

MUNICIPAL DEVELOPMENT PROGRAM

(GU-0134)

EXECUTIVE SUMMARY

Borrower: Government of Guatemala

Executing agency: Instituto de Fomento Municipal (INFOM)

			First Phase	Second Phase	Total
			(in millions of U.S. dollars)		
Amount and source:	IDB:	(OC)	US\$ 9.5	US\$33.1	US\$42.6
		(OC/IFF)	US\$10.0	-----	US\$10.0
	Local:		US\$ 5.0	US\$ 8.3	US\$13.3
	Total:		US\$24.5	US\$41.4	US\$65.9

Financial terms and conditions:

Amortization Period:	20 years
Grace Period:	3.5 years
Disbursement Period:	3.5 years
Interest Rate:	Variable
Supervision and Inspection:	1%
Credit Fee:	0.75% p.a. on undisbursed balance
Currency:	US\$

Objectives: The overall goal of the Municipal Development Program is to advance Guatemala's decentralization program and strengthen the framework for promoting municipal development. In particular, the Program will promote a more equitable and efficient system for providing and financing municipal services. It will support reforms in the principal municipal development agency, INFOM, which will enhance its efficiency, procedures, and sustainability.

The Program has been conceptualized as a multi-phase operation, which will be implemented in two phases. Each phase is scheduled to take approximately three years to execute. This document requests approval of the two-phase approach and of a loan for Phase I of the Program. The recommendation for Board approval of Phase II of the Program would be triggered when the Bank verifies that (i) at least 50% of the loan resources for Phase I have been disbursed and (ii) the benchmarks presented in the Technical Annex have been achieved. A memorandum outlining the achievements of targets and performance benchmarks from Phase I, as well as any design modifications, a cost table and a

procurement plan for Phase II would be presented to the Board of Directors to request approval of the second phase of the Program.

Description:

The Program's underlying strategy sees larger and stronger municipalities working more in the future with the private sector to supply local services and finance infrastructure projects. For them, INFOM will play an increasingly indirect role, providing the information, services and cofinancing arrangements that encourage competition. Smaller, weaker municipalities (which will continue to be the majority) will continue to rely on INFOM as a major source of direct support. However, the Program will develop the incentives and technical assistance to help these municipalities "graduate" towards greater independence.

The Program has four components (a) Reforming INFOM and the municipal sector strategy, (b) Strengthening municipal capacity, (c) Promoting a competitive supply of private sector financing and services, and (d) Municipal infrastructure investments.

The present loan covers only the first phase of this two-phase Program with an estimated cost of \$27.7 million.

Reforming INFOM and The Municipal Sector Strategy (US\$3.7 million)

This component of the operation will support the implementation of reforms in three key areas: (i) a reorganization of INFOM; (ii) creating the program management capacity to carry out the Program; (iii) development of a Medium Term Municipal Strategy.

The Program will implement reforms to improve the efficiency, sustainability and procedures of INFOM and create conditions for a future shift in its role in the municipal sector. Reforms are in the areas of activity accounting, project costing, program monitoring and long-term planning.

In addition, studies will be carried out that the government of Guatemala will need to make decisions about the development of the municipal sector, in particular, institutional arrangements for municipal finance and coordination of development funding at the local level.

Strengthening Municipal Capacity (US\$3.5 million)

This component will finance two sets of activities. It will finance technical assistance to municipalities borrowing under the investment component, or simply requesting technical assistance, to implement institutional arrangements for local service provision and other management reforms. Resources are provided to carry out initial diagnoses and to provide technical assistance to implement the changes.

The component will also support INFOM's activities as manager of the National Municipal Training Plan. In this position, accorded to INFOM in the Peace Process, INFOM—through a network of training providers called RENICAM—organizes basic training for municipalities throughout the country by Department, in areas such as municipal law, service provision and tax collection, and in the modernization of accounting and budgeting.

Promoting Competitive Supply of Private Financing and Services (US\$0.6 million)

This component will support design and implementation of instruments that will promote a larger and more competitive supply of services and financing from the private sector.

Under this component, activities will be undertaken to (i) improve information available about the municipal sector, including the development of a system to evaluate municipal creditworthiness, (ii) facilitate the expansion of private lending by piloting new cofinancing arrangements with private lenders, and (iii) clarify the legal framework, develop policies for municipal finance, and propose reforms.

Municipal Infrastructure Investments (US\$16 million)

The investment component will allow municipalities to continue to invest in projects with adequate social return and provide an incentive to all the actors to institute policy and institutional reforms, including the implementation of (i) new institutional arrangements for service provision, (ii) new INFOM lending policies and (iii) new policies governing the uses and allocation of subsidies, including the overriding policy that all subsidies will be explicit and provided to municipalities only as a capital subsidy to projects.

Municipalities will be evaluated to determine both their financial and institutional readiness to borrow under the terms of the Program. With technical assistance, a series of institutional arrangements and management improvements will be made to ensure the sustainability and quality of the services. Once ready, municipalities will borrow under the terms of new financial policies mentioned above.

**Relationship of
Project in Bank's
country and
sector strategy:**

The project conforms to the Bank's local development strategy for the country, which seeks to support the decentralization process, promote local development and increase the coverage, quality and efficiency in the delivery of basic services. The project advances the Bank's sector strategy, by attempting to reform the practices of a Bank-supported municipal development fund to allow it to serve as a transitional mechanism in the development of a disciplined municipal finance system.

**Environmental/
social review:**

The proposed project will ensure the implementation of environmental procedures for municipal projects more consistent with current national policy, and design the institutional arrangements to support these changes. A consultancy will be arranged to evaluate the environmental impact of a sample of previously executed projects and help INFOM, municipal representatives and CONAMA implement new environmental review procedures. INFOM's institutional capacity will be strengthened through the creation of the Environmental Office and technical assistance will be provided to support the municipal effort to carry out the agreed procedures.

Participatory processes in project planning, approval and implementation will be strengthened through the use of several measures under the Program, including new procedures for selecting and managing municipal projects and allocating subsidies. RENICAM members with expertise in participatory techniques will provide training for municipal officials and community leaders, including women and indigenous people.

Benefits:

The Program will produce interrelated benefits in three areas: within the municipalities at the local level, for the municipal sector as a whole and within INFOM.

At the local level, citizens will have expanded opportunities to participate in the identification of projects and the setting of tariff and service levels, and the projects financed will be more sustainable. New institutional arrangements will allow decisions regarding service improvements to be more technical and less political. The finances of a large group of municipalities will be improved, including those borrowing from INFOM. Poorer municipalities will benefit from the new approach to subsidy allocation. Municipalities and their citizens will also have benchmarks to evaluate progress, using credit evaluations and a system of performance monitoring indicators.

The Program will produce improvements in the quality and quantity of information about the municipal sector available to private lenders and others, and will design and pilot new models of municipal financing and public/private participation. These measures will promote a more diversified, competitive supply of financing and services for municipalities.

INFOM's capacity to support the municipalities in their execution of infrastructure projects will be enhanced. Its ability to manage its operation will be improved, as will its own sustainability. As the government evaluates its options for expanding municipal finance and other forms of support to municipalities, these reforms will create a platform for a future significant role for INFOM in the Guatemalan municipal sector.

Risks:

The success of the operation depends critically on INFOM's continued commitment to a transition towards a new role in the municipal system. It also requires the simultaneous implementation of a range of new procedures and policies. To mitigate this latter risk, the Program provides extensive management support.

The transformation of municipalities into financially autonomous and creditworthy institutions is complicated by their weak financial condition and the flows of nonreimbursable funding invested in the municipalities by the Social Investment Funds. While the current government has expressed its support for a process to better rationalize the current funding framework, INFOM has little or no formal authority over the other agencies involved.

The Program seeks to encourage a wider role for private capital and private enterprises in the municipal system. However, the Guatemalan financial sector is weak and volatile, and its credit evaluation practices are poor. The sector has little access to long-term investment resources. The lack of standardized arrangements for urban service provision makes it expensive to work in the sector, especially with smaller municipalities. How the private sector will respond to the measures taken in the Program will depend on factors, such as the macroeconomy and the condition of the financial sector, over which neither INFOM nor this Program have any control.

Special contractual clauses:Conditions prior to first disbursement

Prior to first disbursement of the financing, INFOM will present to the satisfaction of the Bank:

- Evidence that it has signed a subsidiary agreement with the Ministry of Public Finance, in accordance with a text previously agreed upon with the Bank, which contains, among other things, a definition of how the Program funds will be transferred to INFOM and the commitment of INFOM to execute the Program as agreed by the Government of Guatemala and the Bank (Par. 3.1).
- Evidence that INFOM has contracted the Program Coordinator and the Financial Advisor in accordance with terms of reference previously agreed upon with the Bank (Pars. 3.2; 3.15)
- Evidence that it has contracted, in accordance with terms of reference previously agreed upon with the Bank, the consultants to design and implement the accounting system reforms (Par. 3.7).

- Evidence that it has contracted, in accordance with terms of reference previously agreed upon with the Bank, the consultants to design the performance monitoring system for all components (Par. 3.9).
- Evidence that the institutional reorganization necessary for the implementation of the Program, including creation of the Technical Studies Unit and establishment of the Management Coordination Group, has been approved by the INFOM Board of Directors and is operational (Par. 3.24).
- Evidence of the establishment of the Interinstitutional Working Group for analyzing national policy options in the area municipal financing and interinstitutional coordination and approval of its work plan for Phase I. (Par. 3.8).
- The final version of the Operating Regulations of the Program (Par.3.34).
- The model contract to be signed by INFOM and the municipalities for the execution of Component 4 of the Program, prepared in accordance with text previously agreed to by the Bank (paragraph 3.20).

Other conditions

Conditions appropriate for this type of operation, as well as those pertaining to audits, reports, and monitoring and the establishment of a 10% revolving fund will also be agreed upon.

**Poverty-targeting
and social sector
classification:**

This operation does not qualify as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (Document AB-1704).

**Exceptions to
Bank policy:**

See paragraph on procurement.

Procurement:

It is proposed that municipalities be permitted to execute works costing up to US\$125,000 by direct contracting, provided that the total amount does not exceed 10% of the financing for Component 4 of the program (paragraph 3.49).

International competitive bidding will be required for consulting services in excess of US\$200,000, goods and related services in excess of US\$250,000 and construction works in excess of US\$1,500,000. National competitive bidding will be required for works between US\$250,000 to US\$1,500,000, goods and services between US\$150,000 and US\$250,000 and consulting services between \$150,000 and \$200,000. Local competitive bidding (shopping) will be applied to works under US\$250,000, goods and services under \$150,000 and consulting services under US\$150,000.

I. BACKGROUND

A. Socioeconomic context

- 1.1 Although it has one of the largest economies in Central America, Guatemala is one of the poorest countries in Latin America. The structural economic reform that was started in 1991 has kept inflation under control, reduced the public sector deficit, maintained high levels of growth, and generally accomplished the goals established in the IMF Economic Program. In 1997, Guatemala's GDP was U.S. \$17.8 billion. The average annual growth rate between 1990 and 1997 was 3.9%. However, even with these reforms and recent economic growth, Guatemala has not been able to reduce its poor social indicators.
- 1.2 Eighty per cent of Guatemala's 10.5 million people survive in poor living conditions and 60% in extremely poor conditions. Guatemala has one of the lowest social expenditures among LAC countries, having spent 1.7% and 0.9% of GDP in education and health respectively in 1997 (the average for LAC is 3.9 and 2.9). With a GINI coefficient of 59.6, the country's income distribution is one of the most skewed in the world.
- 1.3 Like most Central American countries, Guatemala has high levels of urban population growth. Between 1990 and 1997, the average annual growth rate for the total population was 2.7% and for the urban population 3.8%. Only 60% of the urban population has access to safe water and 66% access to sanitation.
- 1.4 Within Guatemala, socioeconomic conditions vary considerably across its 22 departments. The under-5 mortality rate varies from 49.6 per 1,000 in the Department of Guatemala to 128.9 per 1,000 in Totonicapán (against an average for the least developed countries of 113 per 1,000). Urbanization rates vary from 20 to 70% and access to piped water from 40% to 90% of households. As a result, the capacity of municipalities to lead the local development process varies considerably as well

B. The Municipal Sector in Guatemala

1. Structure and distribution of the municipal sector

- 1.5 Guatemala, with a population of 10.5 million (in 1997), is composed of 330 municipalities. Most of the population (55%) is concentrated in the top 65 municipalities. Population is dispersed; nearly half of the municipalities have more than 20 outlying aldeas or caseríos, and 85 have over 50. Guatemala City, the largest urban area with 1.7 million inhabitants, is made up of three municipalities. Forty-one municipalities have populations between 200,000 and 50,000; however, outside Guatemala City, the average population per municipality is just over 30,000.

Classification of Municipalities by Population, 1997

Population	Number of Municipalities	Percent of Total	Total Population (thousands)	Percent of Total
1,000 to 10,000	68	20.6%	453.2	4.3%
10,000 to 20,000	96	29.1%	1,413.4	13.4%
20,000 to 50,000	122	37.0%	3,813.2	36.3%
50,000 to 100,000	35	10.6%	2,407.3	22.9%
100,000 to 1,000,000	9	2.7%	2,430.2	23.1%
TOTAL	330	100.0%	10,517.3	100.0%

Source: Daniel Argueta, *Segmentación del Mercado Financiero Municipal*, 1999

2. Municipal Services

- 1.6 Public services are the responsibility of the municipalities in Guatemala to a greater extent than in any other country in Central America. Water and sanitation services are provided exclusively by the municipalities. Nearly all attempt also to provide solid waste management, markets, local roads and street paving, drainage, slaughterhouses, public lighting, cemeteries and parks. Larger municipalities provide electricity, public transport, and recreation and cultural facilities.
- 1.7 The potable water and sewerage sector shares problems with the other countries of the region: inadequate coverage and poor service, and dilapidated infrastructure. These conditions stem from inappropriate institutional arrangements that allow political interference in the management of the services. Tariffs are maintained at levels that are too low, often not even covering routine operating and maintenance costs. The sector is highly dependent on subsidies. Private participation in the provision of local services is quite limited. Municipalities have little experience in how to attract private service operators, and few local officials have a sense of the benefits that such arrangements can produce.
- 1.8 Solid waste collection is often contracted by the municipalities to small local private enterprises, but coverage is often inadequate except in the higher-income urban areas. Final disposal is also inadequate, often to informal or illegal dumps. Even where there is an municipal landfill, there is rarely a sanitary seal. The municipalities themselves assume direct responsibility for the disposal of solid waste from markets and similar institutions, which they manage directly. There is some movement towards the management of markets by cooperatives of stallholders.

- 1.9 A modernized legal, regulatory, and institutional framework for the provision of local services is an urgent priority, and in the water sector the Bank is currently working with the Government of Guatemala to help develop such a structure (See section on the Municipal Development Institute, INFOM, below). However, it is clear that the consensus necessary to effect nationwide reforms in this direction will take some time to develop. In the meantime, there is much valuable progress that can be achieved at the local level. Building on efforts by the Bank and INFOM to improve the management of infrastructure projects and to bring tariffs up to sustainable levels, further steps are possible to separate the service provider from the general management of the municipalities' political authority. A participatory process that involves communities in reform proposals will provide a platform for local implementation of both institutional changes and tariff adjustments. Such projects could play a valuable demonstration role as discussion of the national reforms gets underway.

3. Municipal management and finance

- 1.10 Guatemalan municipalities are financially weak. While they receive financial transfers, municipalities have very limited operating budgets, so maintenance and operation is underfunded. Only half of the municipalities consider cost recovery in setting user charges and poor collection and poor administration make municipal taxation the lowest in the region.

a. Municipal transfers and redistributions

- 1.11 By Constitutional law, 10% of the national budget is transferred to municipalities. In addition, under the Peace Accords, municipalities receive a share of value-added tax. Together these amounted to some Q1,055 million (US\$157 million) in 1998, approximately US\$15 per capita. These resources are distributed according to the following formula: 25% on a proportional basis according to the population of each municipality; 25% divided equally among all the municipalities; 25% on a proportional basis according to municipal income per capita; 15% in direct proportion to the number of villages and settlements; and 10% in direct inverse proportion to municipal income per capita. As a result, a small poor municipality might have more than 80% of its budget financed by these transfers, while in Guatemala City the corresponding share is 12%. More than 80% of these transfers are earmarked for capital expenditures with the result that operating budgets are underfunded. Municipalities receive income from taxes (such as on gasoline, vehicles and alcohol) collected by the central government and then redistributed. In 1998, these amounted to some Q112 million (US\$17 million).

Central Transfers to Selected Municipalities and Percent of Total Budget, 1997

Central Transfers to Selected Municipalities and Percent of Total Budget, 1997							
Municipality	Total Budget in US\$	Transfers				10% and IVAPAZ/ Total Budget	Total Transfers*/ Total Budget
		10% Constitutional		IVAPAZ			
		Amount	%	Amount	%		
Jocotenango	555,670	259,092	47%	194,755	35%	82%	92%
San Antonio Suchitepequez	1,009,265	225,182	22%	169,265	17%	39%	47%
Villa Canales	1,541,432	367,485	24%	276,232	18%	42%	50%
Escuintla	4,649,782	504,088	11%	378,914	8%	19%	51%
Antigua	5,425,433	483,648	9%	365,088	7%	16%	20%
Mixco	34,703,238	1,173,158	3%	886,051	3%	6%	31%
Guatemala City	42,461,538	3,230,760	8%	1,692,308	4%	12%	NA

* Other transfers include central government taxes, such as tax on petroleum, circulation of vehicles, alcohol, coffee, durable goods, coffee export, and in the cases of Mixco and Escuintla, transfers from *Consejos de Desarrollo*.

b. Own tax sources

- 1.12 **Property taxes.** The property tax in Guatemala is a national tax historically administered by the national government and passed through to municipalities. In 1994 a ministerial decree (*The Acuerdo Ministerial de Traslado del IUSI*) allowed municipalities—once certified capable by INFOM—to take over administration of the property tax. To date, 65 municipalities administer their own property taxes, including Guatemala City. To assume management of the tax, municipalities must set up cadasters, management systems and collection arrangements. A number of international programs have been mounted to assist in these complex tasks and although the data is anecdotal, results seem positive. A monitoring system would allow a much-needed systematic evaluation.¹
- 1.13 Technical assistance is needed to help municipalities better utilize available mechanisms for raising revenues. The municipal code gives municipalities the right to charge tariffs for service provision and for the recovery of costs of a range of improvements (*contribuciones por mejoras*). Tariffs are charged, but often at inadequate levels to sustain the service for which they pay. Municipalities greatly underutilize improvement taxes, and successful experiences in employing them, such as that of Guatemala City, are not well known within the sector

¹ A UNDP and World Bank joint effort in 1996-97 was reportedly one of the most successful; others have been carried out by the GTZ, USAID and INFOM under the prior Bank project.

c. Monitoring of municipal finances

- 1.14 Municipalities report their budgets to INFOM for information purposes, and are audited by the national *Contraloría General de Cuentas*. The role of supervising and applying the rules to municipal finances is performed by the *Contraloría* alone and audits are not conducted systematically. Municipalities are not yet part of the national SIAF, and the current municipal budget presentation is standardized, which is potentially helpful in presenting and analyzing municipal sector financial data. Guatemalan municipalities, unlike some others in the region, rarely publish their annual operating results.

C. The Municipal Development Institute (INFOM)

- 1.15 In 1957, the Government of Guatemala created the *Instituto de Fomento Municipal* (INFOM) to support the social and economic development of municipalities, especially urbanized municipalities, through loans and technical assistance. Created as an autonomous state institution, INFOM's role in the past was largely that of a delivery mechanism for government and donor funds.
- 1.16 However, the administration that came to INFOM in 1996 began a transition to an institution that coordinates support to the municipal sector and promotes best practices. It also began streamlining and decentralizing the organization, simplifying procedures and emphasizing responsiveness to clients. Staff was cut significantly and functions previously carried out solely by INFOM began to be delegated to others. The restructuring process is still ongoing as INFOM looks for ways to improve and expand municipal lending and training while ensuring the institution's financial sustainability.

a. Financial arrangements

- 1.17 INFOM is the predominant municipal project lender in the country, providing variable-rate loans for municipal infrastructure with terms up to 25 years, and short-term working capital loans for up to one year. INFOM also makes capital subsidies to municipalities to supplement the loan funds.
- 1.18 The long-term loans and subsidies have been funded over the past 6 years by a Bank loan, the short-term loans from lines of credit from commercial banks, supplemented by INFOM's own resources. The demand for short-term borrowing is strong; as of year-end 1998, loans under two years represented 70% of INFOM's portfolio (See also section on Municipal Credit, below).
- 1.19 The program's operating costs are covered by portions of the Bank loan, and from government counterparts. INFOM earns income on the investment of its own resources and certain tax revenues transferred to the municipalities by the central government. municipal resources that it holds temporarily. Other multi- and bi-lateral institutions support certain INFOM activities.

b. Technical assistance

- 1.20 Municipal strengthening is a core role of INFOM and up until 1997 when the *Plan Nacional de Formación, Capacitación y Asistencia Técnica Municipal* was created, it provided most technical assistance directly. The National Training Plan was

designed to provide technical assistance to mayors, municipal officials and community leaders as part of the decentralization process. Training is focused in areas such as administration, participatory planning, investment planning, financial management, service delivery and project development.

- 1.21 Along with the aforementioned plan, a network of (largely) non-profit local technical assistance providers was formed (*Red Nacional de Instituciones de Capacitación Municipal* or RENICAM), and INFOM was given coordinating responsibilities. Although there has been considerable assistance provided, it is not clear how effective it has been, and a monitoring and evaluation system is urgently needed.
- 1.22 INFOM also provides various services to the municipal sector collectively and to the central government. These include collection of municipal financial information and calculation of the intergovernmental transfer amounts, review of *planes de arbitrios* (municipal tax and fee schedules) and certification of municipalities' readiness to take over management of the IUSI.

c. Potable Water and Sewerage Sector

- 1.23 INFOM has recently assumed a more prominent role in the potable water and sewerage sector. In 1997, it took over the cumbersome bureaucracy that managed rural water projects (UNEPAR and PAYSA), which has been supported over the years by the Bank, USAID and others. The income and expenses from these activities dwarfed INFOM's regular activities when first absorbed, but have been drastically reduced as staffing cuts have taken effect.
- 1.24 In 1998, INFOM was appointed the lead agency (*ente rector*) for the water sector. It is not yet clear what its long-term role will be, but it is leading the incipient process of sector reform in Guatemala. The Bank has begun to discuss with the authorities how best to approach a comprehensive modernization strategy. INFOM has already contracted a consultant to help with the definition of the organization's role and a major workshop is now planned to identify the fundamental problems of the water sector and to define a strategy for tackling them.

d. Business approach

- 1.25 There are both strengths and weaknesses in INFOM's way of doing business. The strengths include the quality of the INFOM portfolio, and the excellent payment performance of INFOM loans, which results from an agreement it has signed with the Ministry of Finance and BANRURAL permitting it to discount payments on short-term loans secured with 10% constitutional annuity and VAT funds under the peace accords.
- 1.26 INFOM has worked to improve its own financial sustainability and has tentatively agreed with the government on a capitalization plan. It has changed a number of policies and procedures such as replacing interest rate subsidies to projects with capital subsidies and charging real, positive interest rates. Staff numbers have been significantly reduced in recent years. It is also improving its information systems, to allow better financial management and full costing of projects. These measures

are emerging from a new internal vision of the organization as a facilitator, rather than dominate deliverer of municipal development.

- 1.27 However, INFOM retains many business practices that limit both municipal development and its own sustainability. INFOM does not have up-to-date methods for choosing projects to finance. Nor does it require the financial qualification of municipalities or projects, nor modern public service arrangements at the municipal level. Financial shortcomings are overcome through the allocation of both direct and indirect subsidies. But this process does not reflect development or financial criteria and produces poor incentives; analysis of the existing portfolio shows that direct subsidies are often given to the financially weakest municipalities who contribute the least to their own projects. Projections of project revenues and costs made when planning investments are not monitored subsequently, so INFOM does not take advantage of its own experience to improve municipal performance. Project environmental procedures are consistent with Bank policy, but are out of step with national policy. INFOM performs various functions that should be managed in distinct ways, but the internal accounting and information systems are inadequate to this task. And in nearly all its activities INFOM maintains no systems for measuring the results from its work, so has no basis for designing new programs nor allocating resources.
- 1.28 The proposed program attempts to address many of these shortcomings in the short run, and to address more fundamental questions about the long-term needs of the municipal sector.

D. Social Investment Funds and Local Development

- 1.29 Social investment funds play a very prominent role in the central government's effort to promote local development. Their prevalence reflects the government's parallel strategy of deconcentration of central government funding to the local level. In the past three years, funding for the largest social funds has grown significantly faster than direct support to the municipal sector, and may soon exceed it, according to World Bank data taken from the SIAF (Integrated Financial Management System). The following illustrates the government and donor support provided to social funds in recent years:

**Execution of Local Development Funding: Social Funds and Municipalities,
1996-99¹**

	1996	1997	1998	1999
FSDC	154,404,118	401,830,782	470,100,123	660,809,723
FIS		40,000,000	74,163,047	152,764,537
FONAPAZ	145,000,000	152,000,000	122,239,443	133,000,000
FOGUAVI		67,082,926	111,653,262	70,482,329
Fondo de Tierras	2,708,123	37,507,345	20,584,000	78,000,000
FONAGRO		2,815,000	17,199,667	38,629,384
FODIGUA	17,519,546	19,760,756	22,000,000	29,766,527
PRONADE		41,000,000	84,499,999	122,000,000
TOTAL²	319,631,787	761,998,806	922,441,539	1,285,454,499
Municipal Transfers	NA	NA	1,055,300,000	1,313,200,000

¹ Source: Unpublished World Bank report, 1999.

² 1996 and 1997 actual, 1998 estimated, 1999 budget.

- 1.30 As a group, the social funds demonstrate a lack of coordination and policy inconsistency. No uniform policy framework governs the allocation of funds to or through the social funds. Each is an instrumentality controlled by its parent office or ministry. The funds do not share common operating procedures, legal structures or reporting relationships. FIS and FONAPAZ work directly with communities, often bypassing municipalities. FSCD supports and coordinates most closely with regional development councils and reports to the Office of the President, who oversees the regions.

1. Effect on Local Development

- 1.31 The system whereby an increasing share of national resources for local development are being channeled into central government-controlled delivery channels is partly a response to the weak execution capacity of municipalities. The government's motivations are to ensure the delivery of investment and retain some influence over investment priorities, but the system creates perverse incentives for local governments, reducing their sphere of influence and serving as a type of bailout mechanism for the weak ones. As a result, a vicious cycle is established where municipal financial autonomy and fiscal responsibility are affected, and the government is obliged to maintain a paternalistic relationship with municipalities.
- 1.32 The system also creates disincentives for the development of a municipal credit system, crowding out lenders by providing grant funding to financeable projects

and failing to establish the framework and rules for the use of credit by municipalities.

- 1.33 Recognizing the drawbacks of the current arrangements, the Government of Guatemala has recently set up an Inter-institutional Commission to coordinate local investment. Supported by INFOM, the Commission drafted a work plan earlier this year. While this is a promising initiative, a strong framework for achieving a measure of consistency between the various efforts and agencies involved in local development has still to be articulated.

E. The Guatemalan Financial Sector

1. General evolution

- 1.34 At the end of 1998, the Guatemalan banking system consisted of 33 private sector banks, two state banks, 21 private sector finance companies and one state-owned finance company. It is largely a domestic banking system with only two foreign-owned banks. Total assets in the system were US\$6.0 billion at the end of 1998.
- 1.35 The Guatemalan capital market handles only debt instruments; no equities are traded. It is a primary market only, because the short-term nature of the paper obviates the need to sell before maturity. Banks have few sources of medium or long-term funding.
- 1.36 Most of the broker-dealers and many of the issuers are related to commercial banking institutions. The market is unregulated and recently problems have begun to appear, as some issuers have been unable to service their debts.
- 1.37 Real and nominal interest rates in the financial system in Guatemala are high and volatile. With annual inflation at 7.5% in 1998, the average bank lending rates was around 18%. Deposit rates during the same year averaged 6.2%, suggesting relatively high intermediation spreads for banks. While some of that spread is due to reserve requirements and to a lack of efficiency on the part of the banks, another factor may be a growing appreciation for the true risks of lending.
- 1.38 Until the second half of 1998, the financial system was growing rapidly with assets increasing by 24% during the 24 months ending in December 1998. In 1999 growth came to a halt, as illiquidity in the markets, increases in past-due loans and a need to correct under-provisioning, caused banks to cut back their lending.

2. IDB Activity in the Financial Sector

- 1.39 In response to these problems, the Bank is preparing a financial sector reform program for Guatemala. Associated with the Program are two loans. This first loan, in the amount of US\$100 million, has components for improving the operations of the Central Bank, for strengthening bank supervision and regulation, and for strengthening the supervision and regulation of the capital markets. The second loan, for US\$200 million, supports activities to improve the solvency of the banking system and is available under the Bank's Emergency Lending Program. The Profile II for this Program has been approved. The final design of the program and action plans for the components are being discussed with the authorities.

3. The Market for Municipal Credit

- 1.40 The two sources of credit for municipalities in Guatemala are INFOM and the commercial banks. The banking sector uses several means to provide municipal credit, and during certain periods has been a major provider of credit to the sector; a Bank study in 1998 roughly estimated bank municipal loan portfolios to total at least \$26 million. Besides making short and medium-term loans from their own resources, since 1995 several banks have participated in the USAID-sponsored PROMUNI program with the Central American Bank for Economic Integration (CABEI). CABEI acts as a second-tier bank to provide medium-term local currency lines of credit to banks for municipal project loans.
- 1.41 An additional option for banks is to work with INFOM. Since 1997, INFOM has arranged lines of credit with commercial banks, which it has used to make short-term loans (6 to 12 months) to municipalities. As of mid-1999, these lines totaled about US\$19 million. Recently, these loans have been priced at around 16.5%. INFOM also provides a credit administration service to banks, whereby it provides information on municipal indebtedness as well as its ability to discount payments on short term loans secured with 10% constitutional annuity and VAT funds under the peace accords. INFOM charges 1% upfront on total loan payments (principal and interest) for this service. At least US\$10 million of these arrangements are currently in place, for loans up to five years.
- 1.42 Municipalities borrow commercially in a largely unregulated manner. They are not required to disclose their borrowing at the time, only to include the debt service in the following year's budget submission, and no regulatory body exists to request the information or set guidelines or limits on borrowing. Municipalities may use their intergovernmental transfers as security for borrowing, but by law, assets of municipalities cannot be seized for the repayment of debts. When borrowing from commercial sources, a municipality may give a bank guaranteed access to the transfer through the credit administration arrangement with INFOM mentioned above, or it may organize a *fideicomiso* or trust directly with the bank, a cumbersome arrangement that is rarely used.
- 1.43 The legal framework for municipal borrowing in Guatemala is poorly defined, due to the inadequacy of the framework and to the lack of precedent in many areas. The options available to municipalities for offering security to creditors are poorly understood; municipal assets, for example, cannot be attached.
- 1.44 In addition to the lack of financial disclosure by municipalities, commercial bank lending risk is increased by the lack of credit evaluation tools for municipal sector projects. Some banks have developed innovative mechanisms to help manage project risk, such as loan payments based on user fees deposited in a special account with the lending bank. Nevertheless, the need for both more rigorous project financial analysis and better disclosure of municipal financial information remain as major gaps in the process of consolidating municipal credit demand.
- 1.45 Lending by banks to the municipal sector, along with other bank lending, has been reduced in 1999 with the drop in financial sector liquidity. In the immediate future, these cutbacks leave municipalities with limited alternatives to financing

from INFOM. Nevertheless, it is clear that there are a number of measures to strengthen the infrastructure for commercial lending to municipalities that could be studied and tested in the short run. Once conditions in the financial sector improve, these measures would be fully deployed so that a commercial market can play an increasing role in meeting the needs of infrastructure investment in Guatemala.

F. Local Development Strategy and the IDB

1. Experience with INFOM

- 1.46 The Bank has contributed greatly to INFOM through six operations totaling approximately US\$89.8 million, four for water and two for municipal development. The latest, Phase II of the Municipal Development Program (PDM II) is still under execution, with nearly all of the program funds committed (including effectively 100% of the funds for onlending for municipal projects) and 60% disbursed as of August 1999. This US\$45 million operation was designed as a multiple works program, focussing principally on providing financing for infrastructure projects and to a lesser extent on institutional reforms.
- 1.47 There were substantial delays at the beginning of the project, due to repeated changes in personnel and difficulty in complying with Bank conditions. Though the program was approved on March 25, 1992, the first disbursement did not take place until May 1994. As a result, the final disbursement date has been delayed three years to February 2001. Once underway, the pace of program execution accelerated rapidly. Approximately \$38 million (84%) of the funds were allocated to municipal projects and when complete, INFOM will have financed approximately 50 works, including markets, aqueducts, drainage and paving.
- 1.48 Direct subsidies have been provided without technical basis to nearly all PDM II projects, averaging nearly 35% of IMFOM'S total investment in projects. Additional indirect subsidies have been made as well, but not recorded as project costs. Repayment performance is excellent, given the institution's ability to discount municipal transfers should payments not be received from certain municipalities, although in only a very few instances has this power been invoked for PDM II projects. Since INFOM does not monitor data on the social or financial impact of projects, nor the financial performance of revenue-producing projects, no such data on the projects is available.
- 1.49 PDM II also supported institutional strengthening for INFOM and municipal capacity building activities for some 40 municipalities. As with other project components, limited efforts were made to monitor the results of the institutional strengthening component. Reporting has consisted largely of demonstrating that various studies were carried out.

2. Other IDB Programs

- 1.50 In the past four years, the Bank has supported both the decentralization and deconcentration activities of the government, with predominant lending for the latter. The Bank has loaned US\$333 million to five projects related to local development. These loans went to the FIS, including for PRORIENTE, to

FOGUAVI (the Guatemalan Housing Fund, through the Ministry of Communications, Infrastructure, and Housing), to the DECOPAZ program (Community Development for Peace) through FONAPAZ, and to SEGEPLAN (General Planning Secretary) for implementation of the Peace Process.

G. The Government's Strategy for the Municipal Sector

- 1.51 The Government's support to the municipal sector is reflected in the guaranteed transfer payment to municipalities and its Action Plan to the year 2000 which prioritizes municipal autonomy and strengthening as well as the improvement, expansion and decentralization of social services delivery. INFOM itself has enjoyed significant political support in recent years, as evidenced by its salient role in the water sector and in the municipal training network.
- 1.52 In support of this approach, the Bank's strategy for the country seeks to support the decentralization process, promote local development and increase the coverage, quality and efficiency in the delivery of basic services.

II. THE PROGRAM

A. Program Objectives and Results

- 2.1 The overall goal of the Program is to advance Guatemala's decentralization program and strengthen the framework for promoting municipal development. In particular, the Program will promote more equitable and efficient arrangements for providing and financing municipal services and provide support for reform of INFOM, the country's primary institution for municipal development, with a view to improving its procedures, efficiency and sustainability. Phase I, covered by the present operation, will seek to develop and test a broad set of reforms in the municipal sector and in INFOM, as the its leading agency. In Phase II, these policies and instruments will be fully deployed.

B. Program Overview

- 2.2 The Program conceived as a multi-phase operation with a total estimated cost of US\$65.9 million (Bank financing US\$52.6 million). Each phase will be supported by a separate Bank loan (US\$19.5 million and US\$33.1 million, respectively), and each phase is scheduled to take approximately 3 years to execute. The recommendation for Board approval of phase II of the Program would be triggered when (i) at least 50% of the loan resources for Phase I have been disbursed; (ii) at least 75% of the loan resources for Phase I have been disbursed; and (iii) Bank Management verifies that the benchmarks presented in the Technical Annex have been achieved. The present operation will cover only phase I of the Program with an estimated cost of \$24.5 million.
- 2.3 During Phase I, the present operation will support the implementation of reforms in three key areas of municipal development:
- **Reform of INFOM.** The Program will implement reforms in INFOM to improve its efficiency, sustainability and procedures; it will create conditions for a future shift in INFOM's role in the municipal sector.
 - **Municipal demand.** The Program will finance technical assistance to municipalities to strengthen their demand for services and financing and to improve their administrative and financial capacity.
 - **Supply of private sector services and financing.** The Program will support design and implementation of instruments that will promote a larger and more competitive supply of services and financing from the private sector.
- 2.4 While the specific instruments and reforms to be deployed in the second stage of the Program will be designed during the first phase to meet the needs of the specific market conditions in Guatemala, the underlying strategy and principles are clear. The larger and stronger municipalities should increasingly be able to turn to the private sector for support in supplying local services, delivering technical support and financing infrastructure projects. For these municipalities, INFOM's role should be increasingly indirect, providing information, services and cofinancing arrangements that encourage a competitive environment for private sector participation. In contrast, for the smaller weaker municipalities (and these will continue to be the vast majority), INFOM will remain a major source of direct support. However, the Program will develop the incentives and provide the

technical assistance that will help municipalities "graduate" towards greater independence. Meanwhile, INFOM itself will need to develop more rigorous financial policies to ensure that its future role is sustainable.

- 2.5 The Program will thus take advantage of the uncertainties and weaknesses in the current environment to develop the reforms and instruments needed for a stronger municipal sector. Under the present Program, INFOM will develop the financial instruments, and promote the regulatory regime and information disclosure policies, that will lower transaction costs and improve incentives for the private sector. As the condition of the financial sector stabilizes, as political uncertainties are resolved, and as INFOM itself becomes more efficient, the Program will be able to effect more far-reaching reforms and innovations in the municipal sector.
- 2.6 Training activities will be deployed to strengthen the municipalities in their new role as facilitators and supervisors rather than the direct providers of the services. Throughout the Program, resources for infrastructure investments will play a dual role. On the one hand, they will continue to be used to finance viable projects with satisfactory rates of social return. More importantly, they will function as an incentive to adopt policy and institutional reforms that would otherwise face substantial barriers. The reforms proposed for INFOM itself and for the municipalities it serves have been agreed with the Guatemalan authorities. As regards the role of the private sector however, while the Program and INFOM can develop instruments that facilitate a wider role for private sector banks and firms, the actual extent to which they will take on a greater share of the market, depends on factors beyond the control of INFOM or the Program.

C. Program Components

- 2.7 The Program has four components: (i) INFOM and the Municipal Sector Strategy, (ii) Strengthening Municipal Capacity, (iii) Promoting Competitive Supply of Private Financing and Services, and (iv) Infrastructure Investments. The amounts for Phase I of each component are shown in the text. The amounts for Phase I, described in this chapter, as well as for Phase II, are shown in the following table:

Component 1. INFOM and the Municipal Sector Strategy	Component 2. Strengthening Municipal Capacity	Component 3. Promoting Competitive Supply of Private Financing and Services	Component 4. Infrastructure Investments
(i) Reorganization of INFOM (ii) Program Management (iii) Medium Term Municipal Strategy	(i) Direct Assistance to Municipalities (ii) Management of National Training Plan	(i) Improve Municipal Information (ii) Facilitate Private Lending (iii) Clarify National Framework for Municipal Finance	(i) Institute New Institutional Arrangements (ii) Implement New Lending Policies (iii) Redefine Subsidies and Change Allocation Method
Phase I: 3,772	Phase I: 3,515	Phase I: 593	Phase I: 16,000
Phase II: 3,490	Phase II: 5,125	Phase II: 1,450	Phase II: 30,900
Total: 7,262	Total: 8,640	Total: 2,043	Total: 46,900

- 2.8 A work plan for developing all the needed elements has been agreed with INFOM and progress will be monitored by a detailed set of indicators.

1. Component 1. INFOM and the Municipal Sector Strategy. (US\$3.8 million)

- 2.9 The goal of this component is to implement some basic reforms in INFOM to help put its affairs on a more technically sound and sustainable basis. In addition, the component aims to carry out the studies that the government of Guatemala will need in order to take more fundamental decisions regarding the development of the municipal sector, and, in particular, the institutional arrangements for municipal finance.
- 2.10 This component will finance three sets of activities: (i) Technical assistance to carry out a basic reorganization of INFOM's functions; (ii) Creating the additional management capacity required to carry out the present Program, and (iii) Studies and other actions to develop a Medium Term Municipal Strategy.

a. Reorganization of INFOM

- 2.11 INFOM will carry out a reorganization to separate its nonlending from its lending activities and it will install the budget and accounting systems that will enable it to better manage its costs and monitor the results of its activities. As part of this reorganization, INFOM will also evaluate its current activities to optimize and increase the efficiency of its services.
- 2.12 With its current information systems, INFOM is not in a position to identify the costs of the different activities that it undertakes. This both handicaps management's attempts to make the institution more efficient, and generates an expensive set of implicit subsidies since the true cost of developing investment projects is concealed in INFOM's own operating expenses. The cost of designing and supervising the reorganization and the installation of the new management systems will be financed under this component.
- 2.13 By clarifying the costs and results of INFOM's wide array of activities, these improvements will facilitate any subsequent reforms without prejudging the role that INFOM should play in the medium term. In addition, policy changes have been agreed with INFOM as part of the development of the Program that will help it take further critical steps towards efficiency and sustainability. These policy changes cover two key areas. Firstly, INFOM will move the terms on which it makes loans towards market levels; secondly, it will implement a more rational system for granting project subsidies. These changes will be incorporated into the Operating Regulations that will govern the use of program resources for infrastructure financing (see Component 4 below).

b. Program Management

- 2.14 To help INFOM coordinate the different aspects of the present Program and to ensure that all the expected outputs are available in a timely fashion, the Program will finance consultants, evaluation studies and other support for program execution. In particular, a Program Coordinator and a Financial Advisor will be hired with Program funds. For further details see Chapter III.

c. Medium Term Strategies for Municipal Development

- 2.15 **Options for Municipal Finance.** The Program will help the Government design a strategy for building a larger and more sustainable municipal finance system. Given INFOM's important role as financial intermediary for the municipal sector, one focus of discussions will be the credit activities of INFOM, and how they can serve as the basis for an expanded system. Three institutional models will be considered during the first phase, for future development in the second phase of the Program, and evaluation by INFOM staff and government. For discussion purposes, the three models being proposed for consideration are: i) commercialization of INFOM's credit function, leaving it under the umbrella of a reorganized INFOM, and carrying out first-tier lending, ii) creation of a second-tier lender to the banking sector (INFOM or other entity), channeling both donor and market funds, and iii) creation of a bond bank (INFOM or other entity), serving as a packager and consolidator of municipal bond issues. A benchmark prior to completion of Phase I will be presentation of a work plan by the government, through INFOM, for implementation of the chosen strategy, that is satisfactory to the Bank.
- 2.16 **Institutional Coordination for Local Development.** The Program will help the Government design a strategy for improving institutional coordination and resource allocation to local development efforts. The roles of the various actors at the local level must also be clarified. Because INFOM is assumed to remain a principal delivery mechanism for municipal technical support and capacity-building, this strategy will identify the means for a more sustainable funding system for INFOM, particularly for those activities that will never be fully self-supporting. Currently the government is heavily dependent on donor loans to support INFOM. Recent discussions concerning INFOM's capitalization are a step in the right direction, as is the creation of the Inter-institutional Commission, but a more systematic and sustainable approach is needed.
- 2.17 The component will finance studies to develop policy options in these areas and provide the means for INFOM to organize the fora needed to generate a broad consensus on the reforms to be adopted. A benchmark prior to completion of Phase I will be presentation of institutional coordination plans by the government that resolve, to the satisfaction of the Bank, the problems being addressed by this component.

2. Component 2. Strengthening Municipal Capacity (US\$3.5 million)

- 2.18 This component will finance two sets of activity. First, it will finance technical assistance to municipalities, including that needed to implement the institutional reforms that will be Rules of Eligibility for INFOM financing of infrastructure investments (See Component 4). Resources will be available to carry out the initial diagnoses and to provide technical assistance to implement specific required changes. It is expected that 10 to 12 borrower municipalities per year will be supported in this way. A similar number will be assisted with more in-depth reforms.
- 2.19 Secondly, the component will support INFOM's activities as technical secretary of the National Network of Municipal Training Institutions known as RENICAM.

According to the training work program, INFOM will finance training in general areas such as municipal law and finance, will help municipalities strengthen service provision and tax collection, and will help modernize the accounting and budgeting systems in a sample of municipalities. Most important, however, is the proposal to implement a performance management system to evaluate the wide range of activities that have been carried out under by the training network since 1997. Where activities are found to have little measurable effect, the study will propose changes in the methodology or content of the training being provided.

3. Component 3. Promoting a Competitive Supply of Private Sector Financing and Services (US\$0.6 million)

- 2.20 The goal of this component is to help create the conditions for expanded private sector involvement in the provision of municipal finance and technical services. The component will finance three sets of activities (i) Improving information on the municipal sector; (ii) Facilitating lending by commercial banks to municipalities; (iii) Clarifying the legal framework for service provision.

a. Improving Municipal Sector Information.

- 2.21 **Municipal Credit Evaluation System.** The Program will finance the development of a municipal credit evaluation system. The system will be designed in collaboration with government and the municipal sector, and initially piloted in a simplified format as part of INFOM's lending decisions. Afterward, it will be made publicly available and workshops will be held to familiarize private lenders and municipalities with its content and uses. Lastly, a decision will be made before the end of Phase I regarding the upgrading, long-term maintenance, and application of the system, which can be performed by INFOM or the private sector.
- 2.22 **Information Disclosure Practices.** INFOM will use its existing information sources, data produced by the credit evaluation system, and new reports required from borrowers to develop a report card system on the municipal sector, along with a plan for annual publication. INFOM will develop a set of performance indicators, including but going beyond their financial condition, to help local actors assess municipal performance and to identify cases of good practice. Municipalities that receive support from the Program will provide INFOM with on-going reporting of debt obligations and municipal service performance.

b. Facilitating Private Sector Lending

- 2.23 **Developing Cofinancing Instruments.** The component will finance a study of the best options for developing cofinancing instruments that would encourage scarce public sector resources to leverage additional investments from the private sector. The study will be completed within the first 12 months of Program operation and if conditions in the financial sector permit, INFOM (with the assistance of the Financial Advisor and Project Financing Assistants that will support Program execution) will implement at least three pilot cofinancing projects by the end of the first phase of the operation. INFOM's share of such projects would be financed under Component 4. A workplan for expanding the scope of cofinancing during the second phase will be prepared before the end of Phase I.

c. Legal Framework for Private Provision of Financing and Services

- 2.24 This component will be used to identify, agree on, and implement (when possible) policies to promote the development of a competitive financial and services market for municipalities, with private sector involvement. The focus of this subcomponent will include: (i) the legal framework defining relations between municipalities and financial institutions; and (ii) government financial policies permitting effective communication channels to be established and information to be disclosed on the actual financial situation of municipalities.
- 2.25 Taking advantage of recent reforms at the national level and the technical analysis performed in the country, examples of activities that could be included in this component are as follows:
- Analysis of the legal framework for municipal financing (public and private) and the proposal of reforms.
 - Proposed mechanisms for communication and dissemination of information on the credit activities of municipalities.
 - Case studies of experiences with municipal financing in the country.
- 2.26 The results of this subcomponent will provide input into other program activities, including medium-term strategies for municipal development and municipal training activities.
- 2.27 An execution indicator for the approval of Phase II of the program will be the establishment or reconfiguration of a national framework for monitoring municipal credit activities, maintaining responsibility at the level of the central government.

4. Component 4. Financing Infrastructure Investments (US\$16 million)

- 2.28 The investment component will allow Guatemalan municipalities to continue to invest in projects with adequate social return and to provide an incentive to INFOM, the municipalities themselves, and the other actors involved, to accommodate critical reforms in policy and institutional arrangements. These reforms will be incorporated in the Operating Regulations for this component and will cover three broad areas: (i) the framework under which municipal services are provided; (ii) the terms under which INFOM loans are made; (iii) the rules by which project subsidies are allocated.

a. Provision of Municipal Services: Implementing a New Framework

- 2.29 The proposed framework will promote a policy that emphasizes a municipality's role as a facilitator or overseer of public services with an important supervisory function rather than as a direct provider of the services. The municipality will also provide a link with the public, especially in responding to demands and complaints, and will be the local entity responsible for the protection of the environment.
- 2.30 To become eligible for Program investments, municipalities will adopt a set of institutional arrangements affecting the way that water, sewerage, solid waste collection, market and abattoir services are provided. They must also assure

INFOM that citizens have agreed to the policies, their implications in terms of service levels and the tariffs required to ensure their sustainability. For example, for water and sewerage, they will create an institutional and contractual framework that is appropriate to the size of the municipality and provides the necessary degree of financial and administrative autonomy. The contractual framework will be used to define a tariff structure that ensures the sustainability of the services. Municipal operators will be required to comply with certain basic standards in the provision of the services.

- 2.31 In addition, municipalities will agree that the following functions will be contracted out to the private sector, wherever possible: (i) the operation and maintenance of markets, (ii) solid waste collection; and (iii) the management of abattoirs. The draft Rules of Eligibility setting out these conditions have been prepared (see the Technical Annex). Resources from the Program will be used to evaluate their operation during the first set of projects to be financed, and to propose changes and refinements to improve their impact.

b. Onlending Policies

- 2.32 As part of its effort to put its project financing on a more sustainable basis, INFOM, with the support of the Ministry of Finance, will implement a series of changes in its lending policies. Interest rates will gradually be brought up to market levels, and loan tenor, amortization schedules and grace periods will be set on a more rational basis. These are briefly described in the table below and will be included in final form in the Operating Regulations. In addition, in order to increase the borrower's stake in the projects financed, INFOM will require "equity" participation by municipalities in the financing of the investment cost, and the creation of reserve funds, constituted with resources generated by the services, to assure the funding of debt service and maintenance expenditures. Covenants regarding tariff adjustments will be more strictly designed and enforced.

Summary of Draft INFOM Lending Policies

Interest Rates (Pricing Policy)	The policy of the institution is that the rate of interest charged by INFOM on municipal loans should move toward the rate of interest on private bank loans during the execution of Phase I of the Program. The interest rate will be set at the beginning of the Program at 4 percentage points below the weighted average loan interest rate in the financial sector, and the differential will be gradually reduced over three years.
Interest Rate Adjustments	Every 6 months or as changed by the Ministry of Finance.
Term of Loans	25 years: water, sewerage, treatment plants, solid waste. 20 years: markets, bus terminals. 10 years: Others. In no case will the term exceed the useful life of the project.
Amortization	In order to accelerate repayment of loan funds, INFOM will begin the project financial analysis with a debt service repayment schedule based on equal annual recovery of principal plus interest (declining annual total debt service). This will be adjusted to a declining or even increasing annual total debt service before a subsidy is allocated to the project.
Grace Period	Reimbursement of principal: Up to 4 months after the termination of the work. Interest: No grace period. The municipalities can pay the interest due during the construction period with the resources of the loan.
Application of the Policies	The policies apply to all loans made under the current program and the reflows from the repayment of loans. It is agreed that during Phase I of the Program, INFOM will receive assistance from the Program to develop credit policies that can be applied to the entire institution, as part of its reforms.
Assignment of Resources	Maximum amount per municipality: US\$2.5 million. Maximum number of projects per municipality: 3.

c. Subsidy Policy

- 2.33 INFOM will implement explicit rules regarding subsidy allocation. The governing principle for the Program will be that only explicit subsidies will be provided by INFOM, thereby eliminating interest rate subsidies and indirect subsidies resulting from free project preparation services. These subsidies will be allocated in accordance with two fundamental factors: the nature of the service to be provided, and the poverty level of the population to be served. The draft rules setting out these conditions have been prepared and agreed with INFOM (See summary table below). The final policy will become part of the Operating Regulations to be approved prior to disbursement of resources for Component 4 of the Program. The impact of the policies on the first round of projects will be evaluated using resources of the Program, prior to the second round of municipal projects, and changes and refinements to improve their impact will be implemented.

Summary of INFOM Draft Subsidy Policies

Qualification of Projects	Category A: Water, sewerage, treatment plants, solid waste. Category B: Markets, bus terminals, parking, pavement, community centers, abattoir, and others.
Qualification of Municipalities	INFOM will develop criteria for qualifying municipalities, giving priority in assigning subsidies to poorer municipalities with that are better organized administratively. The poverty index to be used will be agreed upon.
Municipal Contribution	INFOM will implement a policy to promote greater municipal support of projects. Municipalities will be required to make a monetary contribution to projects. INFOM will give preference in the assigning of subsidies to those municipalities that provide greater support to projects.
Allocation of Subsidies by Category	By type of project and level of poverty. Projects in Category A will receive larger subsidies than those in Category B. (The final allocation strategy will be approved by the Bank as part of the Financial Policies component of the final Operating Regulations, prior to disbursement for Component 4.)
Method for the Assigning of Subsidies	During the project cycle, in an objective manner, and in accordance with with technical methods and the criteria of the subsidy policy (poverty, qualification of municipality, category of project and the level of municipal contribution). (The exact formula will be approved by the Bank as part of the Financial Policies component of the final Operating Regulations, prior to disbursement for Component 4.)
Total Amount of Subsidies	To be negotiated by INFOM and the Ministry of Finance, and approved by the Bank as part of the Financial Policies component of the final Operating Regulations.

2.34 **Dimensioning the investment component.** The size of the investment component in the present operation (US\$16 million) is linked to INFOM's execution capacity and effective municipal demand for financing. In the past three years INFOM has averaged some US\$8 million in annual disbursement from the investment component of the earlier Bank loan. The larger amount expected for the second phase (currently estimated at US\$30.2 million) is intended to both provide a clear incentive to meet the reform goals of the first phase, and also to reflect the increase in project delivery capacity that should result from the restructuring of INFOM's own project management procedures and from the development of co-financing approaches.

2.35 Consistent with the Program objective to quantify and charge to municipalities the major costs related to project development, this component will cover not only construction costs, but also preinvestment studies, design, and supervision. The funds in this component will be provided to municipalities as either loans or non-reimbursable subsidies. INFOM has identified an initial pipeline of more than US\$41 million of projects for the Program.

D. Cost and Financing

2.36 The total cost of the Program has been estimated at the equivalent of US\$65.9 million, divided into two phases. The Bank will finance, through the Single Currency Facility of the Ordinary Capital (OC) resources, in US dollars, a loan in the amount of US\$19.5 million for the first phase and US\$33.1 million for the second phase. US\$10.0 million of the loan for the first phase will be eligible for IFF financing. Total local national counterpart will be equivalent to US\$5.4 million and US\$8.3 million, respectively for each phase.

	Phase I				Phase II		Total Program	
	IDB	Local	Total	%	Total	%	Total	%
Program Components								
Component 1. INFOM and the Municipal Sector Strategy								
Consulting services	750	303	1,053					
Technical Assistance	1,095	706	1,800					
Training	75	72	147					
Equipment and General Support	742	30	772					
Component 1 Total	2,662	1,111	3,772	15%	3,490	8%	7,262	11%
Component 2. Strengthening Municipal Capacity								
Consulting services	180	285	465					
Technical Assistance	850	100	950					
Training	750	1,250	2,000					
Equipment and General Support	100	-	100					
Component 2 Total	1,880	1,635	3,515	14%	5,125	12%	8,640	13%
Component 3. Promoting Private Financing and Services								
Consulting services	60	90	150					
Technical Assistance	410	18	428					
Equipment and General Support	15	-	15					
Component 3 Total	485	108	593	2%	1,450	4%	2,043	3%
Component 4. Municipal Infrastructure Investments								
Preinvestment, construction and supervision of municipal investment projects	14,000	2,000	16,000					
Component 4 Total	14,000	2,000	16,000	65%	30,900	75%	46,900	71%
External Audits	160		160					
Contingencies	150	150	300					
Subtotal—Components	19,337	5,004	24,340	99%	40,965	99%	64,845	98%
FIV	195		195					
Fin Costs and Cont Total	195	0	195	1%	413	1%	1,068	2%
TOTAL PROGRAM	19,532	5,004	24,535	100%	41,378	100%	65,913	100%
Percentage	80%	20%						

1. IDB Financing

- 2.37 Bank financing will defray 80% of the Program's total cost. Interest expenses and the credit commission will be paid directly by the Government of Guatemala. The terms and conditions of the proposed operation are as follows:

Source of funds	Ordinary Capital (IFF)
Amount	US\$ SCF
Terms:	
Amortization	20 years
Grace period	3.5 years
Commitment	3.0 years
Disbursement	3.5 years
Interest rate	Variable
Supervision	1% of loan amount
Credit commissio	0.75% p.a. on undisbursed balance

2. Counterpart Funding

- 2.38 The government of Guatemala will provide counterpart funding for the Program, which will be allocated to various costs of each component, as shown in the cost table, above.

III. PROGRAM EXECUTION

A. The Borrower and Executing Agency

- 3.1 The borrower will be the Government of Guatemala. The executing agency will be the Instituto de Fomento Municipal (INFOM). A transfer agreement (*convenio subsidiario de transferencia de recursos*) will be signed between the government and INFOM, which will stipulate the responsibilities and obligations of each party. **Evidence that INFOM has signed an agreement with the Ministry of Finance, in accordance with text previously agreed upon with the Bank, which contains, among other other things, a definition of how the Program funds will be transferred to INFOM and the commitment of INFOM to execute the Program as agreed by the Government of Guatemala and the Bank, will be a condition of first disbursement under the Program.**

B. Program Execution and Administration

1. Program Management

- 3.2 Execution responsibility will be vested in INFOM, through different units at the central and regional level. INFOM will contract a Program Coordinator, a qualified professional with extensive experience in project management, who will take responsibility for completing the Program on time and in accordance with the Operating Regulations. The Program Coordinator will coordinate the planning of, and be responsible for monitoring and controlling, all activities. In addition, the Program Coordinator will be responsible for coordinating the different actors, including, among others, personnel hired by INFOM for the Program, staff of INFOM, the municipalities, consultants and contractors. **Evidence that INFOM has contracted the Program Coordinator in accordance with Terms of Reference previously agreed upon with the Bank will be a condition precedent to first disbursement under the Program.**
- 3.3 The Program Coordinator will prepare a Base Workplan that includes all of the Program activities. He or she will work in close coordination with the functional managers of INFOM to define the specific activities, their duration and sequence. The Program Coordinator will use the Base Workplan to monitor Program implementation. When a deviation from the Base Workplan is identified, the Program Coordinator will work with the appropriate manager to identify corrective measures necessary and their timing. The Program Coordinator will be given the authority to manage the Program commensurate with his or her responsibility for completing the Program.
- 3.4 The Program Coordinator's performance will be measured against the Base Workplan, through regular progress reports in a form that complies with the reporting required set out in the Loan Contract. The Bank and the General management of INFOM will periodically evaluate the performance of the Program Coordinator.

2. Execution of Components and the Management Coordinating Group

- 3.5 The Program is designed to be executed in a coordinated fashion, since the components support a shared set of objectives. Working with the Program Coordinator, Managers of specific units within INFOM will have functional responsibility for each component, they will be responsible for actually carrying out the work, as shown:

Component 1. INFOM and the Municipal Sector Strategy	Component 2. Strengthening Municipal Capacity	Component 3. Promoting Competitive Supply of Private Financing and Services	Component 4. Infrastructure Investments
Functional Responsibility			
INFOM General management	INFOM Municipal Strengthening Unit	INFOM Finance Unit	INFOM Technical Studies Unit
Supporting Role			
Inter-Governmental Working Group, Manager of INFOM Finance Unit, Project Financing Assistants	RENICAM, INFOM Environmental Office	Project Financing Assistants, Private Banks, Private Investors	INFOM Municipal Strengthening Unit, INFOM Environmental Office

- 3.6 The INFOM Management Coordinating Group (Grupo Coordinador) will work closely with the Program Coordinator. The Group will be made up of the key managers responsible for implementing the Program, and will meet regularly to take action requested by the Program Coordinator to facilitate the Program. The Group will also provide input to the periodic evaluations of the Program Coordinator.

a. Component 1. INFOM and the Municipal Sector Strategy

- 3.7 INFOM's general management will be charged with functional responsibility for this component. The Financial Unit will be responsible for design and implementation of the accounting reforms, including the activity accounting system, and separation of the financial and non-financial activities and the development of the project cost accounting system, with the assistance of short-term consultants whose terms of reference are currently being drafted. **Evidence satisfactory to the Bank that INFOM has contracted, in accordance with terms of reference previously agreed upon with the Bank, the consultancy to design and implement the accounting system reforms is a condition precedent to the first disbursement of the Program.**
- 3.8 INFOM's general management will coordinate activities related to the medium-term strategy on municipal development with the national government through an Interinstitutional Working Group, to be appointed by government and expected to be made up, *inter alia*, of INFOM, the Social Investment Funds, and the Ministry of Finance. The Manager (or his designee) will represent INFOM and will be supported by the Financial Advisor (see Component 3) and others, using funds budgeted for short-term technical assistance. **Evidence satisfactory to the Bank of**

establishment of the Intergovernmental Working Group for analyzing national policy options in Component 1 and approval of its workplan for Phase I, will be a condition precedent to the first disbursement.

- 3.9 The private consulting firm will also develop the monitoring and evaluation system for the entire program under this component. **Evidence satisfactory to the Bank that INFOM has contracted, in accordance with terms of reference previously agreed upon with the Bank, the consultants to design the performance monitoring system for all components will be a condition precedent to the first disbursement of the Program.**

b. Component 2. Strengthening Municipal Capacity

- 3.10 INFOM's Municipal Strengthening Unit (MSU) will be charged with functional responsibility for this component. The Unit will provide or contract technical assistance to municipalities who qualify for borrowing under Component 4, to implement the institutional reforms for service provision. Private consultants will be hired to work with municipalities to implement reforms and to advise INFOM when the reforms have been successfully completed.
- 3.11 A group of approximately 10 municipalities will receive more in-depth technical assistance each year of the Program. The MSU will select these municipalities, partially on the basis of their ability to be "graduated" from future INFOM technical assistance, and oversee outsourcing of their TA, as well as TA provision from within INFOM. INFOM will also contract technical assistance to implement a pilot program to install SIAF in a select group of municipalities of various sizes and to expand implementation of the SAM system.
- 3.12 For the National Training Plan, the MSU will contract technical assistance to organize needs assessments by department and develop the departmental training plans. INFOM will be responsible for ensuring that women and other vulnerable groups participate in these programs.
- 3.13 RENICAM network members will provide the technical assistance and training for municipal officials and employees, community leaders and program beneficiaries, and will participate in activities to monitor and evaluate the impact of the training. This TA is offered by national policy to all municipalities, consistent with their expressed priorities for training. The training entities sign agreements with INFOM that detail the nature and requirements of their participation in RENICAM.

c. Component 3. Promoting a Competitive Supply of Private Sector Financing and Services

- 3.14 INFOM's Finance Unit, supported by long and short-term technical advisors, will be charged with functional responsibility for this component. Prior to first disbursement, INFOM will contract a part-time, long-term Financial Advisor who, in turn, will assist in contracting two Project Financing Assistants who will be located in INFOM's Finance Unit.
- 3.15 The Financial Advisor will have as a principal responsibility developing sustainable institutional financing strategies for INFOM. The Financial Advisor will also help supervise the private consultants who will conduct the legal study

and support INFOM in its work with the national government to develop options for sustainable municipal credit. **Evidence that INFOM has contracted the Financial Advisor in accordance with Terms of Reference previously agreed upon with the Bank will be a condition precedent to first disbursement under the Program.**

- 3.16 The Project Financing Assistants will identify new sources of project financing, develop co-financing models, and oversee the pilot co-financing projects.
- 3.17 Together, the Financial Advisor and the Project Financing Assistants will hire and oversee the short-term consultants designing the credit evaluation system for municipalities and financial analysis process for projects, and will oversee their implementation. They will also supervise implementation of the new financial policies.

d. Component 4. Municipal Infrastructure Projects

- 3.18 A group of professionals, who will be paid by the Program, will be designated to carry out the activities related to infrastructure projects. They will be located in the Technical Studies Unit (TSU).
- 3.19 Working with municipalities, INFOM will organize two calls for project proposals, and allocate both credit and subsidies according to criteria previously communicated to municipalities. The first will take place immediately after the loan is approved in Guatemala; the second, after 18 months of operation. This work process is described in detail in the Technical Annexes .
- 3.20 Investment project proposals will originate with the municipalities by the completion of a form for this purpose. INFOM will then carry out a financial evaluation of the municipality and will design and support the technical assistance needed to enable the municipality to comply with the rules of eligibility set out in the Technical Annex, including developing tariffs for the project. Once it is certified that the Rules of Eligibility have been complied with, a loan agreement will be signed. **Presentation of the model contract to be signed by INFOM with each municipality will be a condition precedent to the first disbursement of the program.**
- 3.21 When requested by a municipality, the TSU will provide the technical assistance and support needed for municipalities to contract out the prefeasibility, feasibility, design, construction and construction supervision of investment projects. The TSU will evaluate projects presented by the municipalities for technical, financial, and economic viability. The TSU will be established on a preliminary basis until an anticipated study of INFOM's municipal project cycle is completed and a final decision regarding staffing and functioning of the TSU is made and agreed to by the Bank, as part of the approval of the final Operating Regulations.
- 3.22 INFOM will ensure that the investment projects conform to the loan and subsidy policies. The Financial Assistants will provide support for the Technical Studies Units to ensure that these policies are correctly applied.
- 3.23 Similarly, INFOM will create an Environmental Office to oversee implementation of procedures and standards for the environmental review of municipal projects

and to assist the Municipal Strengthening Unit and RENICAM with municipal training in environmental planning, assessment and mitigation. The Office may be established on a preliminary basis before the environmental study is completed; final arrangements regarding INFOM's environmental procedures and staffing of the Environmental Office will be agreed to by INFOM and CONAMA, and approved by the Bank as part of the final Operating Regulations.

- 3.24 **Evidence satisfactory to the Bank that the institutional reorganization necessary for the implementation of the Program, including creation of the Technical Studies Unit and establishment of the Management Coordination Group has been approved by the INFOM Board of Directors will be a condition precedent to the first disbursement of the program.**

3. The Municipalities

- 3.25 Municipalities will be required to contribute matching funds for projects and to agree to conform to INFOM policies regarding institutional arrangements, environmental review and borrowing.
- 3.26 By law, municipalities are autonomous institutions, with full capacity to contract goods and services to promote municipal development. INFOM's mandate is to provide financial and technical services to municipalities in order to support their development. Consistent with this legal framework, municipalities will be directly responsible for contracting directly all services required for their projects. While INFOM will support municipalities during the contracting process, the municipalities themselves will sign all contracts. INFOM will develop the disbursement and control procedures necessary to allow municipalities to carry out this function under the Program.
- 3.27 Municipalities will serve as their own executing agencies for projects financed by the Program. Each municipality (or groups of small municipalities) will identify a Project Coordinator to oversee all project activities. For each project, INFOM and the Project Coordinator will develop an implementation plan. In cases where municipalities do not have technical capacity, INFOM will provide the technical assistance necessary.
- 3.28 Relations between INFOM and the municipality receiving a loan will be established in a pre-loan agreement when INFOM agrees to finance the project subject to the municipality's compliance with the rules of eligibility set out in the Technical Annex. The municipality will enter into a lending agreement with INFOM when the rules of eligibility have been met.

4. Other Agencies

- 3.29 **NGOs.** NGOs and academic institutions that are members of RENICAM will provide training to municipal officials and employees, co-financed by the municipalities and INFOM. They will also participate in the development and maintenance of the performance indicators system for the National Training Plan and RENICAM. The nature and requirements of the participation of NGOs in RENICAM is documented by agreements that INFOM executes with each RENICAM member.

- 3.30 **Private sector.** The private sector will play several roles in the Program. It is expected that private financial institutions will extend longer-term loans to municipalities, either directly or in co-financing arrangements with INFOM, with support from the program. NGOs who are members of RENICAM will provide training to municipal officials and employees, co-financed by the municipalities and INFOM. They will also participate in the development and maintenance of the performance indicators system for the National Training Plan and RENICAM. Private firms will also be hired to provide short and long-term technical assistance to INFOM during the Program, and to carry out the development and implementation of the credit evaluation system.
- 3.31 **Central Government.** Central government, by its participation in the Working Group, will take a lead role in analyzing policy options for municipal development and municipal credit during the strategic dialog supported by the Program.
- 3.32 **Other agencies.** Other local development agencies such as the social investment funds and development councils will participate in the analysis of policy options for municipal development through their participation in policy discussions to be held during Phase I of the Program.

5. Other Administrative Matters

- 3.33 The Program will cover program administration expenses, including the costs of the Program Coordinator and the key staff, equipment and annual external audits. Resources will also be provided to finance other specific technical assistance, travel and professional exchanges.
- 3.34 **Operating Regulations.** Program execution will conform with the requirements, rules, technical and financial operating procedures established in (i) the Loan Contract between the Bank and the Government of Guatemala, and (ii) the Program's Operating Regulations. These Operating Regulations will include among other things: (i) the rules of eligibility for municipalities; (ii) procedures and criteria for selecting and ranking projects; (iii) terms and conditions of the subloans; (iv) financial analysis procedures for subloans; (v) procedures for the implementation of the new institutional arrangements; (vi) the new subsidy and credit policies for municipal loans; (vii) environmental procedures and the institutional arrangements for environmental review; (viii) disbursement and control procedures between INFOM and the municipalities for consultant contracts and other costs to be covered from Program resources; (ix) descriptions of the roles and staffing plans for all key units and the roles and responsibilities of key staff involved in the Program, and (x) the form, content and schedule for the periodic monitoring reports to be submitted to the Bank. The project team will be responsible for oversight of the development of the Operating Regulations, and for their approval. **Approval by the Bank of draft Operating Regulations will be a condition precedent to the first disbursement under the Program.**

6. Management of Environmental and Social Issues

a. Environmental Review

- 3.35 Working with INFOM, municipal representatives and CONAMA, Guatemala's principal environmental agency, an international consultant will develop new

environmental procedures for municipal projects and the institutional arrangements to support these changes. The consultant will assist INFOM and CONAMA in arriving at an agreement on the terms and responsibilities for environmental review of municipal projects supported by INFOM. Program resources will be used to establish the Environmental Office to carry out the agreed procedures. This Office will help ensure that conflicts of interest are avoided and will have the capacity to ensure quality control and enforce ex-post monitoring. The institutional arrangements for environmental review as well as environmental procedures will be incorporated in the Operating Regulations.

- 3.36 The consultant will also provide training guidelines to INFOM's Municipal Strengthening Unit for environmental training being provided by RENICAM, to ensure that the training is consistent with the new procedures. Program resources will be used to implement these guidelines. Lastly, a set of indicators for INFOM and municipalities for environmental monitoring of municipal projects will be developed.
- 3.37 The agreed procedures will also become part of the work process for project development that INFOM will utilize in the investment component of the program (see the Technical Annex). Evidence that the guidelines are being followed and monitoring and evaluation of their impact will be a benchmark for the end of Phase I.

b. Community Participation

- 3.38 Beneficiary participation in project planning, approval and implementation will be strengthened through the implementation of the new work process for municipal projects and through the new subsidy allocation policy. Under the new procedures for project approval agreed with INFOM, municipalities will be required to demonstrate that participatory practices have been followed in identifying projects and agreeing on tariff structures. Using the technical assistance resources provided to municipalities under Component 3, Municipal Capacity Building, INFOM will have the means to provide municipalities with expertise in participatory techniques and outreach. The new subsidy policy agreed with INFOM will reward with higher subsidies municipalities that can demonstrate that community involvement has taken place from the early stages of project preparation. (See the Technical Annex).
- 3.39 In addition, the project cycle study will produce recommendations regarding community participation, one of its principal objectives being the enhancement of community involvement in the project cycle and the identification of best practices.

c. Involvement of Women and Indigenous People

- 3.40 INFOM and member NGOs of RENICAM will continue to provide training for municipal officials and employees and local leaders, without discrimination against women or indigenous groups, under its national capacity-building program. This training will be supported by Component 2, Strengthening Municipal Capacity.
- 3.41 Terms of reference have been drafted for an evaluation of the National Training Plan, to be supported by the Bank's CABILICA Fund (Capacity Building for Local Development Institutions in Central America). A principal focus will be to

evaluate the extent to which the commitment to the training of women and indigenous people expressed in the National Training Plan, is being realized and to recommend new approaches. INFOM is responsible for implementing the recommendations of the study that apply to INFOM or RENICAM. In addition, an effort will be made to engage the agencies executing the Bank's Rural Women in the Consolidation of Democracy program to assist INFOM and RENICAM in expanding opportunities for women in local government and monitoring the results. The extent of training of women and indigenous people will be a monitoring indicator for the Program.

C. Benchmarks for Phase II

- 3.42 The recommendations for Board approval of the second phase of the Program would be triggered when Bank Management verifies that (i) at least 50% of the loan resources for Phase I have been disbursed and, (ii) based on the evaluation of Phase I (described in paragraph 3.46, Evaluation), the benchmarks shown in the table below and in the Technical Annex have been achieved, to the satisfaction of the Bank.

Benchmarks for Phase II

Component 1. INFOM and the Municipal Sector
<ul style="list-style-type: none"> • A long-term sustainable financing strategy and plan for INFOM drafted. • Performance monitoring and evaluation systems for all program components implemented. • Financial statements prepared in accordance with generally accepted accounting principles, separating financial from nonfinancial activities. • Work plan for implementation of the chosen strategy for expanding municipal finance presented by the government. • Institutional Coordination Plan for local development presented by the government. • A national framework established or reconfigured for monitoring the credit activities of municipalities maintaining final responsibility at the level of the central government
Component 2. Strengthening Municipal Capacity
<ul style="list-style-type: none"> • Performance indicators for the municipal sector and developed and in use by assisted municipalities. • Performance of assisted municipalities is evaluated. • Monitoring and evaluation system for National Training Plan and RENICAM implemented.
Component 3. Promoting a Competitive Supply of Private Sector Financing and Services
<ul style="list-style-type: none"> • Second report card on municipal sector issued. Plan for regular publication in place. • Three cofinancing projects completed. • Study of legal constraints on municipal finance and privatization completed and plan to address constraints presented. • Results of study and conference on experience in public/private participation published by INFOM. • Reforms in use of municipal transfers proposed and credit oversight procedures established.
Component 4. Infrastructure Investments
<ul style="list-style-type: none"> • Two rounds of investment proposals received and loan commitments made in accordance with the work process set out in the Technical Annex. • Specific changes proposed to institutional arrangements and environmental procedures, if necessary. • Interest rate differential between Program loans and market rates substantially reduced. • Impact of financial policies evaluated and changes proposed.

- 3.43 The second phase of the Program is expected to have similar components, and to allow full deployment of the models being explored and tested in the first Phase. This operation is expected to include implementation of a new model for sustainable municipal financing, including expansion of private financing, and new coordination mechanisms for local development funding at the local level and support to those municipal training activities that have proven to be the most effective. The monitoring and evaluation systems being implemented should provide an improved information base that will facilitate and help to justify decisions regarding the support for these activities. Phase II also is scheduled to take three years.

D. Performance Monitoring and Evaluation, Program Reporting and Supervision.

- 3.44 Performance monitoring and evaluation systems will be designed and implemented in each component of the project in order to evaluate Program results and for

periodic evaluations. The design of the system will be supported by those responsible for functional management of each component, who will also be responsible for ensuring the operation of their respective component of the monitoring system. This monitoring system will be designed to produce information necessary to allow monitoring of the benchmarks for the Program, as well as other key management indicators for each component.

- 3.45 **Reports.** Monitoring reports will be produced regularly throughout the year, and shared with the Bank. INFOM will also be responsible for submitting periodic performance reports to the Bank in a form, and according to a schedule, to be agreed as part of the Operating Regulations. These periodic reports will include but not be limited to, analysis of the results of the performance monitoring process.
- 3.46 **Evaluation.** Full Program evaluations will be conducted at the mid-point of the Program (month 18 unless agreed otherwise by the Bank) and prior to the end of Phase I. The latter will be used to determine whether INFOM has complied with the Phase I benchmarks.
- 3.47 **Supervision.** The Bank, through its Country Office, with support from the project team, will supervise the Program. The project team will visit Guatemala to review the results of the mid-term evaluation of Phase I, and make recommendations for program changes if the reforms are not delivering the desired results. The project team will also assume responsibility for approval of the final Operating Regulations.

E. Procurement of Goods, Works and Consulting Services

- 3.48 International Competitive bidding will be required for consulting services in excess of US\$200,000, goods in excess of US\$250,000 and construction works in excess of US\$1,500,000. Goods, works and consulting services below these sums will be subject to the procedures attached to the loan contract, and summarized below:

Modality	Public National Bidding	Local Competitive Bidding
Works	Between US\$250,000 to US\$1,500,000	Under US\$250,000
Goods and Services	Between US\$150,000 and US\$250,000	Under US\$150,000
Consulting Services	Between US\$150,000 and US\$200,000	Under US\$150,000

- 3.49 INFOM may authorize municipalities to execute projects through forced account system (*sistema por administración directa*) for works costing up to US\$125,000. No more than 10% of total funds assigned to the investment component can be used to execute projects using this methodology. The use of this methodology is proposed because, based on the Bank's experience, the low contract value of some of the works and their geographic location make these contracts unattractive to local contractors.

F. Execution and Disbursement

- 3.50 **Advance of Funds.** A revolving fund mechanism will be used in this Program. Given the variety of activities to be financed, particularly the implementation of the National Training Plan, it is recommended that the equivalent of 10% of the Bank's loan be made available as an advance.
- 3.51 **Disbursements.** The Bank loan and counterpart funds will be deposited in a special INFOM managed account. Justification of requests for advances and reimbursements to INFOM will be made based according to Bank procedures. The requests will be accompanied by the supporting information, which the Bank will review ex-ante, and can include contracts, orders, invoices, receipts, payment vouchers, supplier certificates and other acceptable documentation agreed to with the Bank.
- 3.52 Program disbursements will be done over a three and a half-year period from the effective date of the loan contract. The schedule for disbursements is estimated as follows:

Proposed Distribution of Program Resources by Year				
Year 1	Year 2	Year 3	Year 4 ²	Total
20%	45%	25%	10%	100%

G. Accounting and Auditing

- 3.53 The institution has successfully implemented several loan operations with the Bank. It has adequate internal and independent control mechanisms that ensure compliance with the existing Operating Regulations.
- 3.54 INFOM will establish and maintain adequate accounts and records, in accordance with accepted accounting practices. The municipalities managing program funds will also keep adequate records on project resources and expenditures. These will be audited at the end of each fiscal year by a firm of independent and qualified auditors acceptable to the Bank. The audited financial statements to be submitted to the Bank will include an opinion on the accounts and records kept by the municipalities and on the use of program funds transferred to these municipalities. The cost of audits is included in the Program costs and will be paid with Bank financing. Audited financial statements for the Program and the Institution will be presented commencing with the first year of program execution. In addition, financial statements organized on an activity basis will be required to be submitted under the new format once the accounting reforms to be carried out in Component 1 are completed.

² The execution period for the Program is 3.5 years.

IV. VIABILITY AND RISKS

A. Benefits

- 4.1 The Program will produce interrelated benefits in three areas: within the municipalities at the local level, for the municipal sector as a whole and within INFOM.

1. Local Service Delivery

- 4.2 At a minimum, the Program will produce benefits at the local level for citizens and within the municipalities themselves. There will be expanded opportunities for citizens to participate in the identification of projects and to have input to the setting of tariff and service levels. The new institutional arrangements at the local level that the Program will require as a condition of borrowing, will produce service improvements as decisions become more technical and less political.
- 4.3 Improvements in the system whereby subsidies are allocated to projects will help ensure that projects with higher economic value and more community support will be given more subsidies, and that poorer municipalities will receive the majority of the subsidies. Although the operation is not classified as poverty-targeted, poorer municipalities will benefit the most. In addition, with the reallocation of subsidies among sectors, more projects related to essential services (solid waste, water and sanitation) will be financed under the Program.
- 4.4 The sustainability of the municipal projects financed will improve under the Program. Municipalities will be required to show community support for the project and the tariffs that are to be charged. Moreover, the new institutional and financial arrangements will require that the resources raised from a service be used principally for the operation of that service. Municipalities will not have an incentive to overstate their investment needs since they will have to contribute a portion of the project cost up-front. And lastly, the new financial analysis tools being developed under the Program will impose a more rigorous set of financial rate of return standards on the projects.
- 4.5 Municipalities will have benchmarks to evaluate their progress. Using monitoring indicators and the credit evaluation system to be developed under the Program, they will be able to evaluate themselves, and their condition and progress against other municipalities in the sector, as well as the progress and quality of the National Training Plan.

2. Demand and Supply of Services and Financing

- 4.6 The Program will put the municipal sector as a whole in a better position to articulate its demands from INFOM and the private sector, helping to create a more diversified, competitive supply of financing and services to municipalities.
- 4.7 The availability of information about the municipal sector will improve. Currently, there is a critical lack of information in Guatemala about the municipal sector, its financial condition and its requirements. This reduces the number of potential suppliers of financing, consulting services, contracting, and training because

private firms interested in doing business with municipalities have no information base for deciding the potential size and requirements of this market. The Program will increase the available information by supporting the development of an annual report card on the municipal sector, and through improvements in the reporting of municipal financial information, including credit evaluations and debt obligations.

- 4.8 New models of public/private participation will result from the Program. INFOM will develop and implement new models of public/private co-financing through its pilot projects in this area. The privatization study will identify successful privatization models used in the region, which will be shared with public and private parties by means of a national conference in the second year. The legal framework for privatization will also be clarified, reducing risks for contractors doing work in the sector.
- 4.9 New contracting opportunities will open up. INFOM will be expanding its use of private contractors in project preparation, which will give more private firms exposure to and experience with the sector. The awarding of the credit evaluation system to a private firm is an additional opportunity for the private sector.

3. INFOM

- 4.10 INFOM's ability to manage its operation will be improved. With new management tools such as activity-based accounting and a performance monitoring system, INFOM will be better able to manage its diverse activities, and will be required to report their progress against objectives. In addition, while institutional reforms in prior Bank projects with INFOM have not fully succeeded because the executing unit tended to have a "works" orientation, this operation will include a Program Coordinator who will not be involved in day-to-day Program activities, but will be responsible for the completion of all components, and ensuring coordination between them.
- 4.11 INFOM's sustainability will be enhanced. INFOM is being given the means to better capitalize itself and improve its sustainability by the government of Guatemala, however this will only take place if the tools and policies are in place to allow INFOM to manage in a way that ensures its sustainability. The new financial policies and the subsidy policy are meant to assist INFOM with this task. In addition, INFOM will have the services of the Financial Advisor whose terms of reference call for the development of the financial sustainability plan.
- 4.12 INFOM's overall project execution capacity will be increased. Several elements of the Program will work together to expand INFOM's execution capacity. These include: (a) better analysis and management of the process whereby municipal projects are developed, resulting in the identification and resolution of bottlenecks in the current municipal project cycle; (b) the delegation of more responsibility to municipalities, which will increase the amount of project preparatory work done outside of INFOM by others, (c) the creation of the Technical Studies Unit, one of whose principal purposes is to increase the output of projects through INFOM.
- 4.13 The Program will help create a platform for a future role for INFOM in the sector. The municipal sector will benefit from the government's consideration of the best options for providing support and credit to the municipal sector. Meanwhile, the

results from the Program will allow the government to better evaluate the role of INFOM in providing on-going support to the municipal sector. Financial activities will have been isolated, and their profitability evaluated, and the true costs of subsidies and technical assistance will be clearer. Therefore, as the government analyzes its institutional options for future support at the local level during Phase I, it will have a more accurate understanding of the capacities, requirements and limitations of INFOM to serve various roles in the sector.

B. Risks

1. INFOM and Past Practices

- 4.14 The success of the operation hinges on INFOM's ability to manage the transition towards a new role in the municipal system, a transition that will require changes in the way of thinking of much of its staff, and the simultaneous implementation of a range of new procedures and policies. It also depends on INFOM's ability to continue to overcome its somewhat mixed reputation with municipalities as a producer of projects of its own choosing, rather than those requested by municipalities. The reforms already undertaken recently in INFOM, as well as those that will be supported under this Program, have been strongly supported by the current leadership. If the leadership or strategy changes as a result of the 1999 elections, it may put some of the Program's objectives at risk.

2. Central Government Policy

- 4.15 The task of transforming municipalities into financially autonomous and creditworthy agencies is complicated by two related factors: their weak financial condition and the large annual flows of nonreimbursable project financing available from the Social Investment Funds. INFOM has already begun an effort to achieve some coordination with these funds, and under the present operation, it will work with the government to develop a more integrated institutional framework to guide the rational allocation of both concessional and credit based funding.
- 4.16 The current government has expressed its support for a process to better rationalize the current framework. However, significant political interests are at stake in any strategy for institution reorganization or coordination. INFOM has little or no formal authority over the social investment funds. Therefore, real progress on this issue will depend on the policy of the incoming government and its willingness to undertake this effort.

3. Financial Sector

- 4.17 The Program seeks to encourage a wider role for private capital and private enterprises in the municipal system. However, the Guatemalan financial sector is weak and volatile, and its credit evaluation practices are poor. The sector has access to little in the way of long-term investment resources. The Bank has designed the next stage of a reform program for the financial sector, but its impact will require some time to be felt.
- 4.18 Experienced private operators for urban services are scarce. Many municipalities in Guatemala are small and geographically remote. Even when not the case, the

lack of standardized arrangements for urban service provision makes it expensive to work with the sector.

- 4.19 The Program will support policies and instruments that will create a substantially more favorable environment for the private sector. However, the extent to which private banks and enterprises actually respond to this environment will depend on factors, such as the macroeconomic situation, and the stability of the financial sector, over which neither INFOM nor this Program have any control.

**GUATEMALAN MUNICIPAL DEVELOPMENT
(GU-0134)**

PROCUREMENT PLAN

Main Procurement	Financing	Procurement Method (Thousands)	Prequalification	Expected SPN Publication date
1. Program Execution				
Long-term consultancies – US\$1.4 million - Management advisor; - Support to Technical studies, environment and financial units - Management information, and social promotion	52% IDB 48% GGU	ICB over US\$200 NCB from US\$150 US\$199 LCB under US\$150	No	I/2000
Specialized technical assistance – US\$2.8 million - Develop financial and subsidy policies - Design and implement program cost and accounting systems - Implement SAM and SIAF systems - Design and implement monitoring and evaluation system - Develop credit criteria for municipalities - Develop frameworks for municipal projects - Increase resources from private sector - Municipal legal framework study	74% IDB 26% GGU	ICB over US\$200 NCB from US\$150 US\$199 LCB under US\$150	No	I/2000
Training – US\$2.2 million - Implement National Training Plan - Training in SAM and SIAF systems - Training in Environment measures for INFOM and municipalities - Courses, seminars and study tours	40% IDB 60% GGU	ICB over US\$200 NCB from US\$150 US\$199 LCB under US\$150	No	I/2000 to II/2003
Equipment and vehicles – US\$807,000 - Computers, software and internet system - Radio equipment - Vehicles	100% IDB	ICB over US\$250 NCB from US\$100 to US\$249 LCB under US\$100	No	I/2000 to II/2003
Municipal Infrastructure Projects – US\$16.0 million Water, sewerage, treatment plants, solid waste, markets, bus terminals, pavement, community centers, abattoirs, and others	88% IDB 12% GGU	ICB over US\$1.5 million NCB from US\$250 to US\$1.5 million LCB under US\$250 FA under US\$50	Yes	I/2000 to II/2003
2. Program Coordination				
Short and long-term consultancies and specialized technical assistance – US\$550,000	82% IDB 18% GGU	ICB over US\$200 NCB from \$150 \$199 LCB under US\$150	No	I/2000 to II/2003
Equipment, vehicle and supplies – US\$30,000	100% IDB	ICB over US\$250 NCB from US\$100 to US\$249 LCB under US\$100	No	I/2000 to II/2003

ICB – International Competitive Bidding
 NCB – National Competitive Bidding
 LCB – Local Competitive Bidding
 FA – Forced Account
 SPN – Special Procurement Notice

PROPOSED RESOLUTION

GUATEMALA. LOAN No. ____/OC-GU TO THE REPUBLICA DE GUATEMALA

(Municipal Sector Development Program)

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 República de Guatemala, as Borrower, for the purpose of grant it a financing to cooperate in the execution of a Municipal Sector Development Program. Such financing will be for the amount of up to US\$19,532,000 from the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the "Financial Terms and Conditions" and the "Special Contractual Conditions" of the Executive Summary of the Loan Proposal.

PROPOSED RESOLUTION

GUATEMALA. PARTIAL PAYMENT OF INTEREST ON
LOAN No. ____/OC-GU TO THE REPUBLICA DE GUATEMALA

(Municipal Sector Development Program)

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, as administrator of the Intermediate Financing Facility Account, hereinafter referred to as the "account", to enter into such contract or contracts as may be necessary with the República de Guatemala, as Borrower, and to adopt such other measures as may be necessary to utilize the resources of the account to pay a part of the interest due by the Borrower on outstanding balances of up to US\$10,000,000 of the loan authorized by Resolution DE-____/99, in accordance with applicable Bank policy.