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MEXICO

PROGRAM TO STRENGTHEN FISCAL MANAGEMENT IN STATES AND MUNICIPIOS II

(ME-L1276)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Alejandro Rasteletti (IFD/FMM), Project Team Leader; Andrés Muñoz (IFD/FMM), Alternate Project Team Leader; Huáscar Eguino and Susana Román-Sánchez (IFD/FMM); Mónica Lugo (LEG/SGO); José Yitani (KIC/KLD); Guillermo Lagarda and Alejandro de Gyves (CID/CME); and Germán Zappani (VPC/FMP).

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ABBREVIATIONS

ASF	Auditoría Superior de la Federación [Federal Supreme Audit Office]
BANSEFI	Banco del Ahorro Nacional y Servicios Financieros, S.N.C.
CNBV	Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission]
CONAC	Consejo Nacional de Armonización Contable [National Accounting Standards Board]
GDP	Gross domestic product
IMF	International Monetary Fund
INDES	Instituto Interamericano para el Desarrollo Económico y Social [Inter-American Institute for Economic and Social Development]
INDETEC	Instituto para el Desarrollo Técnico de las Haciendas Públicas [Institute for the Technical Development of Public Financial Administrations]
INEGI	Instituto Nacional de Estadística y Geográfica [National Institute of Statistics and Geography]
LDF	Ley de Disciplina Financiera de las Entidades Federativas y los Municipios [Financial Discipline Act for Federative Entities and Municipios]
LGDP	Ley General de Deuda Pública [Public Debt Act]
LIBOR	London Interbank Offered Rate
PBL	Policy-based loan
PBP	Programmatic policy-based loan
PRODEV	Program to Implement the External Pillar of the Medium-term Action Plan for Development Effectiveness
RPU	Registro Público Único [Single Public Registry]
SHCP	Secretaría de Hacienda y Crédito Público [Department of Finance and Public Credit]

PROGRAM SUMMARY

MEXICO
PROGRAM TO STRENGTHEN FISCAL MANAGEMENT IN STATES AND MUNICIPIOS II
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Financial Terms and Conditions				
Borrower			**Flexible Financing Facility**[a]	
United Mexican States			**Amortization period:**	14.5 years
Executing agency			**Disbursement period:**	12 months
Secretaría de Hacienda y Crédito Público (SHCP)			**Grace period:**	5.5 years[b]
Source	**Amount (US$)**	**%**	**Interest rate:**	LIBOR-based
IDB (Ordinary Capital):	600 million	100	**Credit fee:**	[c]
			Inspection and supervision fee:	[c]
Total:	600 million	100	**Original weighted average life:**	10 years
			Approval currency:	U.S. dollar

Program at a Glance

Program objective/description: The objective of the programmatic series and this operation is to improve fiscal management in federative entities and municipios, in order to strengthen their fiscal sustainability. This will be done by implementing a new financial discipline framework, increasing transparency and accountability, and building institutional capacity in federative entities and municipios for implementing measures in these areas.

This loan operation is the second in a programmatic policy-based loan series, comprised of two contractually independent, but technically linked loans.

Special contractual conditions precedent to the first and only disbursement of the loan: Special contractual conditions precedent to the first and only disbursement of the loan for the second and final operation in the series will be: (i) a signed trust agreement between the borrower and its financial agent, Banco del Ahorro Nacional y Servicios Financieros, S.N.C. (BANSEFI); and (ii) compliance with the policy reform conditions set forth in the policy matrix (Annex II), the policy letter, as well as other conditions established in the corresponding loan contract (see paragraph 3.4).

Exceptions to Bank policies: None.

Strategic Alignment

Challenges:[d]	SI ☐	PI ☐	EI ☐
Crosscutting themes:[e]	GD ☐	CC ☐	IC ☑

[a] Under the terms of the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency, interest rate, and commodity conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

[b] Under the flexible repayment options of the Flexible Financing Facility, changes to the grace period are permitted provided that they do not entail any extension of the original weighted average life of the loan or the last payment date as documented in the loan contract.

[c] The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable policies.

[d] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[e] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1. Programmatic series

1.1 This operation is the second of two operations in a programmatic policy-based loan (PBP) series. The series originated in 2017 (4071/CH-ME and 4072/OC-ME) and was agreed upon with the Mexican government as support for structural measures aimed at improving fiscal management in the federative entities and municipios, in order to strengthen their fiscal sustainability. To that end, a new financial discipline framework was developed and implemented, transparency and accountability requirements were increased, and training events were designed to build institutional capacity in the federative entities and municipios for implementing measures in those areas. The results of the first operation have been quite significant (see paragraphs 1.12 through 1.14), and specific improvements are already being observed in various aspects of the public finances of subnational governments (see paragraph 1.29).

1.2 This operation provides ongoing support for the reforms, in line with the stated objectives of the first programmatic loan (loan contracts 4071/CH-ME and 4072/OC-ME), which was approved and disbursed in 2017. This second operation is intended to lock in the policy reforms adopted by Mexico as part of the process of improving fiscal management in the federative entities and municipios. To that end, certain aspects of the regulatory framework continue to be strengthened and progress is being made with effective implementation of the new measures in the federative entities and municipios.

2. Recent economic performance

1.3 Despite facing an unfavorable external environment in recent years due to uncertainty surrounding the renegotiation of the North American Free Trade Agreement and greater volatility in international capital markets, the Mexican economy has grown at a moderate pace, expanding its GDP at an average real rate of 2.3% between 2016 and 2018.[1] This moderate growth is expected to continue in 2019 and 2020, with median growth rate projections of 1.6% and 2%, respectively.[2]

1.4 On the financial front, the greater volatility observed in the international markets is not expected to pose significant risks to the sustainability of Mexico's financial system. A recent stress analysis by the International Monetary Fund (IMF) indicates that the banking system is appropriately capitalized and that provisioning levels are satisfactory.[3] In addition, despite trade and political uncertainty, the peso did not depreciate between year-end 2017 and year-end 2018. Moreover, annual inflation fell to 4.8% in 2018 and is expected to remain contained.[4]

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[1] Unless otherwise indicated, the figures reported in this document have been provided by the National Institute of Statistics and Geography (INEGI).

[2] Encuesta sobre las expectativas de los especialistas en economía del sector privado. Banco de México, February 2019.

[3] Mexico. Article IV Consultation report. IMF Country Report 18/307. November 2018.

[4] The Banco de México survey of expectations mentioned above puts median expected inflation rate for 2019 and 2020 at 3.65% and 3.6%, respectively.

1.5 On the fiscal front, following a sharp rise in the public debt between year-end 2007 and 2016, owing to larger fiscal deficits and exchange rate depreciation,[5] the government implemented a number of fiscal consolidation measures[6] designed to reduce the deficit and contain the public debt (see Table 1). The new administration, which took office in December 2018, has committed to continuing the fiscal consolidation process, with the objective of stabilizing the expanded fiscal deficit measure at 2.3% of GDP, beginning in 2022, and the debt-to-GDP ratio at around 45%.

1.6 This federal spending control, combined with a scenario of moderate economic growth, could have implications for the public finances of the federative entities and municipios. Under that scenario, less growth is expected in transfers specifically to federative entities and municipios. A decrease in GDP, which is a central variable in distribution formulas, could result in less growth in federal revenue transfers (*participaciones*).

Table 1. Selected economic indicators

	2014	2015	2016	2017	2018
Real GDP growth (% change)	2.8	3.3	2.9	2.1	2.0
Unemployment (% economically active population)	3.8	4.0	3.3	3.1	3.3
Inflation (end of period and as a %)	4.1	2.1	3.4	6.8	4.8
Non-oil revenues (% of GDP) [a]	15.8	18.5	20.2	18.8	17.6
Oil revenues (% of PIB) [a]	7.0	4.5	3.9	3.8	4.2
Total expenditure (% of GDP) [a]	25.9	26.4	26.6	23.6	23.7
Primary expenditure (% of GDP) [a]	23.9	24.2	24.2	21.2	21.0
Public sector fiscal deficit [a, b] (% of GDP)	-4.5	-4.0	-2.8	-1.1	-2.3
Public sector debt [a, c] (% of GDP)	42.6	46.5	48.7	45.8	44.8

Source: INEGI and Department of Finance and Public Credit (SHCP).

[a] Refers to the federal public sector.

[b] Refers to public sector financial requirements.

[c] Refers to the historical balance of the public sector financial requirements, which represents a broad definition of public debt.

3. Mexico's fiscal federalism and the public finances of federal entities and municipios

1.7 **Fiscal federalism in Mexico.** Mexico is a federal republic consisting of 32 federative entities, 2,458 municipios, and the 16 territories of Mexico City governed by mayors. The federative entities are governed according to their own laws and have their own constitutions, which may not contradict the Constitution of the United Mexican

[5] According to the Department of Finance and Public Credit (SHCP), between 2008 and 2016 annual public sector financial requirements represented, on average, 3.4% of GDP. According to Banco de México, the exchange rate rose from Mex$10.9 to the dollar at year-end 2007 to Mex$20.7 at year-end 2016. As a result, the historical balances of public sector financial requirements increased from 28.8% of GDP in 2007 to 48.7% in 2016.

[6] Fiscal consolidation mainly resulted from a reduction in public investment, as well as cuts in subsidies and spending on personnel services.

States. In the fiscal arena, state and municipal governments have the power to approve their own budgets and to contract debt without prior authorization from the federal government.[7] The federative entities and municipios are responsible for a large portion of expenditure, currently executing about 36% of total public spending in Mexico.[8] Nonetheless, the fiscal arrangements on tax collection established in the Ley de Coordinación Fiscal [Fiscal Coordination Act] limit the tax bases of the federative entities and municipios, leaving them highly dependent on federal government transfers.[9] These imbalances between revenue and expenditure responsibilities, combined with the possibility of the federal government making discretionary transfers to the federative entities and municipios, create disincentives for the financial discipline of the latter.[10]

1.8 Deficiencies in controls on the fiscal responsibility of subnational governments became evident following the 2008 international financial crisis, when as a result of greater spending by state and municipal governments, the debt of subnational governments rose sharply. Debt of the federative entities and municipios increased from 1.7% to 3.1% of GDP between 2008 and 2013. Although their debt levels were relatively low and did not represent a significant macroeconomic risk, that increase represented exponential growth of the debt in some states, where it caused serious problems of fiscal sustainability. In addition, several states experienced problems of fiscal sustainability and had to restructure their liabilities. The sharp increase in debt was also a problem observed at the municipal level. The nominal amount of the municipal debt more than doubled in the period from 2008 to 2013. In addition, several municipios faced serious difficulties meeting their debt repayment obligations, and some are in default.

1.9 In order to address the problem of the considerable growth in public debt of the subnational governments, the SHCP led a task force to evaluate institutional framework strengthening options so as to improve the financial discipline of the federative entities and municipios. The Bank provided technical advisory services in this process. As a result of these discussions, a constitutional reform was proposed to empower Congress to pass fiscal responsibility laws that would encourage sustainable management of the public finances of federative entities and municipios. Congress was also explicitly empowered to establish the general guidelines for contracting and recording debt and for the allocation of revenue transfers by the subnational governments. After a lengthy debate in Congress over the sweeping changes in fiscal federalism, the constitutional amendment finally passed in May 2015.

1.10 Following approval of the constitutional amendment, the next step was to regulate the new constitutional principles. This required the development and approval of a regulatory framework designed to strengthen the fiscal management and financial discipline of the federative entities and municipios. This posed a major challenge given the wide range of areas that needed to be strengthened. In particular, there

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7 Mexico City is the exception, which must have prior approval from Congress before contracting debt.

8 Sexto Informe de Gobierno 2017-2018.

9 Transfers to federative entities and municipios represented 8.1% of GDP in 2018 and one third of federal government expenditure (SHCP).

10 Pineda, Ramírez, and Rasteletti (2015). "A Mariachi Medley: Mexico's Long Road to Fiscal Federalism Reform" in *Decentralizing Revenue in Latin America: Why and How.* IDB. Fretes and Ter-Minassian (eds.).

were significant deficiencies in local legislation with respect to budgetary preparation and execution, contracting of debt, fiscal transparency, oversight of the use of public funds, and accountability, which had a negative impact on fiscal sustainability.[11] To address these deficiencies, the federal government approved the Financial Discipline Act for Federative Entities and Municipios (LDF) and amended various laws. The Bank provided technical advisory services to the SHCP in that process.

1.11 Preparation of the programmatic series coincided with the drafting and approval of the aforementioned legislation. The series was structured as two policy-based loan (PBL) operations that are technically linked. The main objective of the first operation was to make rapid headway on the approval and reform of legislation, so as to establish the bases for the new regulatory framework. The second operation was structured to promote the effective implementation of the newly adopted regulatory framework.

1.12 The first operation in the PBP series (loan contracts 4071/CH-ME and 4072/OC-ME) included major reforms, which introduced structural changes in public finance management by the federative entities and municipios. The principal policy reforms achieved include approval of the LDF, which establishes both numerical and procedural fiscal rules in order to: (i) encourage financial discipline;[12] (ii) achieve greater control and efficiency in public spending;[13] and (iii) strengthen processes for contracting obligations use of resources.[14] The LDF also introduces important mechanisms for promoting transparency and accountability with respect to borrowing and the management of public finances. The main method for ensuring the transparency of subnational debt is creation of a Single Public Registry (Single Public Registry)[15] where the federative entities and municipios and their respective public entities are to record all obligations and financing contracted. That information is then published on the SHCP's website.[16] With respect to transparency in public finance management, an alert system was introduced to evaluate the debt level of the federative entities and municipios.[17] The results of that evaluation are published

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[11] For a detailed description of these challenges, see the loan proposal for the Program to Strengthen Fiscal Management in Federative Entities (loan contracts 4071/CH-ME and 4072/OC-ME).

[12] The main financial discipline rules include: (i) limits on contracting new debt; (ii) limits on the amount of funds that can be used for fiscal debts from prior years; (iii) restrictions on the use of surplus revenues; and (iv) the required preparation of medium-term fiscal projections, risk analyses, and actuarial studies of pension systems.

[13] Public spending rules include: (i) the introduction of limits on the growth of spending on personnel services; (ii) required identification of sources of financing for additional expenditures; and (iii) the obligation to establish specialized areas in the economic analysis of programs and projects in the federative entities and municipios.

[14] The main changes to the contracting of obligations are: (i) the requirement to analyze payment capacity before approving the contracting of obligations; (ii) the requirement to introduce competitive processes when contracting debt; (iii) greater control over short-term debt; and (iv) establishment of the mechanism for accessing federal guarantees on debt.

[15] The SHCP is required to publish and provide daily updates on its official website all borrowings and obligations in effect for the federative entities and municipios (recorded in the Single Public Registry).

[16] In addition to bank loans and offerings in the capital markets, this includes financial leasing contracts and factoring operations, guarantees, derivative instruments with a payment obligation greater than one year, and public-private partnership contracts.

[17] The alert system uses three indicators to rate the debt level of federative entities and municipios. Three levels are assigned by the system: sustainable debt, debt under observation, and heavy debt.

on the SHCP website.[18] The alert system also serves to restrict increases in the level of debt, since the LDF sets net financing limits each year based on the rating assigned by that system.[19]

1.13 In order to strengthen oversight of federal funds executed by federative entities and municipios, the oversight authority of the Federal Supreme Audit Office (ASF) was also expanded through reforms to the Ley General de Fiscalización y Rendición de Cuentas [Oversight and Accountability Act] and the Fiscal Coordination Act. With approval of constitutional reforms, the ASF now has the power to oversee compliance with the LDF, activities in the current fiscal year, and the exercise of: (i) federal revenue transfers to federative entities and municipios;[20] (ii) federal resources and contributions[21] administered by public and private trusts, funds, and mandates, or any other legal instrument; and (iii) resources from public debt guaranteed by the federal government.

1.14 The Public Debt Act (LGDP) was also amended to empower the federal government to guarantee obligations representing the public debt of the federative entities and municipios. Prior to that reform, the federal government was only empowered to guarantee Mexico City's debt[22] and was unable to guarantee that of federative entities and municipios. When the amendment to the Public Debt Act was proposed, it was thought that the corresponding reduction in financing costs for the guaranteed state debt mechanism would incentivize the federative entities and municipios to coordinate with the federal government and agree on fiscal consolidation plans that would strengthen the sustainability of their public finances.

1.15 Following approval of the new regulatory framework supported by the first operation, the challenge faced was to effectively implement it, given the sweeping changes established in that framework. The main challenges include standardization of federative entity legal frameworks, in order to make them consistent with the new federal regulatory framework. As mentioned, given that Mexico's states are free and sovereign in all matters related to their internal regime, effective implementation of the regulatory framework required that the states reform their local laws to make them consistent with federal legislation. The states progressed at a different pace in this process, but by year-end of 2018 all federative entities had amended their local legislation to achieve the aforementioned consistency. Another challenge was to ensure effective implementation of the LDF in the federative entities and municipios. In light of the large number of changes in the actions of the subnational governments to comply with the fiscal responsibility provisions included in the LDF, the decision

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[18] Disciplina Financiera de Entidades Federativas y Municipios.

[19] A federative entity or municipio with a sustainable debt rating has an annual net financing ceiling of 15% of its unrestricted revenues. A federative entity or municipio with a rating of debt under observation has an annual net financing ceiling of 5% of its unrestricted revenues. Lastly, a federative entity or municipio with a heavy debt rating has an annual net financing ceiling of 0%.

[20] The use of revenue transfers was audited only by local senior audit entities, which have less capacity and management autonomy than the ASF, which did not intervene in the process.

[21] The ASF was empowered to oversee execution of the revenue transfers up to the point when the funds were distributed to the federative entities, in order to verify that the distribution complied with the provisions of relevant regulations. However, it did not oversee the execution of those funds by the federative entities and municipios.

[22] The ability to guarantee Mexico City's debt was based on the fact that it was a federal district and the nation's capital, with a legal status quite different from that of other federative entities.

was made to follow a staggered implementation strategy. The fiscal responsibility regulations took effect for federative entities in 2017 given their greater institutional capacities. The municipios were given more time, with the regulations set to take effect in 2018. When the first operation was approved, some municipios requested postponement of the entry into effect of the LDF's fiscal responsibility regulations in order to have more time to prepare for their implementation.[23]

1.16 Another challenge was that the new provisions governing fiscal responsibility would require the introduction of new rules and regulations, as well as reforms to existing regulations. New regulations were required for operation of the Single Public Registry and the alert system, and for calculation of the lowest financial cost to identify the winning bids in competitive processes, among others. Yet another challenge was related to the treatment of Service Delivery Projects[24] within the new regulatory framework, since obligations could be assumed without the need to record them in the Single Public Registry or to consider them in the calculation of the alert system indicators. With respect to reforms to existing regulations, the National Accounting Standards Board (CONAC)[25] was required to issue criteria for standardized preparation and presentation of the financial information and forms referenced in the LDF, and to revise the classifiers according to financing sources and income categories, for the calculation of certain fiscal rules set out in the LDF. Various regulations of the National Banking and Securities Commission (CNBV)[26] also had to be revised in order to align them with the new legislation and to create incentives, so that the banking sector would become a partner in overseeing the implementation of legislation related to the debt of federative entities and municipios.

1.17 In addition to these regulatory challenges, there are others for implementing the new regulations at the federal government level and in the federative entities and municipios. The federal government's main challenges were related to improving the recording process, which necessitated a system for managing the Single Public Registry. The alert system evaluation also presented a challenge given the large number of entities to be evaluated.[27] In light of the newness of the guaranteed state debt mechanism, the necessary characteristics of legal documents for contracting guaranteed state debt had to be identified, and standard agreements were drafted

[23] In light of these requests, a condition of the second operation was the entry into effect of the fiscal responsibility regulations for at least the largest municipios, defined as those with a population of more than 200,000 inhabitants. This figure was selected because the LDF makes a distinction at various points between municipios with populations above and below that number.

[24] Under Mexican regulations, "service delivery projects" refers to the group of actions required for an agency or entity to receive services over the long term from an investor/provider through a long-term services agreement, which is different from those defined as long-term productive infrastructure projects with conditional investment.

[25] CONAC is the coordinating body tasked with the standardization of government accounting. Its purpose is to issue accounting standards and guidelines applicable to government entities when generating financial information.

[26] The CNBV is a deconcentrated agency of the SHCP with the authority to authorize, regulate, supervise, and impose sanctions on the various actors of the Mexican financial system.

[27] The alert system ratings are based on three indicators: (i) public debt and liabilities divided by unrestricted revenues; (ii) debt service and liabilities divided by unrestricted revenues; and (iii) current liabilities, suppliers, and contractors, less cash on deposit with banks and short-term investments divided by total revenue.

for underwriting and adoption of the guaranteed state debt mechanism.[28] These also had to be compatible with the existing mechanisms for administering, managing, and recording debt that had proven to be effective.[29] An internal reorganization of the ASF was necessary in order to grant that entity the authority to oversee compliance with the LDF and to advance with effective implementation of the new oversight powers.

1.18 The challenges for implementing the LDF by the federative entities and municipios included compliance with regulations related to improving financial planning and the quality of investment spending. In order to improve financial planning, the LDF requires that the federative entities and municipios prepare and present fiscal projections as input for the budgetary preparation process. To facilitate this process, the SHCP, in collaboration with the Bank, designed a digital platform to prepare fiscal projections and debt sustainability analyses. Development is complete and the platform is in the testing phase. With regard to the quality of investment spending, the LDF requires that federative entities have an area responsible for evaluating the socioeconomic analyses and for creating and administering a registry of its productive public investment projects. Implementation of that registry posed a challenge for some federative entities. Another challenge concerned the effective implementation of new processes for contracting debt and obligations, and their subsequent recording and updating in the Single Public Registry. For example, the LDF requires an analysis of the ability to pay prior to approval of debt by the corresponding state legislature, and that competitive processes be used for contracting debt with lower financing costs.

1.19 Lastly, in order to ensure that implementation of the reform by the federative entities and municipios would be viable, the new regulatory framework had to be disseminated and training provided to the officials in those levels of government. The large number of subnational governments involved necessitated a large-scale training strategy. In the first phase, the SHCP disseminated the new regulatory framework through workshops. It subsequently requested support from the Bank and the Inter-American Institute for Economic and Social Development (INDES) to develop an online course to be implemented in coordination with Mexico's Institute for the Technical Development of Public Financial Administrations (INDETEC).[30] [31] INDETEC also offered various training courses on the LDF,[32] and the SHCP continued with additional training activities.[33] However, those efforts had to be

[28] The LDF stipulates that only those federative entities and municipios that have signed an agreement with the SHCP may adopt the guaranteed state debt contracting mechanism.

[29] The latter mainly refers to irrevocable management and source-of-payment trusts, which are the instruments most frequently used by federative entities and municipios to assure their creditors that debt is repaid on time.

[30] INDETEC is an agency of the National Fiscal Coordination System. Its functions include training, advisory, and technical consulting services for the federative entities and municipios.

[31] INDES and INDETEC held two rounds of virtual training for 430 registered participants from 22 federative entities and 137 municipios.

[32] In 2018, INDETEC held 30 training events on the LDF, providing training to 1,518 officials.

[33] In 2017, the SHCP held training workshops on the use of the Single Public Registry system for 32 federative entities, and four courses were given on the LDF. About 400 municipal civil servants from five entities were trained in 2018. Training workshops were also given to elected municipal presidents from nine states.

systematized for their sustainability over time given the high turnover of public finance officials, particularly at the municipal level.

1.20 **The Bank's operational work and technical support in the country.** For more than six years now, the Bank has been supporting the process of developing legislation related to the financial discipline of federative entities and municipios, offering technical assistance since the inception of the idea to establish a financial discipline law in 2012. In 2013, when constitutional reform was being discussed, the Bank presented the government with international best practices for regulation in order to encourage the financial discipline of subnational governments, and developed proposals for their implementation in Mexico. In 2014, the Bank promoted the sharing of experiences with Colombian government officials (technical cooperation operation ATN/OC-14781-ME) to discuss the details of the regulatory framework in that country and the lessons learned from its implementation. In 2015, after the constitutional reform was passed, the Bank provided advice during the various stages of drafting the proposed LDF. In 2016 and 2017, the Bank provided advice on the drafting of the LDF's various regulations.

1.21 Subsequently, the Bank collaborated with the SHCP on various activities in order to promote effective implementation of the new regulatory framework. A technical cooperation operation (ATN/OC-15559-ME) was executed between 2016 and 2018, aimed at strengthening the fiduciary systems of the SHCP and the institutional capacities of the federal government and federative entity and municipal governments for implementing the new legislation. This technical cooperation supported: (i) development of the Single Public Registry system; (ii) the preparation of regulations for the LDF; (iii) the development of standard agreements for underwriting and adoption of the guaranteed state debt mechanism; and (iv) development of a training course for state and municipal government officials on the new regulatory framework. A new technical cooperation operation (ATN/OC-16690-ME) is currently being executed to support the SHCP with development of a module for obtaining and processing the local public finance information required by the alert system. A platform was also developed to support the state and municipal governments in preparing fiscal projections and debt sustainability analyses.

1.22 **Sector knowledge.** There is ample economic literature examining the impact on fiscal performance of regulatory frameworks designed to control the financial discipline of subnational governments. The most relevant lessons for the Mexican context include:[34] (i) control measures on subnational debt are more effective when there is robust federal government monitoring of fiscal management by subnational governments, and a commitment to enforce such measures; (ii) where financial markets are not developed and good and timely financial information on the finances of the subnational governments is lacking, market control[35] may not be effective by itself for containing subnational debt, and thus robust federal government control and monitoring are required to encourage discipline on the part of subnational

[34] These conclusions are drawn from the study by Deza Delgado and Rasteletti (2016) (see index of sector studies).

[35] "Market control" refers to the financial discipline that can be imposed by capital markets (and credit agencies) on governments through access to financing and financing costs. This market control approach was applied in Mexico prior to approval of the LDF.

governments; and (iii) when subnational governments are heavily dependent on federal transfers, market control tends to be less effective, since there tends to be an assumption that the federal government will financially rescue insolvent subnational governments. These lessons were incorporated into this program mainly through stepped up federal government and ASF monitoring of subnational governments, and involvement of the banking system in supporting the recording of debt contracted by federative entities and municipios. Accountability is also being increased by strengthening the reporting of information with new CONAC guidelines and publication of the evaluations of debt of the federative entities and municipios through the alert system.

1.23 **Bank's experience in the region and lessons learned.** This programmatic series benefits from, among other things, the experiences in other PBLs that have incorporated components with a subnational approach, such as the Consolidation Program for Subnational Fiscal Responsibility in Colombia I and II,[36] with respect to the importance of establishing central level alert systems to monitor and control the debt of subnational entities, promoting standardized classification practices, and thereby instilling a culture of transparency and fiscal responsibility among subnational governments. The program also takes into account the lessons learned from technical cooperation operations under the subnational Program to Implement the External Pillar of the Medium-term Action Plan for Development Effectiveness (PRODEV) in the region, particularly in Mexico,[37] on the importance of adopting medium-term fiscal plans or other fiscal sustainability analysis instruments in order to program subnational public spending in a manner consistent with debt targets. The series also benefits from the lessons learned from the Fiscal Consolidation Programs for the Brazilian States[38] regarding the importance of adopting fiscally relevant policy measures that are effective in improving subnational management. The program also takes into consideration the operations under the Program to Modernize Fiscal Management in Brazil (PROFISCO)[39] with respect to the importance of implementing transparency measures and improving subnational public spending.

1.24 **Coordination with other donors.** The Bank's support for the reforms implemented by the government have been coordinated with the IMF and the World Bank. Technical support for developing the methodology to calculate the lowest financial cost of bids received in competitive processes for contracting debt was coordinated with the IMF. Technical support for developing the alert system methodology and the corresponding annual net financing ceilings was coordinated with the World Bank.

1.25 **Strategic Alignment.** The program is consistent with the Update to the Institutional Strategy 2010-2020 (document AB-3008), aligning with the crosscutting area of

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[36] Loan contracts 2341/OC-CO and 2744/OC-CO.

[37] The technical cooperation operations under PRODEV in Mexico were executed with the states of Baja California (ATN/OC-11970-ME); Campeche (ATN/OC-12940-ME); Mexico City (ATN/OC-11237-ME); Michoacán (ATN/OC-11971-ME); Tabasco (ATN/OC-11923-ME); and Yucatán (ATN/OC-11851-ME).

[38] Alagoas (loan contract 3061/OC-BR), Amazonas (loan contract 3139/OC-BR), Bahía (loan contract 2081/OC-BR), Pernambuco (loan contract 3039/OC-BR), and two in the state of Rio Grande del Sur (loan contracts 2850/OC-BR and 3138/OC-BR).

[39] Operations BR-X1005 and BR-X1039.

institutional capacity and the rule of law, through the institutional strengthening of the SHCP, and improvement in the regulatory framework on financial discipline in the federative entities and municipios. The program will also contribute to the Corporate Results Framework 2016-2019 (document GN-2727-6), through the indicator on government agencies benefiting from projects that strengthen technological and management instruments to improve the delivery of public services, and the additional indicators: (i) strengthened accountability institutions; (ii) subnational governments benefiting from decentralization, fiscal management, and institutional capacity projects;[40] and (iii) strengthened public registries. The program is also consistent with the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2), by strengthening the administrative and fiscal management of subnational governments and establishing institutional mechanisms for promoting transparency and accountability, and with the Subnational Governments and Decentralization Sector Framework Document (document GN-2813-8), by supporting greater coordination of intergovernmental arrangements and strengthening transparency and accountability in fiscal management. In addition, the program is aligned with the IDB Country Strategy with Mexico 2013-2018 (document GN-2749), through the strategic objective to support strengthening of federal and subnational public management in that it contributes to the improvement of subnational public management by promoting fiscal responsibility and control of debt.[41] Lastly, the operation is included in the 2019 Operational Program Report (document GN-2948).

B. Objectives, components, and cost

1.26 **Objective.** The objective of the programmatic series and this operation is to improve fiscal management in federative entities and municipios, in order to strengthen their fiscal sustainability. This will be done by implementing a new financial discipline framework, increasing transparency and accountability, and building institutional capacity in federative entities and municipios for implementing measures in these areas.

1.27 The series is structured as two PBPs that seek to address the main challenges facing the country with respect to effective implementation of the constitutional reform on the financial discipline of the federative entities and municipios, and the strengthening of transparency and accountability. The first programmatic operation was primarily intended to establish the legal and regulatory bases of the constitutional reform by issuing laws, regulations, and guidelines. This second operation continues the work of developing the regulatory framework and is making headway on measures to promote effective implementation by the federative entities and municipios of that new framework.

1.28 The reforms supported in the first operation made far-reaching changes to the regulatory framework governing relationships between the different levels of

[40] Program measures include the establishment of a Single Public Registry, an alert system, and the development of a digital platform for preparing medium-term fiscal frameworks and debt sustainability analyses. These technological instruments will make it possible to strengthen fiscal management and fiscal transparency. Measures are also included to strengthen oversight of how federative entities and municipios use funds from federal transfers.

[41] The program's measures also affect the Evaluation System (PES)-PRODEV indicator in the country strategy results matrix, by contributing to the public financial management and auditing components.

government in Mexico. With respect to the fiscal responsibility of the federative entities and municipios, a condition of the first operation was enactment of a new law (the LDF) and reform of the Public Debt Act, in order to improve regulation of the processes of budgetary preparation and execution by state and municipal governments. Processes for contracting public debt were also reformed and a new mechanism was created for coordination between the federal government and the federative entities and municipios through guaranteed state debt. In order to increase transparency and accountability, a Single Public Registry was established that tracks all debt of the federative entities and municipios, along with an alert system to track the level of debt of governments and to monitor changes. The Oversight and Accountability Act and Fiscal Coordination Act were also amended to grant the ASF greater powers of oversight of the federal funds executed by federative entities and municipios. Lastly, in order to bolster effective implementation of the above, a large-scale training strategy was designed to build capacities in the state and municipal governments.

1.29 Most of the policy conditions included in this second operation have been implemented during the 2017-2019 period in the context of preparing this operation and form part of the policy matrix. It is worth noting that, at the time this document was prepared, the results observed following the reform and implementation of the new regulatory framework have been largely positive. The debt ratio of the federative entities and municipios and their public entities as a percentage of total revenue transfers fell from 90.7% in 2013 to 71.6% by end-September 2018. At the same time, while the alert system's first rating identified 11 states in the heavy debt or debt under observation[42] categories, the most recent binding evaluation[43] identified only nine states in those categories.[44] While 20.6% of municipios evaluated were rated in the heavy debt or debt under observation categories in the first evaluation, that percentage fell to 18.9% in the second evaluation.[45] Significant reductions were also observed in the surcharges paid by subnational governments on their debts over the interbank equilibrium interest rate.[46] While at the end of 2016 the average surcharge for state debt was 154 basis points over the interbank equilibrium interest rate (TIIE), by the end of third quarter of 2018 that surcharge was 39 basis points. This would be mean annual savings for the states of around US$300 million (1% of total state debt). With regard to the states, the average real growth rate for expenditures on personnel services dropped from 4.5% in 2015 to -3.7% in 2017. Lastly, since publication of the LDF, the SHCP, and INDETEC have trained more than 4,000 civil servants on the content of the new regulatory framework.

1.30 This program is organized into the following components:

[42] Disciplina Financiera de Entidades Federativas y Municipios.

[43] The first alert system evaluation for the states was presented on 30 June 2017 and the most recent binding evaluation was issued on 29 June 2018. Binding evaluations are those that affect the net financing ceiling for the next fiscal year and are based on public account data.

[44] This improvement is mainly due to the federal entities' lower levels of relative debt. The average ratio of debt to unrestricted revenues, which corresponds to the alert system's first subindicator, was reduced from 73% to 68.4% between 2016 and the most recent binding evaluation in June 2018.

[45] The first alert system evaluation for the municipios was presented on 31 October 2017 and the second on 31 July 2018.

[46] The interbank equilibrium interest rate, which is calculated by Banco de México, corresponds to interest rates agreed upon by the various banks.

1.31 **Component 1. Macroeconomic stability.** The objective of this component is to ensure the maintenance of a macroeconomic context consistent with the program objectives as established in the policy matrix and sector policy letter.

1.32 **Component 2. Strengthening the fiscal responsibility of federative entities and municipios.** The objective of this component is to increase the financial discipline of the federative entities and municipios and their public entities, to strengthen their fiscal sustainability. This second operation of the programmatic series maintains four of the original conditions, modifies five, and adds one new condition. As discussed below, the changes and additions to the policy conditions do not affect fulfillment of the development objectives of this operation or of the programmatic series.

1.33 The four conditions that remain the same or have minor changes in their wording are:[47] (i) certification by the federative entities and municipios and their public entities that the payment capacity was analyzed before those obligations were approved by the respective state legislature, as established in the LDF;[48] (ii) maintenance of the balance of guaranteed state debt below 3.5% of Mexico's nominal GDP;[49] (iii) amendment of the provisions applicable to credit institutions empowering the CNBV to order the establishment and maintenance of higher-than-normal loan loss reserves when a loan is not recorded in the Single Public Registry;[50] and (iv) approval by CONAC of changes to classifiers according to financing sources and income categories.[51]

1.34 Of the five measures that were modified, three now have a broader scope. The first of these measures is the entry into effect of the fiscal responsibility provisions of the LDF in the municipios and in their respective public entities, under the terms established in that law. This measure initially applied only to municipios with more than 200,000 inhabitants, but it has now been expanded to include all municipios. The second measure modified to expand its scope and to reflect progress made is approval of at least 30 reforms to regulatory frameworks for fiscal management in the federative entities, to make them consistent with the LDF. Initially, 20 reforms to the regulatory frameworks for federative entities were required. The third measure modified is certification by the federative entities and municipios and their public entities when requesting recording of their obligations in the Single Public Registry that the financing was contracted through competitive processes.[52] Originally, competitive processes were required for the contracting of debt in excess of a certain amount,[53] whereas competitive processes are now required for all debt contracted.

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47 These changes to clarify the wording of the conditions do not affect the scope of the measures.

48 This condition is intended to encourage responsible borrowing by the federative entities and municipios and their public entities.

49 This condition is intended to limit the impact of federal guarantees for debt of the subnational governments on the public finances of the federal government.

50 This condition is intended to incentivize banks to require the federative entities and municipios and their public entities to record their debt in the Single Public Registry.

51 This condition is intended to facilitate the calculation of the budgetary balance of available resources referred to in Articles 6 and 19 of the LDF.

52 This condition is intended to reduce financing costs for the federative entities and municipios and their public entities.

53 Those amounts were 40 million investment units in the case of federative entities and their public entities and 10 million investment units for municipios and their public entities.

The scope is narrowed for the remaining two measures, without affecting fulfillment of the program objectives. The first of these measures is development of a platform to prepare medium-term fiscal projections and debt sustainability analyses. Previously, the operation required both development and launching of the platform. The change is due to the fact that development of the platform took longer than originally anticipated. The narrowed scope of the measure does not affect the program objectives since the federative entities and municipios are required to make projections of their public finances as established in the LDF.[54] The platform was envisioned as a tool to support the federative entities and municipios in this task. The aforementioned platform has already been developed and the SHCP is testing it prior to making it available to the federative entities and municipios.[55] The second measure modified to have a narrower scope is related to guaranteed state debt. The condition originally established required the signing of at least three adoption agreements for the guaranteed state debt mechanism. However, to date no federative entities have asked the SHCP to sign such an agreement for guaranteed state debt. This is partially a consequence of improvements in the public finances of the federative entities and successful debt restructuring carried out by the federative entities rated at the heavy debt or debt under observation levels by the alert system,[56] for which the federal guarantee became less attractive. The goal of the new condition regarding guaranteed state debt is for the SHCP to be able to quickly execute a guaranteed state debt agreement upon request. To that end, the new condition requires a study to identify the necessary characteristics of legal documents for contracting guaranteed state debt and the drafting of standard agreements for underwriting and adoption of the guaranteed state debt mechanism.

1.35 Lastly, the new condition added is related to the provision to encourage greater financial discipline in public investment spending in order to increase efficiency in the processes of planning and executing public investment. The condition refers to implementation of the requirement that at least 20 federative entities have a registry of productive public investment projects.

1.36 **Component 3. Strengthening transparency and accountability in the federative entities and municipios.** The objective of this component is to strengthen transparency and oversight, to enhance accountability mechanisms. This second operation of the programmatic series maintains the two original conditions, modifies one, and adds two new conditions. As discussed below, the change and additions to the policy conditions do not affect fulfillment of the development objectives of this operation or of the programmatic series.

1.37 The conditions that remain the same or have minor changes in their wording are: (i) the issuance of guidelines for the Single Public Registry system and its implementation; and (ii) internal reorganization of the ASF to grant it powers to

[54] Articles 5 and 18 of the LDF.

[55] In order to encourage its use, the platform will be made available to the federative entities and municipios via the financial discipline web page, and it will be publicized through INDETEC courses and social networks.

[56] Of the nine federative entities rated by the alert system at the heavy debt or debt under observation level based on the 2017 Public Account, eight entities restructured their debt and achieved, on average, a reduction in average surcharges with respect to the interbank equilibrium interest rate of 75 basis points. This is partially a consequence of financial innovations related to the use of various trusts for debt contracting and repayment, which improved the ratings issued by risk rating agencies on the bank loans.

oversee compliance with the LDF. The condition modified concerns the development of the methodology for calculating the fiscal performance indicators included in the alert system for the federative entities and municipios, and application of the binding evaluation for the net financing ceiling in federative entities and municipios that have contracted financing and obligations recorded in the Single Public Registry, when the source or guaranty of payment is unrestricted revenues.[57] This condition eliminates mention of the public entities since the deadline for their evaluation to be completed was extended so as to reach consensus on the methodology to be used in this widely heterogeneous sector, and to define a flexible mechanism for collecting the information used to calculate the indicators, taking into account the experience with the alert system evaluation in the municipios.[58] The extension of the deadline does not affect achievement of the program objectives since the law stipulates that the evaluation is to be completed by no later than the last business day of August 2019.[59] It should be noted that the evaluation in question is binding for purposes of defining the net financing ceiling. In addition, the evaluation will be for those federative entities and municipios that have contracted financing and obligations recorded in the Single Public Registry, where the source or guaranty of payment is unrestricted revenues.[60] Based on the above, federative entities and municipios that rely exclusively on contributions as the source of payment of their debt are exempt from the evaluation.[61]

1.38 The two conditions added are: (i) approval of the requirement that federative entities and municipios record service delivery projects in the Single Public Registry, and that they be considered in the calculation of the alert system indicators; and (ii) approval of the Annual Audit Program for Supreme Oversight of the Public Accounts 2018, which includes oversight of compliance with the LDF by the federative entities and municipios and of execution of federal revenue transfers. The first condition has been incorporated to increase transparency regarding commitments for future outlays by the federative entities and municipios through these instruments, and to eliminate incentives for contracting debt through service delivery projects rather than through traditional debt. The second condition has been incorporated to ensure that the ASF will begin overseeing compliance with the LDF and the exercise of revenue transfers by the municipios, thereby increasing accountability.

1.39 **Component 4. Institutional strengthening of federative entities and municipios with regard to fiscal responsibility, transparency, and accountability.** The

[57] Unrestricted revenues correspond to local revenue and federal revenue transfers, as well as resources that, where applicable, may be received from the Federative Entity Revenue Stabilization Fund, and any other resources not allocated for a specific purpose.

[58] In 2017, a total of 241 municipios could not be evaluated because they did not provide sufficient information for the analysis.

[59] The evaluation will be based on information gleaned from the 2018 Public Account.

[60] This is because the reform to the LDF dated January 2018 eliminates the obligation to evaluate federative entities and municipios that rely only on contributions. This is intended to facilitate the work of the SHCP, given that only two contribution funds can be designated as a source of payment and those designations can only amount to a maximum of 25%.

[61] Currently, only 161 municipios are in this situation. It is worth noting that those debts continue to be recorded in the Single Public Registry, and if a federative entity or municipio in these conditions wants to contract new debt with unrestricted revenues as the source of payment, it must first obtain an evaluation from the alert system.

objective of this component is to build the institutional capacity of federative entities and municipios for the timely implementation of approved regulations on fiscal responsibility, transparency, and accountability. This second operation of the programmatic series maintains the two original conditions, but clarifies their scope. The conditions for this component are: (i) drafting of agreements between the SHCP and the federative entities, through the Permanent Committee of Fiscal Officials, for INDETEC to hold training sessions on local financial discipline; and (ii) INDETEC holds least 60 training courses or events on financial discipline.

1.40 **Challenges and pending gaps.** Although the new regulatory framework strengthens financial discipline, challenges persist at the subnational level in terms of enhancing capacity to raise own-source revenue and increasing the efficiency of public spending. Accordingly, subnational capacity building is needed in these areas as are stronger incentives to achieve these ends through federal government-subnational government cooperation agreements, and through the federal revenue transfer system. With the aim of strengthening revenue collection, the Bank is supporting capacity building for gathering tax information at the federal government's Tax Administration Service. In turn, this would strengthen subnational revenue collection as a result of tax information exchange agreements. Collaboration will continue with the Banco Nacional de Obras y Servicios Públicos (BANOBRAS) to modernize real property registers, with the aim of increasing the collection of property taxes. In terms of public spending, efforts will be made to collaborate directly with the states to strengthen their public financial management processes, through technical cooperation as well as investment loans. Lastly, with respect to the creation of incentives, opportunities will be pursued with the SHCP to strengthen cooperation agreements with state governments, and to consolidate the current fiscal coordination system through technical dialogue.

C. Key results indicators

1.41 The program's expected outcomes and impacts are listed in the results matrix. The impact indicators included are the balances of obligations and borrowings of the states and municipios as a percentage of GDP. The outcome indicators are: (i) number of federative entities rated at the heavy debt or debt under observation level, in accordance with the alert system regulations; (ii) number of municipios rated at the heavy debt or debt under observation level, in accordance with the alert system regulations;[62] (iii) the federative entity level average real rate of growth in spending for personnel services; (iv) the federative entity level average of the differential between the weighted average interest rate paid by the federative entities on their obligations and the interbank equilibrium interest rate; and (v) the amount of debt recorded in the CNBV that is not recorded in the SHCP, as a percentage of recorded debt. In this second operation in the programmatic series, more ambitious targets were set for the impact indicators by the end of the program than originally planned. This is due to the anticipated better fiscal outcomes for the subnational governments. Regarding the results indicators, more ambitious targets were set for

[62] In the first operation of the series, outcome indicators (i) and (ii) were expressed as changes in the number of federative entities and municipios since no baseline was available. For this operation, the indicators are expressed as levels to facilitate their interpretation. The indicator has also been expanded to include federative entities and municipios rated at the heavy debt level as well as those at the debt under observation level.

three of the five than originally planned,[63] while the targets for the remaining two results indicators remained unchanged.

1.42 **Internal and external validation.** There is ample evidence in the economic literature regarding the effectiveness of the main measures included in the programmatic series. In the United States, Poterba (1994)[64] finds evidence that states with stronger fiscal rules have higher fiscal balances. In Brazil and India, countries where, as in Mexico, the federal government exerts significant control, Martell (2008) and Kishore and Prasad (2007), respectively, find that the restrictions imposed on the coordination arrangements were effective in increasing fiscal discipline. In Spain, Cabasés, Pascual, and Vallés (2007) find that institutional restrictions on debt increased financial discipline in the debt policies adopted by local governments. In Colombia, Chamorro Narváez and Urrea Bermúdez (2016) find that the implementation of an alert system and debt control strengthen the fiscal sustainability of subnational entities. In Mexico, the federal government's guarantee has been very effective in reducing the cost of financing for Mexico City.[65] There have also been successful experiences of coordination between the federal government and one state in the context of fiscal consolidation processes. For example, this was the case with the State of Mexico in 2009, where debt was reduced by more than 25% of revenue transfers between that year and the third quarter of 2016.

1.43 **Economic analysis.** Based on the recommendations of the Office of Evaluation and Oversight (OVE) in its 2011 Evaluability Review of Bank Projects[66] and on the results of the review of evaluation practices and standards for PBLs carried out by the Evaluation Cooperation Group (comprised of the independent evaluation offices of the multilateral development banks)[67] as set out in paragraph 1.3 of document GN-2489-5 (Review of the Development Effectiveness Matrix for Sovereign-Guaranteed and Non-Sovereign Guaranteed Operations) which, inter alia, indicate that it would not be necessary to include an analysis of efficiency in the use of financial resources,[68] it was determined that an economic analysis would not be performed for this type of loan. The Bank's Board of Directors was informed of this determination. Accordingly, this loan operation does not include an economic analysis and was therefore not considered for purposes of measuring the evaluability score in the program's development effectiveness matrix.

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[63] The improvement in the indicator *number of federative entities rated at the heavy debt or debt under observation level* is due to the better fiscal outcomes observed in the federative entities. The improvement in the indicator interest rate differential is due to more-than-anticipated success of the competitive processes and innovations in financial products. The improvement in the indicator *difference in debt recorded* is due to more-than-anticipated short-term debt being recorded.

[64] See the monitoring and evaluation plan for references to the studies mentioned in this paragraph.

[65] See economic analysis of the first operation of the programmatic series.

[66] Document RE-397-1: Currently, the economic analysis section is computed as the maximum between the cost-benefit analysis and the cost-effectiveness analysis. Yet neither a cost-benefit analysis nor a cost-effectiveness analysis is applicable to PBLs.

[67] Good Practice Standards for the Evaluation of Public Sector Operations. Evaluation Cooperation Group, Working Group on Public Sector Evaluation, 2012 Revised Edition. February 2012.

[68] According to the Evaluation Cooperation Group, PBLs should be evaluated based on their relevance, effectiveness, and sustainability. Efficiency was not included as a criterion, as the size of a PBL is tied to a country's financing gap and is independent of the project's benefits.

1.44 **Beneficiaries.** The direct beneficiaries are the citizens of the federative entities and municipios as a result of improvements in the management of public finances and greater fiscal information available to demand accountability from their public officials. The users benefiting from the program include: (i) civil servants in state departments of finance or municipal treasury departments due to training received; and (ii) the federal government due to greater information available on subnational public finances.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 **Financial instrument.** This operation has been structured as a PBP and corresponds to the second operation of a programmatic series to consist of two contractually separate but technically linked loans, consistent with document CS-3633-2 on the preparation and implementation of PBPs. The programmatic approach was selected to: (i) provide medium-term support to the government's program of fiscal policy reforms; (ii) promote ongoing dialogue; and (iii) facilitate the monitoring and refinement of the implementation strategy, given the highly complex nature of the reform involving policy actions at various levels of government.

2.2 **Dimensioning.** This operation will be for US$600 million, which will be financed by the Bank from the Ordinary Capital resources. The funds will be disbursed in a single tranche. The amount of this operation is justified by the financial requirements of the public sector and is not directly related to the reform-associated costs of the program, as per the Policy-based Loans: Guidelines for Preparation and Implementation (document CS-3633-2 [paragraph 3.27 (b)]). The public sector financial requirements for 2019 are estimated at approximately US$90 billion. This operation meets 0.7% of those needs and 6% of external financing.

B. Environmental and social risks

2.3 Based on Directive B.13 of the Environment and Safeguards Compliance Policy (Operational Policy OP-703), this program does not require classification. The operation supports the definition of policies, standards, management instruments, and other institutional strengthening actions, so no social/environmental risks are anticipated.

C. Fiduciary risks

2.4 No fiduciary risks associated with the operation were identified. Funds for this operation will go directly to the treasury single account to cover the federal government's financing needs, for which the executing agency has the necessary financial management instruments and control systems. The loan proceeds will be disbursed once the policy measures established in the loan contract are fulfilled.

D. Other risks and key issues

2.5 **Fiscal sustainability.** The main fiscal sustainability risk, classified as medium, relates to an adverse international context, with continuing uncertainty surrounding international trade relations and Mexico's moderate economic growth. This could lead the federal government to reduce transfers to federative entities and municipios, hampering attainment of the program's financial discipline objectives. Although this

risk cannot be fully controlled, the new regulatory framework for fiscal discipline strengthens the response capacity of the federative entities and municipios for this type of risk. In addition, the federal government will continue to develop and publish projections of the main variables used to determine federal transfers, which will allow the governments of the federal entities and municipios to be alerted to possible future reductions in transfers. The federal government will also continue to use the Federative Entity Revenue Stabilization Fund to reduce volatility in transfers to the federative entities and municipios.

2.6 **Public management and governance risks.** There are four public management and governance risks, all classified as medium. The first risk is that the lack of technical capabilities in the state and municipal governments and public entities will delay the alert system evaluations and hinder fiscal transparency and accountability. To mitigate this risk, the government has already provided for an increase in technical support to develop and implement the alert system module in the Single Public Registry system. This will primarily be accomplished by contracting programmers and analysts, financed with funds from technical cooperation operation ATN/OC-16690-ME with the Bank. They will be responsible for developing various systems and training the personnel that will later be in charge of the systems' ongoing maintenance. INDETEC will offer training courses on the alert system module to civil servants from the federative entities and municipios. The second risk is that civil servants in the federative entities and municipios will fail to attend the training courses and their lack of technical training will hinder compliance with the rules governing financial discipline, transparency, and accountability established in the law. To mitigate this risk, the courses will be disseminated in a variety of media so as to increase the number of officials interested in receiving the training. The third risk is that the federative entities and municipios will provide incorrect or inconsistent information for calculating the alert system indicators, and that those errors and inconsistencies might not be detected by the SHCP given the vast amount of information managed by the system. To mitigate this risk, it was determined that the information should be prepared using the forms and guidelines developed by CONAC, and that the information used to calculate the indicators would be made public, so that the press and civil society can identify and report any errors in the information used. Moreover, the alert system regulations establish time frames for making clarifications related to the evaluations. Lastly, the training course to be developed will include a section on reporting information, and computer codes will be included in the alert system for detecting inconsistencies in the information supplied. The fourth risk is that changes in the priorities in INDETEC's work plan will affect its training activities on the LDF. To mitigate this risk, large-scale online training courses will be held to reach a wider audience and to mitigate the impact of changes in priorities, and the materials developed for the various training courses will be made publicly available on the SHCP and INDETEC websites.

2.7 **Sustainability of reforms.** The regulatory framework introduced for financial discipline is expected to have a high degree of sustainability since it is derived from a constitutional reform that sets guidelines on controlling debt and greater oversight of the use of federal resources by federative entities and municipios. Eliminating these guidelines would require a new constitutional amendment. In addition, the policies supported under this operation are consistent with the financial discipline

strategy of the new administration. Consequently, it is anticipated that the progress supported by this programmatic operation will continue in the medium term.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 **Borrower.** The borrower will be the United Mexican States, through the SHCP. The borrower will execute the program through the SHCP's Unit for Coordination with Federative Entities, with support from the SHCP's Public Credit Unit, a financial agent of the government, and BANSEFI, which will serve as the borrower's financial agent for the program.

3.2 **Executing agency.** The SHCP will have technical responsibility for execution and agrees as follows: (i) to itself maintain, or maintain through an assignee, official communication with the Bank and deliver reports and evidence of compliance with the conditions of the operation, and any other reports the Bank may request by the deadlines and under the conditions agreed; (ii) to promote actions to achieve the policy objectives defined in the program; and (iii) to complete, file, and deliver to the Bank all information, indicators, and parameters allowing the Mexican government and the Bank to monitor, measure, and evaluate the program's outcomes.

3.3 **Coordination mechanism.** Responsibilities for complying with measures in the programmatic series lie with the SHCP, federative entity and municipal governments, CONAC, the CNBV, and the ASF. The SHCP, primarily through the Unit for Coordination with Federative Entities, but also through its various units, maintains free-flowing dialogue with the states, and the states in turn maintain that dialogue with the municipios, which will help in coordinating the implementation of measures. In addition, there is a National Fiscal Coordination System, in which the federal government and federative entity governments participate, that may serve as a coordinating entity to advance the measures proposed in this program. The SHCP chairs CONAC, and the CNBV is a deconcentrated body of the SHCP. The SHCP also maintains free-flowing dialogue with the ASF.

3.4 **Special contractual conditions precedent to the first and only disbursement of the loan: Special contractual conditions precedent to the first and only disbursement of the loan for the second and final operation in the series will be: (i) a signed trust agreement between the borrower and its financial agent, BANSEFI; and (ii) compliance with the policy reform conditions set forth in the policy matrix (Annex II), the policy letter, as well as other conditions established in the corresponding loan contract.**

B. Summary of results monitoring arrangements

3.5 **Monitoring.** The program will be monitored by verifying the agreed policy measures (monitoring and evaluation plan). The SHCP and the Bank will hold periodic meetings to monitor the results of the operation and to anticipate and resolve technical difficulties related to its execution. The SHCP will provide the Bank with all information necessary to measure achievement of program targets and will provide timely information on progress thereon.

3.6 **Evaluation.** The evaluation strategy will consist of two parts. First, the results of reform of the regulatory framework will be analyzed, in terms of how public finances

of the federative entities and municipios evolved following implementation of the measures in the program. Second, the impact of certain specific measures that are part of the program will be analyzed. The proposed studies would estimate: (i) the effect of greater competency in debt contracting processes on the cost of financing for the federative entities and municipios; and (ii) the impact of financial planning on municipal fiscal balances (monitoring and evaluation plan). A project completion report will also be prepared. Both the studies mentioned and the project completion report will be prepared at the end of the programmatic series' execution.

IV. POLICY LETTER

4.1 The policy letter reiterates the Mexican government's commitment to the objectives and actions set forth for the programmatic operation as a whole. The Bank and the Mexican government also agreed on a policy matrix, which describes the policy actions of this programmatic operation.

Development Effectiveness Matrix		
Summary		
I. Corporate and Country Priorities		
1. IDB Development Objectives	**Yes**	
Development Challenges & Cross-cutting Themes	**-Institutional Capacity and the Rule of Law**	
Country Development Results Indicators	**-Government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery (#)* -Subnational governments benefited by decentralization, fiscal management and institutional capacity projects (#)* -Public registries strengthened (#)* -Accountability institutions strengthened (#)***	
2. Country Development Objectives	**Yes**	
Country Strategy Results Matrix	**GN-2749**	**Support the strengthening of public management at the federal and subnational levels**
Country Program Results Matrix	**GN-2948**	**The intervention is included in the 2019 Operational Program.**
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability		**Evaluable**
3. Evidence-based Assessment & Solution	**8.8**	
3.1 Program Diagnosis	**2.4**	
3.2 Proposed Interventions or Solutions	**4.0**	
3.3 Results Matrix Quality	**2.4**	
4. Ex ante Economic Analysis	**N/A**	
5. Monitoring and Evaluation	**9.3**	
5.1 Monitoring Mechanisms	**2.5**	
5.2 Evaluation Plan	**6.8**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Medium**	
Identified risks have been rated for magnitude and likelihood	**Yes**	
Mitigation measures have been identified for major risks	**Yes**	
Mitigation measures have indicators for tracking their implementation	**Yes**	
Environmental & social risk classification	**B.13**	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, Accounting and Reporting, External Control, Internal Audit. Procurement: Information System.**
Non-Fiduciary		
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**The Bank has accompanied with technical advice in the preparation of the Financial Discipline Law for Federal Entities and Municipalities, its regulations and guidelines. A technical cooperation was also executed (ATN / OC-15559-ME) and another is in execution (ATN / OC-16690-ME) to support the implementation of this Law**

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

Evaluability Assessment Note:

This operation is the second of a Policy-Based Programmatic Series (PBP) with the main objective to promote fiscal sustainability. This operation has three specific objectives: (i) Promote financial discipline; increase transparency and accountability and; (iii) strengthen the institutional capacity of the States and Municipalities in the country. The diagnosis is based on a description of the fiscal dynamic and how the current structure relates to this dynamic based on data from the Central Bank in Mexico, The Finance Secretariat, and the National Statistics Institute among others. The proposal includes a qualitative description of the gaps in mechanisms which lead to gaps in fiscal discipline, transparency and capacities, but there is no quantification. The results matrix includes SMART outcome and impact indicators. However, there is a limited number of output indicators which are not SMART. The data to verify the implementation of policies rely on publications of the Official Journal of the Federation, and publications on the Finance Secretariat website, among others.

There is no efficiency analysis as this program is part of a PBP.

The project includes a proposal for an impact evaluation on the effects of financial planning on municipal public finances through a regression discontinuity design. The methodology explores the differences in requirements for municipalities with a population of just over 200,000 inhabitants and those with a population of just under 200,000. The project also proposes to identify the causal effect of bank competition on the cost of financing through a strategy of instrumental variables. The rest of the indicators will be evaluated with a reflexive methodology.

The proposal identifies five risks all classified with medium risk that include delays due to lack of technical capacities in subnational governments, lack of participation in training, errors in the information for calculating indicators of the Alert System, changes in policy priorities, and macroeconomic external shocks.

POLICY MATRIX

Objective: The objective of the programmatic series and this operation is to improve fiscal management in federative entities and municipios, in order to strengthen their fiscal sustainability. This will be done by implementing a new financial discipline framework, increasing transparency and accountability, and building institutional capacity in federative entities and municipios for implementing measures in these areas.

Components/ Policy objectives	Policy conditions Programmatic loan I	Policy conditions Programmatic loan II	Status of compliance with conditions for programmatic loan II[1]
Component 1: Macroeconomic stability			
Ensure maintenance of a macroeconomic context consistent with the program's objectives as established in the policy matrix and sector policy letter	1.1. Maintenance of an economic framework consistent with the program objectives and with the guidelines established in the sector policy letter	1.1. Maintenance of an economic framework consistent with the program objectives and with the guidelines established in the sector policy letter	Fulfilled
Component 2: Strengthening the fiscal responsibility of federative entities and municipios			
Enhance the financial discipline of the federative entities and municipios and their public entities, to reinforce their fiscal sustainability	2.1. Approval of a legal framework on fiscal responsibility for federative entities and municipios that provides for: (i) The establishment of financial discipline measures, including limits on the contracting of new debt and the amount of funds used for tax debt from previous years, restrictions on the use of surplus revenues, and the requirement to prepare medium-term fiscal projections, risk analyses, and actuarial studies of pension systems; (ii) Greater control and efficiency in public spending, by introducing limits on growth in spending for personnel services, the requirement to identify financing sources for additional expenses, and the obligation to establish specialized areas in the economic analysis of programs and projects in the federative entities and municipios; and (iii) Changes in processes for contracting obligations, including the requirement to perform analyses of the ability to pay before approval of the contracting of obligations, the obligation to introduce competitive processes in the contracting of debt in excess of a certain amount, greater control over short-term debt, and establishment of the mechanism for accessing federal guarantees on debt.	2.1.a Entry into effect of the fiscal responsibility provisions of the Financial Discipline Act for Federative Entities and Municipios (LDF) in the municipios and their respective public entities, under the terms established therein.	Fulfilled (2018, Q1)
		2.1.b Implementation of a productive public investment project registry by at least 20 federative entities	Fulfilled (2018, Q4)
		2.1.c Certification by the federative entities, municipios, and their public entities that the ability to pay was analyzed before such obligations were approved by the respective state legislature, as established in the LDF.	Pending (II Quarter 2019)

[1] This information is merely indicative as of the date of this document. In accordance with the provisions of *Policy-based Loans: Guidelines for Preparation and Implementation* (document GN-3633-2), fulfillment of all specified conditions for disbursement, including maintaining an appropriate macroeconomic policy framework, will be verified by the Bank at the time of the relevant disbursement request from the borrower and be duly reflected in the disbursement eligibility memorandum.

Components/ Policy objectives	Policy conditions Programmatic loan I	Policy conditions Programmatic loan II	Status of compliance with conditions for programmatic loan II[1]
	2.2. Approval of a legal reform empowering the federal Executive Branch to guarantee the public debt obligations of the federative entities and municipios	2.2.a. Preparation of a study to identify the mandatory features of legal documents for contracting guaranteed state debt and the drafting of model agreements for underwriting and adoption of the guaranteed state debt mechanism	Fulfilled (2017 Q4)
		2.2.b. Maintenance of the balance of guaranteed state debt below 3.5% of Mexico's nominal GDP	Pending (2019 Q2)
	2.3. Approval of at least 10 reforms to regulatory frameworks on fiscal management in the states to make them consistent with the LDF	2.3. Approval of at least 30 reforms to regulatory frameworks on fiscal management in federative entities to make them consistent with the LDF	Fulfilled (2018 Q2)
	2.4. Development of a methodology for calculating the lowest financial cost of financing and obligations	2.4. Certification by the federative entities, municipios, and their public entities when requesting recording of their obligations in the Single Public Registry (RPU) that the financing was contracted through competitive processes	Pending (2019 Q2)
	2.5. Establishment of disclosure requirements with respect to expenses related to the offer of securities to be issued that federative entities and municipios and their public entities must meet in the respective placement prospectus	2.5. Amendment of the provisions applicable to credit institutions empowering the National Banking and Securities Commission (CNBV) to order the establishment and maintenance of higher-than-normal loan loss reserves when a loan is not recorded in the RPU	Fulfilled (2017 Q3)
	2.6. Approval by the National Accounting Standards Board (CONAC) of criteria for the standardized preparation and presentation of financial information and forms referenced in the LDF	2.6. Approval by CONAC of revisions to classifiers according to financing sources and income categories	Fulfilled (2018 Q3)
	2.7. Development of a digital platform design that allows federative entities and municipios to: (i) prepare medium-term projections (at least five years) for fiscal revenues, outlays, and debt levels; and (ii) perform debt sustainability analyses	2.7. Development of the platform for preparing medium-term fiscal projections and debt sustainability analyses	Fulfilled (2019 Q2)

Components/ Policy objectives	Policy conditions Programmatic loan I	Policy conditions Programmatic loan II	Status of compliance with conditions for programmatic loan II[1]
Component 3: Strengthening transparency and accountability in the federative entities and municipios			
Strengthen transparency and oversight, to enhance accountability mechanisms		3.1. Approval of the requirement that federative entities and municipios record service delivery projects in the RPU, and that they be considered in the calculation of the alert system indicators	Fulfilled (2018 Q1)
	3.2.a. Approval of a legal framework on fiscal responsibility for federative entities and municipios that provides for: In the area of public debt transparency and accountability: (i) Creation of an RPU to replace the Registry of Federative Entity and Municipal Obligations and Borrowings to lend transparency to all financing and obligations for which federative entities and municipios and their public entities are responsible; (ii) Requirement to record in the RPU financial leasing contracts and factoring operations, guarantees, derivative instruments resulting in a payment obligation of more than one year, and public-private partnership contracts; (iii) Requirement that the Department of Finance and Public Credit (SHCP) publish and update daily on its official website all financing and obligations in effect in the federative entities and municipios recorded in the RPU; and In the area of transparency and accountability regarding the financial management of federative entities and municipios: (iv) Requirement to create an alert system to evaluate the debt levels of federative entities and municipios that have contracted financing and obligations recorded in the RPU.	3.2. Development of the methodology for calculating the fiscal performance indicators included in the alert system for the federative entities and municipios, and application of the binding evaluation for the net financing ceiling in federative entities and municipios that have contracted financing and obligations recorded in the RPU, when the source or guaranty of payment is unrestricted revenues	Fulfilled (2018 Q3)
	3.3. Issuance of regulations establishing the requirements for recording, amending, and settling all financing and obligations contracted by states, municipios, and their public entities.	3.3 Issuance of system guidelines for the RPU and implementation thereof	Fulfilled (2017 Q4)
	3.4.a. Approval of a legal reform empowering the Federal Supreme Audit Office (ASF) to oversee compliance with the LDF, activities of the current fiscal year, and the use of: (i) federal revenue transfers received by federative entities and municipios; (ii) federal payments and resources administered by public or private trusts, funds, and mandates, or any other legal instrument; and (iii) public debt resources guaranteed by the Federation	3.4.a. Internal reorganization of the ASF to grant it oversight powers regarding compliance with the LDF.	Fulfilled (2018 Q3)

Components/ Policy objectives	Policy conditions Programmatic loan I	Policy conditions Programmatic loan II	Status of compliance with conditions for programmatic loan II[1]
	3.4.b. Approval of the legal reform empowering the ASF to audit federal contributions received by federative entities and municipios	3.4.b. Approval of the 2018 Annual Audit Program for the Supreme Oversight of the Public Account, which includes oversight of compliance by the federative entities and municipios with the LDF and of execution of federal revenue transfers	Fulfilled (2019 Q1)
Component 4: Institutional strengthening of federative entities and municipios in the area of fiscal responsibility, transparency, and accountability			
Build the institutional capacity of federative entities and municipios for timely application of approved regulations on fiscal responsibility, transparency, and accountability	4.1 Signing of a cooperation agreement between the Institute for the Technical Development of Public Financial Administrations (INDETEC) and a specialized institution to design a training program on fiscal responsibility, transparency, and accountability in the federative entities and municipios	4.1. Establishment of agreements between the SHCP and federative entities within the context of the Annual Meetings of Fiscal Officials, for implementation by INDETEC of training in local financial discipline	Fulfilled (2018 Q2)
	4.2. Development of a training plan on the content and application of the LDF and other laws and secondary regulations addressed in the program	4.2. INDETEC holds at least 60 training courses or events on financial discipline	Fulfilled (2019 Q2)

RESULTS MATRIX

Program objective:	The objective of the programmatic series and this operation is to improve fiscal management in federative entities and municipios, in order to strengthen their fiscal sustainability. This will be done by implementing a new financial discipline framework, increasing transparency and accountability, and building institutional capacity in federative entities and municipios for implementing measures in these areas.

EXPECTED IMPACT

Indicator	Unit of measure	Baseline	Baseline year	Final target	Means of verification	Comments
IMPACT 1.						
Obligations and borrowings of the federative entities as a percentage of GDP	Percentage points	2.6	2016	2.4 (2019)	Report on the obligations and borrowings of the federative entities and municipios published on the Department of Finance and Public Credit (SHCP) website[1]	Baseline and targets as of December of the corresponding year
Obligations and borrowings of the municipios as a percentage of GDP	Percentage points	0.23	2016	0.21 (2019)	Report on the obligations and borrowings of the federative entities and municipios published on the Department of Finance and Public Credit (SHCP) website	Baseline and targets as of December of the corresponding year

1 http://obligaciones_entidades.hacienda.gob.mx/.

EXPECTED OUTCOMES

Indicator	Unit of measure	Baseline	Baseline year	2016	2017	Final target	Means of verification	Comments
OUTCOME 1. FINANCIAL DISCIPLINE								
Number of federative entities rated at the heavy debt or debt under observation level, in accordance with alert system regulations	Federative entities	11	2016	11	9	8	Alert system ratings published on the official SHCP website[2]	The alert system regulations establish a methodology for rating federative entities by debt level. There are three debt level ratings: sustainable debt, debt under observation, and heavy debt. The alert system assesses federative entities on a quarterly basis, and the rating is based on three indicators. Baseline and targets refer to public account data. The final target is for 2018 because data for 2019 may not be available when the project completion report (PCR) is produced. If data for 2019 is available, the target is 8.
Number of municipios rated at the heavy debt or debt under observation level, in accordance with the alert system regulations	Municipios	105	2017	-	105	≤105 (2018)	Alert system ratings published on the official SHCP website[3]	The alert system assesses municipios on a quarterly basis. The information used refers to municipal public account data. For the final target, only municipios that were able to be evaluated in 2017 will be considered. In 2017, 241 municipios could not be evaluated because the information submitted was insufficient to issue a rating. The final target is for 2018 because data for 2019 might not be available when the PCR is produced. If data for 2019 is available, the target is ≤ 105.

[2] https://www.disciplinafinanciera.hacienda.gob.mx/.

[3] https://www.disciplinafinanciera.hacienda.gob.mx/.

Indicator	Unit of measure	Baseline	Baseline year	2016	2017	Final target	Means of verification	Comments
OUTCOME 2. CONTROL IN PUBLIC SPENDING								
The federative entity level average real rate of growth in spending for personnel services	% of growth	4.5	2015	5.8	-3.7	≤ 3 (2018)	National Institute of Statistics and Geography (INEGI)[4] or state public accounts published on the official websites of state departments of finance	The Financial Discipline Act for Federative Entities and Municipios (LDF) establishes that the average real rate of growth in spending for personnel services must not exceed the lesser of 3% or the amount of real GDP growth indicated in the General Criteria for Economic Policy for the fiscal year being budgeted. The nominal values for state public accounts budget heading 1,000 (personnel services) will be used and converted into real figures using the national consumer price index published by Banco de México. Baseline and targets are as of December of the corresponding year and are based on public accounts. The final target is for 2018 because data for 2019 may not be available when the PCR is produced. If data for 2019 is available, the target is ≤ 3.
OUTCOME 3. COST OF FINANCING								
The federative entity level average of the differential between the weighted average interest rate paid by the federative entities on their obligations and the interbank equilibrium interest rate	Basis points	154	2016	145	48	40 (2019)	Report on the obligations and borrowings of the federative entities and municipios published on the official SHCP website and the interbank equilibrium interest rate series published on the Banco de México website[5]	The interbank equilibrium interest rate corresponds to interest rates agreed upon by various banks and is calculated by Banco de México based on quotes submitted by credit institutions. The differential will be taken in relation to the 28-day interbank equilibrium interest rate. Baseline and targets as of December of the corresponding year.

4 http://www.inegi.org.mx/est/lista_cubos/consulta.aspx?p=adm&c=2.

5 http://www.banxico.org.mx/SieInternet/consultarDirectorioInternetAction.do?accion=consultarCuadro&idCuadro=CF111.

Indicator	Unit of measure	Baseline	Baseline year	2016	2017	Final target	Means of verification	Comments
OUTCOME 4. STATE AND MUNICIPIO DEBT LEVEL TRANSPARENCY								
The amount of debt recorded with the National Banking and Securities Commission (CNBV) that is not recorded with the SHCP	% of debt recorded	5.4	2015	3.6	3.0	3.0 (2019)	Report on the obligations and borrowings of the federative entities and municipios published on the official SHCP website[6]	Baseline and targets as of December of the corresponding year

[6] The SHCP currently produces this information but does not disclose it to the public. Beginning in mid-2017, it should be published each quarter at http://obligaciones_entidades.hacienda.gob.mx/.

OUTPUTS

Output	Unit of measure	Baseline	Baseline year	2017	Final target (2019)	Means of verification	Comments
COMPONENT 2. STRENGTHENING THE FISCAL RESPONSIBILITY OF FEDERATIVE ENTITIES AND MUNICIPIOS							
Entry into effect of the LDF in the municipios and their public entities	Law	0	2015	0	1	Publication in the Federal Official Gazette	Baseline and targets as of December of the corresponding year
Registry of productive public investment projects implemented by the federative entities	Registries	Not available (n.a.)	2015	15	20	Websites of the federative entities' registries of productive public investment projects	Baseline and targets as of December of the corresponding year. Indicator is cumulative. Links to these websites will be provided by the SHCP or its financial agent at the time of disbursement.
Analyses of federative entities' and municipios' ability to pay conducted	Reports	n.a.	2015	130	300	Decrees authorizing the maximum amounts of debt to be contracted, verifying that an analysis of the ability to pay has been conducted, published in the states' official gazettes	Baseline and targets as of December of the corresponding year. Indicator is cumulative. The source of information for this indicator is the Single Public Registry (RPU).
Study to identify the necessary characteristics of legal documents for contracting guaranteed state debt conducted	Report	0	2015	1	1	Final report from the consulting firm that conducted the study for contracting guaranteed state debt	Baseline and targets as of December of the corresponding year
Standard agreements for underwriting and adoption of the guaranteed state debt mechanism drafted	Standard agreement	0	2015	2	2	Draft standard agreements for underwriting and adoption of the guaranteed state debt mechanism developed	Baseline and targets as of December of the corresponding year
Balance of guaranteed state debt	Percentage	0	2015	0	<3.5	Quarterly publication of the Report on the Economic Situation, Public Finance, and Public Debt on the SHCP website	Baseline and targets as of December of the corresponding year
Reforms to regulatory frameworks for fiscal management in the federative entities, to make these frameworks consistent with the LDF	Law	0	2015	28	30	Publication in the federative entities' official gazettes	Baseline and targets as of December of the corresponding year. Indicator is cumulative.

Output	Unit of measure	Baseline	Baseline year	2017	Final target (2019)	Means of verification	Comments
Competitive processes for the contracting of debt carried out	Competitive process	n.a.	2015	130	300	Certifications from the federative entities and municipios and their public entities presented when registering debt in the RPU, certifying that the contracting of debt was carried out through a competitive process under best market conditions.	Baseline and targets as of December of the corresponding year. Indicator is cumulative.
Reforms to provisions of the National Banking and Securities Commission to make the documentation of credits to federative entities and municipios consistent with the LDF	Resolution	0	2015	2	2	Publication in the Federal Official Gazette	Baseline and targets as of December of the corresponding year
Reforms to National Accounting Standards Board (CONAC) standards to make accounting criteria consistent with the LDF	Agreement	0	2015	2	2	Publication in the Federal Official Gazette	Baseline and targets as of December of the corresponding year
Platform to prepare medium-term fiscal projections and debt sustainability analyses designed	Software	0	2015	0	1	Report from the independent consulting verifying the effective development of the platform	Baseline and targets as of December of the corresponding year. The platform will be considered designed when a document describing its different modules exists.
COMPONENT 3: STRENGTHENING TRANSPARENCY AND ACCOUNTABILITY IN THE FEDERATIVE ENTITIES AND MUNICIPIOS							
Service delivery projects registered with the RPU	Service delivery projects	0	2015	15	35	RPU	Baseline and targets as of December of the corresponding year. Indicator is cumulative.
Methodology for calculating the fiscal performance indicators included in the alert system for the federative entities and municipios developed	Methodology	0	2015	1	1	Publication in the Federal Official Gazette	Baseline and targets as of December of the corresponding year

Output	Unit of measure	Baseline	Baseline year	2017	Final target (2019)	Means of verification	Comments
Binding evaluations of federative entities and municipios by the alert system	Evaluation	0	2015	1	5	Publication on the Federative Entity and Municipio Financial Discipline page of the SHCP website	Baseline and targets as of December of the corresponding year. These evaluations will be applied to federative entities and municipios that have contracted financing and obligations recorded in the RPU, when the source or guaranty of payment is unrestricted revenues.
RPU system guidelines developed	Guidelines	0	2015	1	1	Publication in the Federal Official Gazette	Baseline and targets as of December of the corresponding year
RPU system operational	Software	0	2015	1	1	Notification from SHCP confirming that the system has been launched	Baseline and targets as of December of the corresponding year. The computer system will be considered operational when federative entities and municipios are able to upload their obligations and borrowings into the system.
Internal reorganization of the Federal Supreme Audit Office approved	Reorganization	0	2015	1	1	Publication in the Federal Official Gazette	Baseline and targets as of December of the corresponding year
Annual Audit Program for Supreme Oversight of the Public Accounts, which includes oversight of compliance with the LDF by the federative entities and municipios and of execution of federal revenue transfers, approved	Audit program	0	2015	0	1	Publication in the Federal Official Gazette.	Baseline and targets as of December of the corresponding year.

Output	Unit of measure	Baseline	Baseline year	2017	Final target (2019)	Means of verification	Comments
COMPONENT 4. INSTITUTIONAL STRENGTHENING OF FEDERATIVE ENTITIES AND MUNICIPIOS WITH REGARD TO FISCAL RESPONSIBILITY, TRANSPARENCY, AND ACCOUNTABILITY							
Agreements between the SHCP and the federative entities, through the Permanent Committee of Fiscal Officials, for the Institute for the Technical Development of Public Financial Administrations (INDETEC) to hold training sessions on local financial discipline	Agreements	0	2015	1	1	Agreements from the Forty-seventh National Meeting of Fiscal Officials	Baseline and targets as of December of the corresponding year
Training courses or events on financial discipline held by INDETEC	Courses or events	0	2015	35	60	INDETEC Reports to the Annual Meetings of Fiscal Officials	Baseline and targets as of December of the corresponding year. Indicator is cumulative.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/19

Mexico. Loan ____/OC-ME to the United Mexican States
Program to Strengthen Fiscal Management
in States and Municipios II

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 United Mexican States, as borrower, for the purpose of granting it a financing to cooperate in the execution of the Program to Strengthen Fiscal Management in States and Municipios II. Such financing will be for the amount of up to US$600,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on ___ ____________ 2019)

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