governments that wish to take part in the program. These studies, which will be done using the program's financial and institutional analysis manual, will be the responsibility of BANOBRAS's Economic Studies and Strategic Planning Department [Dirección de Planeación Estratégica y Estudios Económicos] (DPEEE). Once finalized, the studies are to be presented to the Bank for its no objection.

3. Preparation of core action plans

3.20 On the basis of the analysis conducted and the best practices manual, BANOBRAS—by way of the DPEEE—will prepare a preliminary core action plan containing: (i) specific objectives for strengthening in the financial, institutional, and service management areas; (ii) recommended activities to attain those objectives; (iii) dates by which the subnational government would commit to

attaining the targets; and (iv) the means of verification of outcomes. The financial and institutional strengthening areas included in the core action plans will be defined case by case in accordance with needs and the subnational government's execution capacity, using for that purpose the results of the analysis for each of the submodules contained in the financial and institutional analysis manual and the expected level of progress towards the benchmark for each submodule. The only mandatory area of application for all subnational governments will be the establishment of an investment planning system.

3.21 In parallel with the preparation of the preliminary core action plan, BANOBRAS will set: (i) the ceiling for borrowing by the respective subnational government; (ii) the amount it may access under the credit line; and (iii) lending conditions. This information will be processed by the Risk Management and Credit Departments and will be included with the DPEEE-reviewed core action plan for negotiation with the subnational government.

3.22 On the basis of the preliminary core action plan and the information indicated in the preceding paragraph, BANOBRAS, through its Promotion, Risk, and Credit Departments, will negotiate with the respective subnational government in order to decide on the modules representing the most important institutional and financial reforms for the subnational government, performance benchmarks and expected targets, means of verification, amount and terms of the loan, performance benchmarks to be used for gradual access to the credit line, and monitoring and control instruments. Once negotiations are finalized, BANOBRAS will prepare a final report on the core action plan, which is to be approved by the DPEEE, which will subsequently send it to the Bank for its no objection.

4. Preparation of the investment plan and verification of compliance with public utilities policies

3.23 Once a decision has been made on the amount the respective subnational government may have access to under the credit line, that government will submit an investment plan to BANOBRAS for evaluation by the DPEEE, identifying the list of projects that should meet the sector criteria indicated in the program's operations manual. After BANOBRAS approves the investment plan, it will send it to the Bank for its no objection.

3.24 All projects included in the approved investment plan will be subject to the various phases and stages of ex ante appraisal established in the investment planning system guidelines of the participating subnational government. The DPEEE will verify that the guidelines are observed by examining a sample of projects that are subject to the sector criteria set forth in the program's operations manual. BANOBRAS will inform the Bank of the composition of the sample, and will present a report on compliance.

3.25 The DPEEE, assisted by the CEPEP, will review the investment plan and verify compliance with the sector criteria for economic, financial, and environmental viability and sustainability of the investments, and with the public utilities policy of the Bank. The plan must receive the Bank's no objection.

3.26 Any change to the investment plan must be approved by the DPEEE and must go through the various phases and stages of ex ante appraisal established in the investment planning system guidelines of the participating subnational government.

5. Credit line formalization and access guidelines

3.27 The agreements on the core action plan and access to the credit line to finance the investment plan will be formalized through a loan agreement between BANOBRAS and the respective subnational government, which will include among its annexes: (i) the core action plan; (ii) the approved investment plan; and (iii) a procurement plan. Approval of the model agreement between BANOBRAS and a subnational government will be a condition precedent for program resource eligibility.

3.28 Resources under the credit line will be available in three tranches, as follows:

a. Upon signature of an agreement with BANOBRAS whereby the participating subnational government pledges to execute the agreed financial and institutional strengthening plan, it will have access to 12% of the credit line. A substantial part of this first disbursement is expected to be used for technical assistance to carry out the core action plan. The rest will be used to finance a portion of the participant's investments under its investment plan.

b. Once the initial conditions set forth in the core action plan have been fulfilled, the subnational government will have access to a second amount of 48% of the credit line. These resources are to be used to finance the participant's investment plan or the unfinanced remainder of the strengthening plan.

c. Upon fulfillment of the remaining conditions, the subnational government may have access to the remainder of its resources in order to finance another part of its investment plan.

d. The disbursement and expenditure-verification arrangements used by BANOBRAS with each subnational government are to be part of the program's operations manual and will be included in the respective onlending contract.

6. Process review and evaluation

3.29 All the aforementioned matters will be subject to joint periodical reviews by BANOBRAS and the Bank to verify the attainment of their objectives and scope. This exercise will also serve to make any necessary adjustments to the various

mechanisms utilized so as to meet the subnational governments' needs in a way that is at once practical, flexible, and timely.

3.30 The following table presents the flow of activities and responsibilities relating to these matters.

Stage 1: Promotion		
	Activity	**Responsible office/agency**
1	Promotion	Promotion Department
2	Preparation of financial and institutional analysis	DPEEE and Technical Assistance
3	Forwarding of the analysis to the IDB	DPEEE
4	Review of the analysis	IDB
Stage 2: Preparation and approval of the core action plan		
1	Preparation of the plan and agreement on eligibility criteria	DPEEE and Technical Assistance
2	Credit process	Credit
3	Aggregate borrowing ceiling	Risks
4	Negotiation (amount, areas, interest rates)	Promotion, subnational government, Credit, and Risks
5	Approval of the plan	DPEEE
6	No objection	IDB
Stage 3: Preparation and approval of the investment plan		
1	Review of the plan	DPEEE, Technical Assistance, with clearance by IDB
Stage 4: Access to resources		
1	1.Proposal for disbursement 2.Review of compliance 3. No objection for release of resources 4. Disbursements	Promotion DPEEE and Technical Assistance IDB Credit/Promotion
Stage 5: Reviews and evaluations		
1	Process review and certification	DPEEE and Technical Assistance
2	Quarterly monitoring and evaluation meetings	DPEEE and IDB

D. Disbursement procedures and revolving fund

3.31 As executing agency, BANOBRAS will present disbursement requests exclusively to the Bank's Country Office in Mexico (COF/CME), accompanied by a breakdown of payments based on the transmission forms of the Expanded Electronic Payment System [Sistema de Pagos Electrónicos de Uso Ampliado] (SPEUA), in accordance with the specifications agreed upon with the Bank and control of disbursements and local contributions. All original supporting documentation for disbursements will remain with the executing agency's state offices.

3.32 BANOBRAS is to make sure that all information contained in the SPEUA is duly backed up by the normally required proofs, as agreed with the Bank. BANOBRAS and the subnational governments participating in component I are to keep all the supporting documentation for SPEUA data (e.g., contracts, orders, invoices,

receipts, payment vouchers, supplier certificates, certificates of origin) duly filed and available for review by authorized officers of the Bank and external auditors.

3.33 During its technical and financial inspection visits, COF/CME will verify, on a sample basis, that the executing agency has in its files the supporting documentation for the disbursement requests and that resources have been used in the manner indicated in the loan agreement.

3.34 Disbursements to establish or replenish the revolving fund in the amount of up to 5% will follow applicable Bank rules and regulations. The fund will be replenished whenever requested by BANOBRAS, as justified by information presented in the breakdown of payments.

3.35 The preliminary disbursement schedule for phase I of the program (Table III-3) is compatible with the execution capacity in place and the availability of local counterpart resources.

Table III-3
Preliminary disbursement schedule
(in millions of U.S. dollars)

Source	Year 1	Year 2	Year 3	Total
IDB (OC)	100	100	100	**300**
Local	100	100	100	**300**
Total	200	200	200	**600**
%	**33.3**	**33.3**	**33.3**	**100.0**

E. Procurement

3.36 Bank policies and procedures will be followed for the procurement of all goods, services, and works, which will be subcontracted in their entirety. International competitive bidding will be used whenever the estimated value of the goods or related services being procured is US$350,000 or more, with the threshold set at US$5 million for works contracting. Tenders for amounts below these thresholds will be conducted in accordance with local legislation, to the extent that this is compatible with Bank principles in this regard.

3.37 The preliminary procurement schedule for goods and works during year 1 of the program has been agreed upon (see project files). The schedule for subsequent years will be decided upon at the annual supervision and monitoring meetings.

3.38 International open calls for proposals will be used for consulting services estimated at US$200,000 or more. Consulting services estimated at less than US$200,000 will be procured in accordance with the provisions of Annex D to the loan contract.

3.39 BANOBRAS will conduct an ex ante review of all procurement processes for goods, works, and consulting services by the subnational governments. To this end, BANOBRAS has presented, to the Bank's satisfaction, evidence that it has the necessary staff and a procurement system to perform this task. It has been agreed with COF/CME that all controls and verifications by the IDB will be done ex post on a sample basis when the amounts involved are below the threshold for international tenders.

F. Monitoring

3.40 As indicated above and inasmuch as this is a multiphase program, monitoring and evaluation will be ongoing so as to validate and verify the effectiveness of the mechanisms proposed to support the subnational governments in their efforts to improve their financial and institutional situation.

3.41 The Bank will review and give its no objection, ex ante, to: (i) the financial and institutional analyses conducted by BANOBRAS; (ii) the core action plans for the subnational governments; and (iii) the investment plans presented by the subnational governments. The program's operations manual will indicate the percentages and amounts for investments in specific sectors. After the first few reviews have been conducted, the Bank and BANOBRAS may decide on different review arrangements.

3.42 In addition to the semiannual progress reports that BANOBRAS is to present, annual review meetings will be held with the Bank. The progress reports are to contain details on: (i) operations approved and committed; (ii) progress with implementation of the core action plans and status of disbursements, by subnational government; (iii) analysis of investments financed, by subnational government; and (iv) compliance with environmental legislation.

3.43 With support from external consultants, an evaluation will be carried out when at least 75% of the financing proceeds have been committed and at least 50% of those resources have been disbursed. This evaluation should analyze the triggers defined in paragraphs 3.46 and 3.47. The findings of the evaluation will be used as input for preparing the request that the Board of Executive Directors approve the program's second phase.

3.44 Annual financial and operations audits of the program will be conducted by a consulting firm acceptable to the Bank. The operations audit will analyze: (i) attainment of the program's objectives and targets, especially the subnational governments' meeting of the financial and institutional strengthening commitments assumed in the core action plan; (ii) use of the program's various manuals; (iii) a sample of completed works and investment projects in terms of compliance with the criteria for technical, financial, environmental, and social viability, especially their compliance with the Bank's sector policy; and (iv) compliance with the

program's accounting requirements by the subnational governments. The auditors who conduct the operations audit will also examine, on a sample basis, the supporting documentation for disbursement requests and will present a separate report on the supporting documentation for disbursements.

G. Supervision by the Bank

3.45 COF/CME, with technical support from the project team, will supervise the program's performance. Given the multiphase nature of this program, it has been agreed to hold quarterly monitoring and supervision meetings, to track overall execution of each of the program activities.

H. Activation of phases II and III

3.46 According to the operating guidelines for multiphase programs, in addition to commitment of 75% of resources and disbursement of 50% of resources for phase I, phase II of the proposed program could be submitted to the Board of Executive Directors when the following targets and indicators are met, subject to the findings of the aforementioned operations audit (paragraph 3.44):

a. For subnational governments:

(i) that they have earned, from rating agencies, a credit rating higher than at the time they joined the program;

(ii) that they have basic investment planning guidelines that guarantee that investment projects are evaluated financially, economically, and environmentally;

(iii) that they have effected a significant improvement in local tax effort;

(iv) that they have an integrated financial management system containing, as a minimum, modules for accounting, budget, and cash flow;

(v) that they have adequately separated environmental normative and execution functions;

(vi) that they present financial statements audited each year by an independent external auditor, publish their financial statements, and have an action plan to address observations and recommendations made by the external auditors;

(vii) that they show, in a sample of randomly selected projects, that the projects comply with sector criteria for economic, financial, and environmental viability, criteria of long-term financial sustainability, and procurement and contracting procedures (paragraph 3.36); and

(viii) that they comply with the Bank's public utilities policy, for which purpose a review will be undertaken of the existing regulatory framework and of the rates to be charged for the delivery of these services.

b. For BANOBRAS:

(i) that it has moved forward in its process of financial and institutional strengthening, particularly with regard to the functional separation and strengthening of the normative and operations areas;

(ii) that it has pared back its operating costs to levels that are sustainable over the long run;

(iii) that it has made significant headway in implementing its information technology plan and has implemented a management information system that is consistent with that plan;

(iv) that at least 15% of its processes have become ISO 9000 certified; and

(v) that it has launched a pilot credit project for municipios classified in the category of medium to high marginality, according to the criteria of the Social Development Secretariat. Participation by relatively less developed subnational governments will also be verified in order to continue promoting social equity.

3.47 These indicators are largely consistent with the ones set forth in the program's manuals on operations, best practices, and financial and institutional analysis. Progress will be measured against the baseline profile produced by the financial and institutional analysis of participating subnational governments and measurable progress against the respective benchmarks.

3.48 Progress by the individual subnational governments will depend to a great extent on their respective starting points, which will be defined by the financial and institutional analysis, the commitments assumed under the core action plan, and the achievements posted. Since these will differ for each of the subnational governments participating in the program, it is not possible to set numeric indicators.

3.49 Phase II would continue to pursue the main thrusts launched in phase I, making any necessary adjustments to heighten the program's impact and effectiveness. During phase II, the necessary changes would be made to adjust, improve, and consolidate the new criteria, mechanisms, and products. Lastly, phase III would continue with the adjustments and expand the program's coverage.

IV. VIABILITY AND RISKS

A. Institutional viability

4.1 Implementation of the Institutional Modernization Program at BANOBRAS during the FORTEM operation currently under way (loan 1214/OC-ME) has been an important step in the process of modernizing this institution. The plan was developed by BANOBRAS's management with advice from specialized independent consultants, and has received full support from the institution's senior management and board of directors. Building consensus on the problems facing the bank and on needed measures has maximized the likelihood of success for the complex process of institutional transformation launched as part of the modernization program.

4.2 Aware that recovery of the commercial banking sector is a process that is just beginning and will likely extend over the coming years, BANOBRAS will have to continue to be the main provider of credit to subnational governments for at least the near future. Against such a backdrop, BANOBRAS's senior management has continued to pursue a sweeping plan of reform and modernization that calls for a reorganization of the agency, including a substantial reduction in the workforce (up to 40%) and targeting its activities to promote private-sector participation in investment and financing of investment, infrastructure project finance, and promoting and financing the modernization and institutional strengthening of subnational governments. More importantly, the institution has been reorganized, creating the Economic Studies and Strategic Planning Department [Dirección de Planeación Estratégica y Estudios Económicos] (DPEEE), which will be responsible for: (i) quality management models; (ii) medium- and long-term vision; (iii) social evaluation of projects; (iv) specific economic studies; and (v) units for the analysis and evaluation of local public finances and government management. BANOBRAS's organizational manual will be updated to reflect this new structure, whose sole purpose is to serve clients better.

4.3 Coupled with the experience gained by BANOBRAS during execution of the current FORTEM operation (loans 1213 and 1214/OC-ME), the new commitment assumed and the decisions taken recently by BANOBRAS's board of directors with regard to its organizational structure provide ample evidence of the institutional viability to carry out the proposed program.

B. Technical and economic viability

4.4 Recent years have seen a transfer of key responsibilities from the national to subnational governments. However, since the latter's capacity to rise to this challenge is very disparate, a number of mechanisms were identified during preparation of the present program—such as the financial and institutional analysis

manual and the core action plan—which together with the criteria used in the current FORTEM operation will help to strengthen subnational governments.

4.5 The financial and institutional analysis manual will help to provide a more complete description of the desirable features of a subnational government and will give greater rationality and coherence to actions taken by these governments under the program. It also sets an example and gives a benchmark against which all the state governments can be measured and against which the public can assess how well their government is working. This manual could ultimately be converted into a system for disseminating best practices.

4.6 Adopting financial best practices will make for more efficient use of public resources and will also help to avoid possible overcommitments of those resources and the ensuing negative consequences (overindebtedness, limited financial viability, etc.).

4.7 The program's economic viability is underpinned by the commitment of the subnational governments to allocate counterpart resources of their own for BANOBRAS's participation. This will be evidenced in the contracts signed between BANOBRAS and a subnational government.

C. Environmental considerations

4.8 Inasmuch as any type of infrastructure works in 32 states and nearly 2,428 municipios can be financed under the program, the possibilities for environmental impact, both positive and negative, are extensive. For this reason, it will be necessary to enforce the **Mexican government's Environmental Protection Act** [Ley General del Equilibrio Ecológico y la Protección al Ambiente]. To ensure compliance, its Chapter II (on jurisdiction and coordination) states that the federal government, the states, the Federal District, and the municipios shall exercise their powers in the area of preservation and restoration of ecological balance and environmental protection in accordance with the distribution of responsibilities assigned under that law and other legal regulations. The Bank will begin by reviewing environmental and natural-resource management in the preparation of the financial and institutional analysis manual. Then, it can verify inclusion of the environmental variable in the best practices manual. Lastly, the environmental variable will be an essential element in the preparation of the investment plans of a subnational government and must be reflected in the contract to be signed between the subnational government and BANOBRAS. Annex II presents greater details on how the activities of evaluation, control, and supervision will be carried out in terms of environmental impact.

4.9 The program's operations manual for states participating in the program requires that there be separation of functions between the entities responsible for promoting projects and the entity responsible for environmental regulation, charged with

environmental review and control. For municipios with over 200,000 inhabitants, there must be an environmental affairs office responsible for defining and reviewing environmental studies before they are submitted to the regulatory agency. For states, the main indicator of compliance is the existence of a procedures manual stating that projects are reviewed by an environmental regulation agency before they are implemented and that said entity must be different from the one promoting the project. If such a manual does not exist, evidence must be provided of payment of an advance to a consulting firm to prepare the manual in cases of states or municipios with over 200,000 inhabitants. For municipios of less than 200,000 inhabitants, the required indicator is that there be an environmental engineer to define and review environmental studies before they are submitted to the regulatory agency.

4.10 In view of the foregoing, the program will require compliance with the aforementioned legislation, which will be reflected in the program's operations manual to be used by all participating subnational governments. For participating states, Article 7 in Chapter II clearly defines the powers delegated by the Environment and Natural Resources Secretariat (SEMARNAT) and requires that they be complied with. For participating municipios, the same principle is followed although the relevant article is Article 8, since the legislation does not distinguish states and municipios by size. Accordingly, the legislation must be adhered to, and this will be reflected in the program's operations manual, without exception, for municipios both larger and smaller than 200,000 inhabitants. With regard to compliance indicators, the operations manual will require all such aspects as are set forth in national legislation—and not only manuals or specific regulations—for each participating subnational government

4.11 Chapter II of the aforementioned legislation, as well as its Articles 7, 8, and 10, will be incorporated in all three of the program manuals, and will be used as environmental measurement criteria in the new program on the basis of the following:

(i) National legislation on the environment is observed, this being mandatory regardless of whether the Bank wishes to establish any additional requirements. Failure to comply with this legislation could create problems for the new program and for the Bank.

(ii) It facilitates program administration, monitoring, and follow-up for the Bank's Country Office in Mexico by standardizing environmental policies for all subnational governments on the basis of national legislation.

(iii) Subnational governments are modernizing their institutional structures and building environmental policies into their strengthening processes, which is a key objective of the proposed program.

(iv) It stimulates decentralization of environmental policy, which is mandated under the mentioned legislation and is a fundamental policy of the government, as reflected in the 2001-2006 National Development Plan.

D. Social considerations

4.12 Monitoring and compliance with eligibility criteria and the agreed program implementation arrangements will enable the subnational governments to adopt best practices in financial and administrative management that will have a positive impact on society in general. Organized finances, transparent processes, and investment planning will allow subnational governments to meet their needs in a timely and orderly fashion. A critical issue in the new operation is the inclusion of the most marginalized municipios so they can improve their capacity to provide services to their communities.

E. Social equity and poverty reduction classification

4.13 This operation qualifies as a social equity enhancing project as described in the key objectives for the Bank's activity set forth in the report on the Eighth General Increase in Resources (document AB-1704). The experience gained under the FORTEM operation in the states of Quintana Roo, Oaxaca, and Veracruz indicates that there is an unmet demand for programs to provide institutional and financial strengthening in subnational governments in whose territory a high percentage of the population is poor. This demand was taken into account in the design of the proposed program, which expects to secure greater participation in the lower-income states, such as Campeche, Puebla, and Yucatán. The program also includes a pilot project to strengthen the governments of municipios classified in the category of medium to high marginality, with the objective of supporting BANOBRAS in designing and implementing new intervention methodologies that could be replicated on a larger scale during a second phase of the program. The operation does not quality as a poverty-targeted investment (PTI).

F. Benefits

4.14 Mexico currently has no programs that focus on enhancing subnational government management systems. The component I activities will encourage subnational governments to strengthen their financial management as a complement to the decentralization measures taken by the federal government. The mechanisms to be implemented will yield important benefits for subnational governments. The adoption of financial best practices will make for more efficient use of public funds and prevent the overcommitment of these resources and the ensuing negative consequences (overindebtedness, limited financial viability, etc.).

4.15 The financial and institutional analysis manual will provide a more complete description of the desirable features of a subnational government and ensure greater rationality and coherence in the actions taken by those governments under the program. Also to be established are best practices and benchmarks against which all the governments can measure their performance and against which the public can assess how well their government is working. The manual is expected to be converted into a system for disseminating best practices. For instance, proper regulation of Ramo 33 (one of the federal government's mechanisms for transferring resources to subnational governments) and better management of investments and audit, budgeting, and accounting systems would allow subnational governments to meet citizens' needs more efficiently and with greater equity. Similarly, making operations more transparent will give financial agents as well as the general public better criteria for assessing subnational government performance. To this end, the financial and institutional analysis manual will include key, measurable benchmarks against which subnational governments can chart their progress.

G. Risks

4.16 Considering the demand for resources under a new operation, BANOBRAS's execution capacity—at headquarters and at its 31 branches—bears special significance. Specific actions will be designed to ensure ongoing training and institutional strengthening within BANOBRAS.

4.17 BANOBRAS needs to boost its technical capacity to formulate strengthening plans and provide advice and monitoring in implementing those plans. The diagnostic capacity required is very broad, and includes analysis of the finances of subnational governments, the sectors served (water, transportation, education, health, waste management, etc.), as well as the institutional strengthening requirements. Although the diagnosis may hinge, to a certain extent, on external sources, the key element is the internal capacity of the organization to add value to available information and in many cases generate information where none is available. Under the program, BANOBRAS should improve and acquire such capacity and, accordingly, it will be necessary to appoint a team to perform the analyses and persons to guide a policy dialogue so as to begin their training as soon as possible. The team would initially receive advice from the IDB, but would rapidly become an independent team, self-sufficient to perform this task.

4.18 There was a risk that all the activities to prepare diagnostic studies and approve financing would be concentrated in a single unit within BANOBRAS. This concern has been dispelled by BANOBRAS's recent reorganization, which has established a clear and transparent separation of the promotion, approval, lending, and monitoring of operations funded for subnational governments. In this regard, the flowchart presented at paragraph 3.28 (in chapter III on program execution) illustrates the process to be followed, as well as the scope and responsibilities of the

various departments within BANOBRAS. A key consideration is that the process will include active involvement by the Center for Studies on the Economic Evaluation of Projects (CEPEP), an agency that operates within BANOBRAS with a select group of professionals with recognized experience in project analysis who will be responsible for the projects' socioeconomic evaluation and will check that the individual projects to be funded comply with the technical, financial, and environmental viability and sustainability criteria.

LOGICAL FRAMEWORK
(ME-0231)
MULTIPHASE PROGRAM FOR INVESTMENT AND FINANCIAL AND INSTITUTIONAL STRENGTHENING OF STATES AND MUNICIPIOS
PHASE I

SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
lp implement the national t plan by supporting the tion process in Mexico.			
Participating subnational s adopt improvements in d institutional t.	15 subnational governments participate in the program. 10 municipios in medium and high marginality areas participate in a pilot plan for institutional strengthening.	Contracts signed between BANOBRAS and the participating subnational governments to finance technical assistance and/or investment activities.	Demand on the part of subnationa governments for the program's pr remains high. BANOBRAS deve promotes methodologies and tool promote the participation of the p municipios.
ts:			
credit	Some 80% of the participating subnational governments have: 1. A credit rating issued by a rating agency that is higher than its rating upon entry into the program. 2. A core action plan and investment planning methodologies that ensure that investment projects are evaluated from a financial, economic, and environmental perspective. 3. An improvement in local taxation efforts. 4. A functioning comprehensive financial management system, consisting of accounting, budget, and treasury modules. 5. Functional separation between the regulatory and enforcement areas for environmental regulations.	For indicators 1 through 7, the monitoring reports and evaluation of the core action plans prepared by BANOBRAS. For the BANOBRAS strengthening indicators, a midterm evaluation report and program evaluation report, prepared by external consultants.	Increase in the number of subnati governments participating in the

SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
	6. Financial statements audited annually by an independent external entity. 7. A sample of random projects that comply with the sector criteria for economic, financial, and environmental viability. 8. BANOBRAS has achieved functional separation of operational and regulatory areas. 9. Reduced their operating costs to sustainable levels. 10. Implemented their management information systems. 11. 15% of their processes certified under ISO 9000. 12. Implemented a pilot lending program for municipios classified in the category of medium to high marginality.		
e practices intended to hen the management of resources by subnational nents. e the financial position of onal governments. e investment and technical nce projects to increase the y of subnational nents to provide services blic infrastructure.	Use of the program's US$600 million.	Accounting records of the program.	1. Subnational governments sig commitment with BANOBR 2. BANOBRAS continues its in modernization program. 3. BANOBRAS acquires the tec capacity to implement the financial/institutional analysi 4. BANOBRAS develops the ca review the economic, financi environmental evaluation of t projects.

MEXICO

Multiphase Program for Investment and Financial and Institutional Strengthening of States and Municipios. Phase I ME-0231

ENVIRONMENTAL ANNEX

1. Background

1.1 Inasmuch as any type of infrastructure works in 32 states and nearly 2,428 municipios can be financed under the program, the possibilities for environmental impacts, both positive and negative, are extensive. For this reason, it will be necessary to enforce the **Mexican government's Environmental Protection Act** [Ley General del Equilibrio Ecológico y la Protección al Ambiente]. To ensure compliance, its chapter II states that the federal government, the states, the Federal District, and the municipios shall exercise their powers in the area of preservation and restoration of ecological balance and environmental protection in accordance with the distribution of responsibilities assigned under that law and other legal regulations.

1.2 The Bank will begin by reviewing environmental and natural-resource management in the preparation of the financial and institutional analysis manual. Then, it can verify inclusion of the environmental variable in the best practices manual. The operations manual will also include specific environmental topics, particularly in eligibility criterion 2 on investment plans. The environmental variable will be an essential element in the preparation of the investment plans of a subnational government and must be reflected in the contract to be signed between the subnational government and BANOBRAS. Even more importantly, the normative documents specified above will include and faithfully reflect the opinions of Mexico's Environmental Protection Act, to avoid duplication of efforts and to facilitate subnational government compliance with environmental regulations.

2. Evaluation, control, and supervision of environmental impact issues

1.3 In consultation with the Bank's Country Office in Mexico (COF/CME), an agreement has been reached to conduct strict monitoring of compliance with the Environmental Protection Act, which will be reflected in the program's guidelines and instruments (financial and institutional analysis manual, best practices manual, and the operations manual). During the annual meetings between the Bank and BANOBRAS, special attention will be given to verification of compliance with the sector criteria of economic, financial, and environmental viability and the sustainability of investments and of the Bank's public utilities policy. The persons responsible for the external evaluations at the end of each year of the program will

use the Environmental Protection Act, the financial and institutional analysis manual, the best practices manual, and the operations manual as reference points.

1.4 Articles 7 and 8, paragraphs XVI and XIV, respectively, of the Environmental Protection Act require that for the environmental impact evaluation of construction projects or activities not expressly reserved to the national government under the Act, authorizations shall be issued pursuant to Article 35 (b) 2, which states: The environmental impacts that construction projects or activities not covered under Article 28 may cause, which, owing to their scope and implications at the regional and national level, restricts authorization to the national government, shall be evaluated by the authorities of the respective Federal District, states, and municipios when, owing to their location, size, or characteristics, such construction projects or activities will have a significant impact on the environment and are expressly noted in the state's environmental legislation. In such cases, the environmental impact assessment may be conducted under the procedures for authorization of land use, construction, subdivisions, or other uses as established by state laws and the regulations deriving therefrom.

1.5 Article 7, paragraphs V, VI, VII, and VIII and Article 8, paragraphs VI and VII, of the Environmental Protection Act require that the provisions of the law be applied with regard to prevention and control of air pollution generated by fixed sources that operate as commercial or service establishments and the emission of air pollutants from mobile sources; the enforcement of legislation on prevention and control of the environmental impact caused by the generation, transport, storage, handling, treatment, and final disposal of solid waste; the enforcement of legislation concerning prevention and control of the pollution of water discharged into drainage and sewer systems in population centers, as well as of national water allocated to them, with the participation of state governments as provided by local legislation; the regulation of sustainable use and pollution prevention and control of water under state jurisdiction, and of national water allocated to them.

3. Land-use management and master plans for land-use planning

1.6 In accordance with Articles 7 and 8, paragraphs IX and VIII, respectively, of the Environmental Protection Act, the formulation, issuance, and implementation of environmental management programs within state territory must be done with the participation of the respective municipios, pursuant to the provisions of Article 20 (2) of the Act: "The governments of the states and of the Federal District, under the terms of applicable local laws, may formulate and issue regional environmental management programs that cover all or part of the territory of a state."

1.7 If an environmental region is located in the territory of two or more states, the federal government, the governments of the states and respective municipios and, if applicable, of the Federal District, within the limits of their authority, may formulate a regional environmental management program. To that end, the federal government will sign the relevant agreements with the local governments.

1.8 Article 8, paragraph V requires the creation and administration of ecological preservation areas for populated areas, urban parks, public gardens, and other similar areas as provided by local legislation.

4. Participation of civil society

1.9 There is a long-standing tradition in Mexico of community involvement in decision-making concerning the use of resources for community infrastructure projects, particularly at the municipal level, which has produced excellent results as a control mechanism for social planning. In this respect, the Bank will promote and encourage the participation of civil society, based on the Environmental Protection Act, which, in paragraph XIV, refers to the conduct of state policy on information and dissemination regarding environmental matters. Similarly, paragraph XV of the Act requires that the participation of civil society be encouraged with regard to environmental matters, as provided in the Act.

1.10 In light of BANOBRAS's decision to encourage the participation of less developed municipios and municipios with smaller populations (under 200,000), the institution's role in disseminating best practices among indigenous communities will be of fundamental importance where applicable. These communities will have access to technical-assistance resources and their action plans will be custom-tailored pursuant to the financial and institutional analysis manual and best practices manual, taking the setting and special characteristics of these communities into account.

5. Institutional strengthening

1.11 One of the specific basic objectives of the proposed program and, naturally, of the FORTEM program currently in execution is institutional strengthening. Without properly functioning institutions, sector development policies and national legislation cannot be implemented. Consequently, a decentralization and good governance process cannot be carried out. This is a fundamental premise for environmental issues as well, and accordingly the Environmental Protection Act delegates the authority to enforce its provisions to the states and municipios.

1.12 To achieve the stated objectives, states and municipios must create an office or unit responsible for including the environmental variable in planning and implementation. There can be no better opportunity to strengthen this process than the FORTEM. This should be a requirement of the program, rather than merely hiring an environmental engineer. It is important to note that there is considerable controversy about this issue within the Bank, because a consultant may do the work well, but when he/she leaves the institution, nothing is left behind and the objective of institutional strengthening is not attained, because the idea is that the states and municipios be more autonomous and decentralized.

6. Conclusion

1.13 The proposed program will provide considerable support to ensure that states and municipios benefit from existing laws and, ultimately, that their communities will benefit in terms of environmental concerns. By simply conducting an institutional financial analysis and committing to moving forward with an action plan, an entity participating in the program may qualify to receive program resources that it can use for technical assistance or to finance part of its investment plan. Importantly, the FORTEM program now in execution was not and is not, and the proposed program will not be, a substitute for Mexico's environmental laws and regulations. The program's guidelines and instruments (i.e., the financial and institutional analysis manual, the best practices manual, and the operations manual) provide assurance for the Bank that its environmental policies and guidelines will be followed. In this sense, and in accordance with the flow chart of activities and responsibilities, each action plan will be prepared with the support of BANOBRAS, but the Bank, through its environmental sector specialist at the Bank's Country Office in Mexico, will issue a statement of no objection before any construction project included in the investment plan is carried out.

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MEXICO. LOAN ____/OC-ME TO "BANCO NACIONAL DE OBRAS Y SERVICIOS PUBLICOS, S.N.C."
(Multiphase Investment Program for the Institutional and Financial Strengthening of States and Municipalities, Phase I)

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 first phase of a Multiphase Investment Program for the Institutional and Financial Strengthening of States and Municipalities. Such financing will be for the amount of up to US$300,000,000, which are part of the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the "Special Contractual Conditions" and the "Financial Terms and Conditions" of the Executive Summary of the Loan Proposal.