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MEXICO

**PROGRAM TO SUPPORT THE CONSOLIDATION
OF FISCAL SUSTAINABILITY
(ME-L1090)**

LOAN PROPOSAL

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Required
1. DEM Questionnaire
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1. SHCP (2010). General economic policy criteria
2. CEFP (2010). Analysis of the Mexican Fiscal System
3. SHCP (2009). Report on the Economic Situation, the Public Finances and the Public Debt. Activities and Results in the Fourth Quarter of 2009
4. OECD (2009). OECD Review of Budgeting in Mexico
5. CEFP (2009). Calculation of the Structural Balance for Mexico
6. IMF (2009). Mexico: Review Under the Flexible Credit Line Arrangement – Staff Report
7. IMF (2010). Mexico: Article IV Consultation – Staff Report
8. IMF (2010). Mexico: Article IV Consultation – Selected Issues
9. Evaluation and Monitoring Plan
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ABBREVIATIONS

APF	Federal Public Administration
CITA	Tax and Customs Intelligence Center
CONAC	National Council for Accounting Harmonization
CUT	Single Treasury Account
FOGAREF	Treasury Reimbursements Guarantee Fund
GDP	Gross domestic product
IEPS	Special tax on products and services
IMF	International Monetary Fund
LFPRH	Federal Law on Budget and Fiscal Responsibility
LGCG	General Law on Government Accounting
OECD	Organization for Economic Cooperation and Development
PBL	Policy-based loan
PEMEX	Petróleos Mexicanos (national oil company)
PRODEV	Program to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness
RBB	Results-based budgeting
SAT	Tax Administration Service
SHCP	Ministry of Finance
TESOFE	Federal Treasury
TIM	International Goods Transit
VAT	Value-added tax

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PROJECT SUMMARY

Financial Terms and Conditions				
Borrower: United Mexican States			Amortization period:	20 years
Executing agency: United Mexican States through the Mexican Ministry of Finance (SHCP)			Grace period:	5 years
			Disbursement period:	24 months
Source	Amount US\$	%	Interest rate:	LIBOR-based
IDB (Ordinary Capital)	1 billion	100	Credit fee:	*
			Inspection and supervision fee:	*
Total	1 billion	100	Currency:	U.S. dollars from the Single Currency Facility. Conversion to Mexican pesos: Local Currency Facility (LCF), GN-2365-6
Project at a glance				
Project objective/description: The objective of the program is to support Mexico's federal government in its efforts to consolidate medium-term fiscal sustainability, maintain countercyclical policies to promote quicker economic recovery, and make fiscal management more effective and efficient. The program has four components: (i) macroeconomic stability and revival of growth; (ii) tax and customs policy and administration; (iii) fiscal rules and fiscal responsibility; and (iv) quality of fiscal and budgetary management. The program is a policy-based loan (PBL) under the programmatic modality of two operations. The amount of financing for the first operation is up to US\$1 billion, to be disbursed in a single tranche.				
Special contractual conditions: The disbursement of funds for the first operation is subject to compliance with the measures regarding policy reforms or institutional changes agreed for release of the respective tranche, pursuant to section F of Chapter I (paragraph 1.36) and the Policy Matrix (Annex II).				
Exceptions to Bank policies: None.				
Project consistent with country strategy: Yes [X] No []				
Project qualifies as: SEQ [] PTI [] Sector [] Geographic [] Headcount []				

* The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. DESCRIPTION AND RESULTS MONITORING

A. Frame of reference, issues addressed, and rationale

1. Recent macroeconomic performance

- 1.1 Having emerged from the financial crisis of 1994-1995, Mexico launched a series of economic reforms that allowed the economy to grow steadily, if at a moderate rate (3.5% real annual growth), during the period 1996-2008, with relatively low inflation. This outcome can be laid to implementation of a monetary policy based on inflation targets that succeeded in reducing inflation to single digits, a flexible exchange rate regime, and prudent fiscal policy. That policy focused on reducing the public debt (particularly the external debt) in order to reinforce fiscal sustainability and financial stability. The gross debt of the public sector fell from 51.3% of GDP in 1996 to 44.6% in 2009. Over that same time, the external public debt shrank from 78% to 29% as a proportion of total public debt, reducing significantly the economy's vulnerability to external shocks. At the same time the authorities reinforced financial system regulation and supervision in order to reduce the weaknesses that had sparked episodes of financial crisis in the past. The progress achieved with this set of reforms has bolstered the credibility of economic policy on international and domestic markets alike. That confidence was particularly strong in the years prior to the recent international crisis, with year-on-year inflation dropping to 4.4% over the period 2005-2008, along with an investment-grade rating for the country's debt (Table 1.1).

Table 1.1. Main macroeconomic indicators 2005-2011 (% GDP)

	2005	2006	2007	2008	2009	2010/e	2011/p
Real GDP (% change)	3.2	4.9	3.3	1.5	-6.5	4.2	4.5
Inflation rate (end of year)	3.3	4.1	3.8	6.5	3.6	5.3	3.0
Current account balance (% GDP)	-0.5	-0.5	-0.8	-1.5	-0.6	-1.4	-1.5
Fiscal balance (% GDP)*	-0.1	0.1	0.0	-0.1	-2.3	-2.7	-2.3
Net public-sector debt/GDP	35.2	32.4	31.4	35.8	38.8	39.1	39.0
Net international reserves**	68.7	67.7	78.0	85.4	90.8	105.8	120.8

Source: International Monetary Fund. *The change in the series in 2009 is due to definitional and accounting changes.

**Billions of dollars. /e Estimated; /p Projected.

- 1.2 The international financial crisis of 2009 hit Mexico particularly hard, primarily because of its integration with the United States economy.¹ In addition, the terms of trade deteriorated during 2009 by slightly more than 11%, mostly owing to falling oil prices.² The combined effect of these factors was a 6.5% drop in real economic

¹ Close to 75% of Mexican exports go to the United States, which in turn is the main source of foreign tourists to the country and represents the principal source of family remittances (around 99%).

² The A/H1N1 influenza outbreak in the second quarter of 2009 also lowered the economic growth rate by 0.5% of GDP.

activity during 2009. Despite the severity with which the international crisis affected Mexico, the strengthened macroeconomic policy framework has made the country's economy more resilient to external shocks. In addition, the authorities designed a series of countercyclical policies in the monetary, exchange, fiscal, and social areas and these not only prevented a deeper retrenchment in real economic activity but also facilitated a relatively swift return to growth, which became evident in the second half of 2009.³

- 1.3 The free-float exchange regime, measures agreed by the Exchange Commission, and timely intervention by the Bank of Mexico to promote orderly financial market operation were successful in stemming the outflow of capital, while lower interest rates and the real adjustment of the exchange rate helped to soften the impact of falling aggregate external demand on the real sector of the economy. The financial authorities made more dollars available through such mechanisms as the US\$30 billion swap line arranged between the Bank of Mexico and the United States Federal Reserve Bank (announced on 29 October 2008 and activated for the first time in April 2009). In addition, Mexico was the first country to seek a Flexible Credit Line (FCL) from the International Monetary Fund (IMF), in the amount of US\$47 billion (approved on 17 April 2009 and renewed in March 2010). The authorities have not drawn on this line of credit, and it was renewed only as a precaution. The monetary and exchange policies adopted together with access to these facilities generated greater confidence among economic agents and allowed for a rapid restoration of financial stability.
- 1.4 Fiscal policy was the principal instrument used to counter the effects of the crisis on economic activity. This involved the application of countercyclical policies and the use of nonrecurring revenues, including accumulations in the federal government's Oil Revenue Stabilization Fund. Fiscal stimulus measures adopted between 2008 and 2009, amounting to 2.5% of GDP, included: (i) increased transfers to low-income families and communities; (ii) an increase in public investment to maintain growth and employment; and (iii) the injection of additional credit to maintain private investment and employment, channeled primarily through the State-owned development banking system, with priority to small and medium-sized enterprises.
- 1.5 The application of a vigorous countercyclical fiscal policy was made possible by the Federal Law on Budget and Fiscal Responsibility (LFPRH), which provided for running a budget deficit in exceptional economic and social conditions instead of the balanced budget required by that statute in normal times. The authorities intend to maintain a temporary, moderate fiscal deficit over the medium term until the economy returns to its potential growth rate, estimated to occur in 2012. In this context, the authorities' commitment is consistent with a return to balanced budgets

³ Among the countercyclical measures taken in the social sphere by the Mexican government in February 2009, special mention should be made of the National Agreement in Support of Households and Employment (ANAFEFE), along with the October 2008 Growth and Employment Program (PICE), the fiscal stimulus during 2009 is estimated at around 1.4% of GDP. See *Perspectivas Económicas para 2009 y el Acuerdo Nacional a Favor de la Economía Familiar y el Empleo*. SHCP, February 2009.

in 2012, as defined in the fiscal rule (this excludes gross fixed investment by PEMEX), with a declining deficit from 2010 until that date (Table 1.2).

Table 1.2. Fiscal accounts of the public sector 2005-2011 (% of GDP)

	2005	2006	2007	2008	2009	2010/e	2011/p
Tax revenue ^{/1}	8.6	9.0	9.3	10.0	9.4	10.4	10.7
Oil revenue	7.9	8.3	7.9	8.7	7.9	7.0	6.7
Primary expenditure	18.9	19.3	20.0	21.8	23.7	22.4	21.7
Traditional fiscal balance ^{/2}	-0.1	0.1	0.0	-0.1	-2.3	-2.7	-2.3
Fiscal balance for balanced-budget rule ^{/3}	—	—	0.0	-0.1	-0.2	-0.7	-0.3
Augmented fiscal balance ^{/4}	-1.4	-1.0	-1.4	-1.5	-4.7	-3.4	-3.0

Source: International Monetary Fund. ^{/1}Excludes excise tax on gasoline and social security contributions. ^{/2}The change in the series in 2009 is due to definitional and accounting changes. ^{/3}The LFPRH excludes gross fixed capital investments of PEMEX from consideration in evaluating the fiscal balance target. ^{/4}Public-Sector Borrowing Requirements excluding nonrecurring revenues. /e Estimated; /p Projected.

2. The fiscal trend

- 1.6 Between 2003 and 2008, public-sector revenues and expenditures rose significantly, primarily as a result of higher oil revenues, which accounted for around 36% of total public-sector revenues. During that time public-sector revenues rose by 2.5% of GDP while expenditure increased from 21.8% to 23.8% of GDP. The fiscal reform of 2007 (under which non-oil tax revenues of the federal government peaked at 10% of GDP in 2008) also contributed to this outcome. However, despite government efforts to boost non-oil revenues, the domestic tax burden in Mexico is still below that of countries at similar levels of development.⁴
- 1.7 In 2009 the public finances deteriorated sharply as a result of the international financial crisis and the collapse of oil production. Non-oil tax revenues were down by 11.5% in real terms, and oil revenues by 21.3%. Given public spending growth of 2.1% over 2008, as a result of countercyclical policies, the public deficit stood at 2.3% of GDP in 2009 (including PEMEX fixed investment). Toward the end of that year, in a bid to strengthen the sustainability of fiscal policy in the medium term given the drop in oil production and to promote financial sustainability, and with the first signs of domestic economic recovery, the authorities adopted a package of fiscal measures that, taken together, should produce an estimated increase of 1.3% of GDP in annual revenue intakes. These measures, combined with the recovery of economic growth, should lay the foundation for restoring budgetary balance in 2012, as planned by the government. It is important to note that, in addition to the measures taken at the end of 2009, the Mexican government has in recent years

⁴ Net tax revenues as a proportion of GDP in Latin America average around 16%. Economic Commission for Latin America and the Caribbean (ECLAC), *Economic Survey and Social Panorama of Latin America and the Caribbean*, various years.

accelerated the fiscal reform process in order to strengthen the sustainability of its public finances, ensure macroeconomic and financial stability, improve the quality and efficiency of expenditure, and bring greater transparency to the use of public resources. Accordingly, it is estimated that non-oil tax receipts will rise from 9% of GDP in 2006 to 12% in 2012.

- 1.8 The LFPRH, passed in 2006, made it mandatory to achieve a balanced budget in each fiscal year (barring exceptional circumstances) and created the Oil Revenue Stabilization Fund, which gives the federal government resources with which to manage fluctuations in the Mexican oil mix price relative to the figure set in the budget. In 2007 the Congress approved a fiscal reform that included the introduction of new taxes, while at the same time the government adopted tax administration measures involving inspection and audit, subsidy control, a taxpayer registry, and control of evasion risks. That reform also introduced results-based budgeting (RBB) based on the Performance Evaluation System (SED) and the General Law on Government Accounting (LGCG), intended to improve the quality of budgetary information and the control of public spending. In addition, the first steps were taken in 2007 to create the Single Treasury Account (CUT), with a view to improving control and efficiency in the use of public resources.
- 1.9 Despite the fiscal measures taken by the authorities in recent years, the decline in oil output in the past several years may create uncertainty about the sustainability of fiscal policy, and this could compromise the country's long-term economic growth and financial stability. In particular, the low rate of non-oil taxation remains a key problem in this context. The significant increase in oil prices between 2005 and 2008 in effect offset the drop in oil output, in terms of fiscal revenues. However, the country's public finances remain vulnerable and this is one of the issues to be addressed by the authorities with Bank support through this program.

B. Government commitment

- 1.10 The authorities are committed to the pursuit of the fiscal reforms initiated in 2006. In particular, in late 2009 the federal government adopted measures in response to two major structural problems facing the Mexican economy: (i) the decline in oil production and (ii) the low rate of non-oil taxation. The recent international crisis also revealed the need for a significant improvement in the fiscal rules in order to reduce even further the cyclical vulnerability of the public finances and increase the authorities' capacity to counter the impacts of negative shocks on public revenues.
- 1.11 The fiscal reform program approved by the government in late 2009 and early 2010 is a response to the challenges mentioned above. That program is intended to reduce the public deficit gradually until budgetary balance is restored in 2012. The operation proposed here is intended to support the Mexican government's efforts to: (i) strengthen the sustainability of fiscal policy; (ii) pursue a countercyclical policy to restore the economy to its potential growth rate; (iii) ensure macroeconomic and financial stability; (iv) improve the collection of non-oil revenues; and (v) make the use of public-sector resources more efficient and transparent.

C. Bank strategy with the country and the sector

- 1.12 This operation is consistent with the Bank's strategy with Mexico, which includes support for modernization of the State and strengthening the public finances at both the federal and subnational levels. The program is consistent with the operation for Strengthening States and Municipalities – Conditional Credit Line for Investment Projects (CCLIP, ME-X1002), which seeks to strengthen the capacity of subnational entities in terms of planning, fiscal management and investment within a framework of medium and long-term fiscal sustainability. It is also consistent with the Results-based Budgeting Program (2043/OC-ME) and technical cooperation activities under PRODEV (Program to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness) for implementing RBB in selected Mexican states.

D. Program objectives and structure

- 1.13 The objective of the program is to support Mexico's federal government in its efforts to consolidate medium-term fiscal sustainability, continue pursuing countercyclical policies to quicken the economic recovery, and make fiscal management more effective and efficient.
- 1.14 The Bank's financing for the program will be channeled through a programmatic loan to be executed in two operations involving policy reforms. Following approval of the loan and verification of compliance with the conditions established in the policy matrix attached as Annex II, the first operation will be disbursed in recognition of the countercyclical measures and steps taken to strengthen fiscal sustainability as well as the efforts to improve the quality and efficiency of fiscal and budgetary management. The measures adopted in these areas were approved in late 2009 and the first quarter of 2010, when the program was designed. The triggers for the second operation constitute essential milestones for the continuity of implementation of each of the program components at the end of 2010. Support for continuity of the aforementioned policies would be the pillars of the second program operation, which would be established in light of the targets, objectives and execution timetables proposed by the Mexican government. The actions supported by this operation also mark an important step in reducing the risks inherent in the current external environment.

E. Program components

Component I. Macroeconomic stability and revival of growth

- 1.15 **Subcomponent 1. Macroeconomic stability.** A general condition of disbursement under the program will be the maintaining of a stable macroeconomic policy consistent with the program's objectives and with the policies and measures set out in the country's sector policy letter.
- 1.16 **Subcomponent 2. Reviving growth.** This subcomponent will support the countercyclical fiscal policy for reviving the economy, through gradual restoration of budgetary balance in the public sector; this is to be achieved in 2012, when the

economy is expected to have returned to its potential output level. The recovery of economic activity also constitutes an important element for consolidating fiscal sustainability, as it will allow for an increase in non-oil fiscal revenues along with the progressive unwinding of the package of countercyclical measures introduced in 2008.

- 1.17 **Actions leading to the second operation.** The triggers for this subcomponent include: (i) reductions in the budget deficits of the federal government and federal entities under direct budgetary control, to achieve budgetary balance (not including PEMEX investment) in 2012; and (ii) sustained countercyclical policy through the use of nonrecurring revenue and a fiscal deficit of the federal government and federal entities under direct budgetary control not to exceed 0.7% of GDP in 2010, with an acceptable variance of +/-0.3% of GDP for unforeseen and estimation errors⁵ (not including PEMEX capital investment).
- 1.18 **Policies expected for the second operation.** Under subcomponent 1 the maintaining of stable macroeconomic and financial policy consistent with the program objectives will continue as a general disbursement condition. In subcomponent 2 the countercyclical fiscal policy will be moderated with a 2011 deficit lower than the one planned in 2010 and consistent with the objective of restoring budgetary balance in 2012.

Component II. Tax and customs policy and administration

- 1.19 **Subcomponent 1. Tax reform.** The objective of this component is to boost non-oil revenue intakes in order to reduce the fiscal vulnerability inherent in the current high dependence on oil revenues.⁶ During the current administration efforts have been made to consolidate the public finances by improving the collection of non-oil revenues. The 2007 tax reform includes: (i) approval of a broad-based, no-exemptions tax (the Single Rate Business Tax) supplementary to the Income Tax (ISR), and abolition of the Assets Tax; (ii) a new “special tax on products and services,” IEPS) on retail sales of gasoline and diesel, as a way to bolster the revenue intakes of the federal entities; this tax will not be levied in states that establish local taxes on gasoline and diesel sales; (iii) creation of a Cash Deposits Tax applicable to monthly deposit balances to control evasion and other unlawful activities; and (iv) a series of tax administration measures relating to audit and inspection, subsidies control and the taxpayer registry, which has better equipped the tax authorities to combat evasion.
- 1.20 In late 2009 the authorities adopted a set of tax measures to be approved in the 2010 federal budget and implemented in that year. These measures constitute the basis of

⁵ This percent variance is provided for in the Regulations under the Budget and Fiscal Responsibility Law.

⁶ For decades Mexico has recorded low non-oil tax revenues. Experience has shown its non-oil tax receipts to be very low: in the last 20 years non-oil revenues averaged just under 10% of GDP—a low proportion relative to countries at similar stages of development. In past years the problem of low non-oil revenue intakes has been offset by high oil revenues, which have contributed one third of public-sector revenues.

this subcomponent, and include: (i) a one percentage point increase in general and cross-border VAT rates over the 2009 rates; (ii) a two percentage point increase in the corporate income tax rate and in the upper marginal income tax rate for individuals—not affecting the first five brackets—with a phased return to the 2009 levels by 2014; (iii) an increase in the Cash Deposits Tax of at least 50% and a reduction in the nontaxable minimum of at least 40%; (iv) a permanent increase in the IEPS on tobacco and a temporary increase of IEPS on alcoholic beverages and beer; (v) a new telecommunications tax; (vi) a 10 percentage point increase in the IEPS on gaming and lotteries; and (vii) an adjustment in the domestic price of gasoline and diesel, increasing IEPS receipts from these products. The tax revenues this reform would produce, together with the anticipated yields of the tax modernization discussed below, could come to 1.3% of GDP.

- 1.21 **Subcomponent 2. Enhanced efficiency in tax and customs administration.** This subcomponent will support measures to improve tax and customs administration in order to reduce tax evasion. They include: (i) increasing the number of registered taxpayers by more than 10% with respect to December 2007; (ii) achieving a target of about 75% of tax returns e-filed; (iii) implementing the electronic portal for microenterprises; (iv) creating the Tax and Customs Intelligence Center (CITA) for analyzing and managing evasion risks; and (v) designing and pilot testing risk analysis processes⁷ in order to select taxpayers for audit.
- 1.22 **Actions leading to the second operation.** The tax component supports consolidation of progress and effective implementation of the tax reform measures approved in 2009, and bolstering of the audit and inspection capacity of the Tax Administration Service (SAT), including: (i) launching the CITA; (ii) submitting studies on evasion and SAT efficiency; and (iii) signing the Mexico-Guatemala bilateral agreement to establish joint control systems for international goods transit (TIM).
- 1.23 **Policies expected for the second operation.** Under subcomponent 1, steps will be taken to formalize and implement the requirement for resetting deferred income tax balances dating back more than five years for groups subject to tax consolidation. Subcomponent 2 would strengthen the SAT's compliance and evasion detection capacity through: (i) implementing electronic invoices for large taxpayers, at least; (ii) effective application of the risk models for audit selection provided for in the first tranche of this program, for large taxpayers in particular; (iii) introduction of direct collection of tax payments in financial institutions; and (iv) introduction of TIM controls at the major border crossings with Guatemala.

⁷ (i) VAT refund risk management model for small and medium-scale taxpayers (MODEVO) and VAT balance risk management model for large taxpayers (MORSA); (ii) Automated A Priori Customs Analysis System (SAAPA); and (iii) Foreign Trade Risk Analysis System (SARCE).

Component III. Fiscal rules and fiscal responsibility

- 1.24 **Subcomponent 1. Fiscal rules.** This subcomponent will support measures to better shield the public finances from oil price fluctuations. The 2006 LFPRH called for creation of the Oil Revenue Stabilization Fund, which institutes mechanisms for saving a portion of the difference between the international market price for the Mexican crude mix and the price established in the budget, along with other excess-revenue mechanisms.⁸ The purpose is to reduce the procyclicality of fiscal policy and its attendant macroeconomic and financial impacts. However, since that law placed a cap on the monies that could be accumulated, the countercyclical objective of the Fund was only partially achieved. Without this ceiling on savings in the Fund, the authorities would have had greater capacity to pursue countercyclical policies during the crisis. This subcomponent will support government efforts to eliminate that cap, which was waived for fiscal year 2010. The authorities plan to waive the ceilings for the 2011 draft budget as well, with the intention of ultimately removing them permanently in the LFPRH.
- 1.25 **Subcomponent 2. Fiscal risk management.** This subcomponent will back the expansion of the system for managing fiscal risks posed by natural disasters, as a fiscal responsibility policy. Its objective is to mitigate the fiscal impact of disaster-related damage to public infrastructure and the expenses of providing relief to victims living in extreme poverty. This will be accomplished by transferring risks to the insurance and capital market through the use of financial instruments (catastrophe bonds and insurance) without generating moral hazard incentives.⁹
- 1.26 **Actions leading to the second operation.** In the fiscal risk management subcomponent, the main trigger is to maintain, in the 2011 federal revenue and expenditure laws, the waiver of ceilings on the accumulation of savings in the operating rules of the Oil Revenue Stabilization Fund. This subcomponent includes: (i) the launch of studies to identify at-risk zones and assess the economic feasibility of expanding the program to include flood risk cover for public assets; (ii) identifying the resources needed to extend natural disaster risk coverage to infrastructure of the public highway system and the education sector, nationwide; and (iii) developing and defining a system for managing and transferring risk

⁸ The oil price set in the budget for each fiscal year under the LFPRH is to be a weighted average between the moving average of crude prices over the last 10 years, the futures price for the respective budget year (which is approved at the end of the previous year) and the average of futures prices for the following 3 to 5 years.

⁹ In 2006 Mexico began to implement this system through a combination of index-linked insurance and cat-bonds to protect public infrastructure in areas of high seismic risk. At the end of 2009 it renewed coverage against earthquakes and added the risk of hurricanes on both the Atlantic and Pacific coasts. By expanding the coverage and diversifying the types of risk the financial cost was reduced significantly, as no insurance policies were used but only cat-bonds. Issuing such bonds does not increase the public debt since, if none of the stipulated contingencies materializes, the money invested is returned to the investors. On the other hand, if one of those contingencies occurs, the government has funds available without the need to increase the debt, because the bonds are issued at the risk of the investors.

through index-linked insurance to protect the dwellings of extremely poor households in high-risk zones.

- 1.27 **Policies expected for the second operation.** Subcomponent 1 will support the Mexican government's effort to remove ceilings on savings accumulation in the Oil Revenue Stabilization Fund resulting from excess revenues during the fiscal year.
- 1.28 Subcomponent 2 will support the authorities' efforts to produce studies for estimating risks, valuing public assets, and determining the economic and fiscal feasibility of the financial vehicle to be used (cat-bonds or index-linked insurance) in order to: (i) bring more public infrastructure under protection against natural disaster risks and (ii) expand the types of disasters (flooding and landslides, in addition to earthquakes and hurricanes) to be included in the risk management system.

Component IV. Quality of fiscal and budgetary management

- 1.29 The objective of this component is to support the authorities' efforts to strengthen the reform process to improve the quality of fiscal management.¹⁰ The basic pillars in this policy area are: (i) harmonization of public accounting and (ii) creation of a Single Treasury Account for better control over the use of public funds.
- 1.30 **Subcomponent 1. Harmonizing accounting rules and budget recording.** The objective of this subcomponent is to support the creation and consolidation of a public accounting system that is uniform, reliable, relevant, timely, and transparent and will help measure the quality, efficiency, and effectiveness of the use of public funds. The creation and implementation of such a program throughout the public sector is an essential step for achieving the authorities' goal of improving the quality of fiscal management.
- 1.31 In 2008 the federal government enacted the General Law on Government Accounting (LGCG), which came into force on 1 January 2009. Its objective is to establish a uniform system of government accounting to facilitate the recording and tracking of public-sector assets, liabilities, revenues, and expenditures.¹¹ The most important features of the law are these: (i) introduction of accrual accounting at all levels of government to facilitate the recording and tracking of assets, liabilities, revenues, costs, and expenditures, to be completed in 2012; (ii) establishment of a technological platform for real-time data generation; (iii) inclusion of data based on program evaluation indicators and outcomes; and (iv) delivery of quarterly financial updates. To date, under the LGCG, the federal government has completed: (i) the conceptual framework for government accounting and its basic concepts; (ii) the

¹⁰ The most important reform that Mexico has adopted in recent years to improve the quality of fiscal management was introduction of results-based budgeting (RBB), based on the Performance Evaluation System (SED), which the Bank is supporting under loan 2043/OC-ME (Results-based Budget Program).

¹¹ The new law created a National Council for Accounting Harmonization (CONAC) comprising representatives of the federal, state and municipal governments, tasked with overseeing the law's implementation.

chart of accounts; (iii) harmonized budget classifiers; (iv) rules and procedures governing the timing of revenue and expenditure recording; (v) the structure and scope of the basic financial statements; and (vi) guidelines on the indicators used to measure physical and financial progress in the use of federal funds.¹²

- 1.32 **Subcomponent 2. Single Treasury Account (CUT).** The objective of this subcomponent is to strengthen the financial administration of federal funds by instituting a CUT that will: (i) reduce financial costs; (ii) optimize management of the cash balances of the Federal Treasury (TESOFE); and (iii) improve transparency and control over objects of expenditure.
- 1.33 The bulk of federal government revenues and expenditures are handled in a decentralized way through numerous bank accounts. Consequently, the TESOFE's control and monitoring of those flows is costly and complex.¹³ With the proliferation of accounts, the Treasury was unable to keep accurate and up-to-date information on them. Under the LFPRH, the federal government began work on a strategic plan for the TESOFE and a program to modernize and transform the agency, including the design of the CUT, implementation of which began in 2008.¹⁴ In 2009, the TESOFE produced and implemented guidelines regulating the CUT and the registry of bank accounts under this modality. Through this subcomponent, the Bank will support implementation of the CUT so as to make it easier to monitor and control public expenditure, avoid idle balances in the accounts of government agencies, minimize financial costs and public borrowing requirements, foster the use of electronic payment, and bring greater transparency to the public finances.
- 1.34 **Actions leading to the second operation.** Under subcomponent 1, the triggers are execution of the timetable for implementing the harmonized accounting system, including the program for issuing new accounting rules for the federal, state and municipal governments, to include at least: (i) the expenditure item classifier, by type of expenditure and source of financing; (ii) the public accounting manual; (iii) asset recording and valuation rules; and (iv) guidelines for measuring physical and financial progress in the use of federal funds. Under subcomponent 2 the triggers are: (i) replacing the "reciprocity" system with fixed fees to compensate the banks for their tax collection services; (ii) the system for paying federal employees directly through the TESOFE; (iii) consolidation of federal revenues in the CUT (50% of the federal revenue budget); and (iv) automation of federal funds

¹² The technical cooperation with the states under PRODEV (paragraph 1.14 of the Bank's strategy with Mexico) includes support for the accounting harmonization program called for in the LGCG.

¹³ Prior to establishment of the CUT, tax payments and other federal revenues were deposited in numerous bank accounts in 18 commercial banks; these were then transferred to the TESOFE account in the Bank of Mexico, a process that took on average three days. Subsequently, these funds were transferred to the numerous accounts of the various agencies and entities.

¹⁴ The CUT was established by decree of 1 October 2007 amending, adding and repealing various provisions of the Federal Law on Budget and Fiscal Responsibility; the Federal Public Administration Act; the Fiscal Coordination Law; the Law on Public Sector Procurement, Leasing and Services; and the Law on Public Works and Related Services.

accounting through establishment of the Integrated Federal Funds Accounting System (SICOFFE).

- 1.35 **Policies expected for the second operation.** For subcomponent 1 the Finance Ministry authorities intend to design and publish: (i) the lists of accounts aligned with the chart of accounts and the harmonized budget classifiers; (ii) the catalogs of goods and the respective conversion matrices; (iii) rules and procedures to determine revenue and expenditure recording timing; (iv) indicators for measuring physical and financial progress; and (v) periodic publication of accounting and budget reports under the administrative, economic and functional-programmatic classifications. With respect to subcomponent 2, TESOFE will draft the Treasury Service Law and its regulations, to include at least: (i) guidelines for use of the CUT system throughout the central government; (ii) redefinition of the TESOFE's auxiliary entities; (iii) adaptation of federal funds accounting to LCGC provisions; (iv) changes to the Federal Treasury Reimbursements Guarantee Fund (FOGAREF); (v) redefinition of the functions of cash and securities surveillance; and (vi) redefinition of the TESOFE functions in the administration of assets transferred by the SAT.

F. Principal outcomes and indicators

- 1.36 Disbursements of the loan funds under the program's first operation will be subject to fulfillment of the conditions established in the Policy Matrix (Annex II of this document). The expected outcomes of the planned program activities are indicated in the Results Matrix (see electronic link). These outcomes include: (i) contribution to stable and sustained growth within a framework of macroeconomic equilibrium; (ii) higher tax revenues through adjustments to the principal taxes; (iii) protection for the public finances against oil price fluctuations and damage to public infrastructure from natural disasters; and (iv) better financial administration of federal funds.
- 1.37 The main indicators detailed by component in the Policy Matrix ([see electronic link](#)) for measuring these outcomes are: (i) a revenue increase of 1.3% of GDP as a result of the tax correction calculated in terms of full application of the measures included in a year's yield; (ii) continuation of the no-cap resource accumulation provision for the Oil Revenue Stabilization Fund in the Federal Revenue Law; (iii) expanded coverage for public assets against natural disaster risks, through the issuance of new cat-bonds; (iv) establishment of a public accounting system that is uniform, reliable, relevant, timely, and transparent; and (v) more efficient financial administration of federal funds through implementation of a CUT that will reduce financial costs, optimize the management of treasury balances, and provide greater transparency and control over expenditures.

II. FINANCIAL STRUCTURE AND MAIN RISKS

A. Financial instrument

- 2.1 The total amount of financing is US\$1 billion, to be disbursed in a single tranche, using resources of the Ordinary Capital Single Currency Facility, with the Local Currency Facility (LCF) option.¹⁵ The second operation would be carried out in 2011 and the amount would be decided with the authorities, on the basis of the outcomes of the current fiscal year and the Bank's programming with Mexico.

B. Coordination with other lending and cooperation agencies

- 2.2 This program is part of the Mexican government's comprehensive strategy to reinforce the country's macroeconomic stability and continue the process of fiscal strengthening with the support of multilateral agencies. The Program to Support the Consolidation of Fiscal Sustainability is consistent with the recommendations of the March 2010 IMF Article IV consultation and complements the World Bank's US\$1.504 billion development policy loan approved in October 2009 in recognition of the economic policies adopted to mitigate the impact of the global crisis and strengthen the medium-term policy framework for sustainable economic recovery.

C. Social and environmental risks

- 2.3 According to Directive B.13 of the Bank's Environment and Safeguards Compliance Policy (GN-2208-20 and OP-703) this program, which involves a sector policy loan, does not require an ex-ante environmental impact classification. Moreover, the policy changes considered in this operation will have no direct or significant impact on the environment or on the country's natural resources.

D. Other key issues and risks

- 2.4 The main risks to this operation, examined jointly with the national authorities, are the following: (i) lack of political consensus for carrying out some of the reforms that Mexico would have to adopt in order to strengthen the sustainability of fiscal policy, such as reducing tax evasion and increasing fiscal revenue intakes, particularly VAT and income tax receipts; (ii) lower-than-expected economic growth and the attendant need for greater-than-planned fiscal restraint in order to restore budgetary balance in 2012; and (iii) the possibility of further declines in oil production, even though output began to stabilize in mid-2009.
- 2.5 The reforms adopted in 2006, 2007, and 2009 demonstrate the government's intention to maintain the required course of action. It is significant that those reforms required legislative approval and even a constitutional amendment in 2006. There is broad consensus in Mexico on the need to pursue the reform effort to counter the decline in oil production and to consolidate fiscal sustainability. Moreover, the government is implementing the approved legislative and executive reforms with highly trained professional teams. To mitigate this risk even further,

¹⁵ Document GN-2365-6.

the triggers for the second operation include the implementation programs defined by the authorities themselves with technical assistance from the Bank.

- 2.6 An element that does much to reduce some of the risks mentioned is that, during the first half of 2010, economic growth has exceeded government estimates, and oil production began to stabilize in mid-2009. If these trends continue, Mexico could return to its potential growth rate faster than expected and could restore budgetary balance before the target date. Moreover, the fiscal rule established in the LFPRH excludes the PEMEX capital investment program in order to leave more fiscal room for investment in the oil industry. All of these measures are intended to stabilize oil production. Finally, the government pushed for a reform of PEMEX in 2008, approved by the Mexican Congress, giving that agency greater management, technical, and operational autonomy in order to improve its governance and its investment and project execution capacity so as to maintain or increase output.
- 2.7 In order to assess fiscal sustainability, the Bank prepared a public debt sustainability analysis which included not only the traditional factors that determine debt growth dynamics but also the potential impacts of a major drop in crude prices and oil production. The findings show that: (i) public debt as a proportion of GDP would remain within a manageable range even under extreme scenarios; and (ii) the countercyclical policies designed to restore the economy to its potential growth rate are in themselves an important component of economic policy for consolidating fiscal sustainability. However, these findings are not an argument for downplaying the need to continue with the fiscal reform efforts mentioned. On the contrary, the analysis makes it clear that in order to reduce the fiscal vulnerability of the Mexican economy it is essential to continue broadening the tax base and improve non-oil revenue collection ([see electronic link](#)).

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

- 3.1 The borrower will be the United Mexican States. The executing agency will be the Mexican Ministry of Finance (SHCP), which will have the following responsibilities: (i) provide the Bank with reports and evidence that the loan disbursement conditions have been met, and such other reports as the Bank may request; (ii) promote actions to achieve the policy objectives defined in the program; and (iii) compile, keep on record, and deliver to the Bank all the information, indicators and parameters that will assist Mexico and the Bank in monitoring and evaluating the program outcomes. Banco del Ahorro Nacional y Servicios, S.N.C. (BANSEFI) will be the borrower's fiscal agent.

B. Summary of agreements for monitoring results

- 3.2 The Bank, in coordination with the borrower, will present a Project Completion Report (PCR) within six months after the conditions have been fulfilled for the disbursement and the final disbursement of the second operation. That report will

assess the program's impact and the achievement of its expected outcomes. The borrower and the Bank have agreed on the indicators and baselines for conducting that final evaluation.

- 3.3 The borrower will compile and process all the data necessary for monitoring and evaluation of the operation. Consulting services to verify the indicators included in the Results Matrix ([see electronic link](#)) and the activities included in the Policy Matrix ([Annex II](#)) will be financed from the Bank's administrative funds.

IV. POLICY LETTER

- 4.1 The Bank and the Mexican government have agreed on the macroeconomic and sector policies included in the Policy Letter. That letter describes the main components of the strategy that the government is pursuing in the program areas described in this document, and reaffirms the government's commitment to carry out the reforms and activities of the agreed program.

**Development Effectiveness Matrix
Summary**

Indicator	Score	Maximum Score
<i>I. Strategic Relevance</i>	Low-High	
1. IDB Strategic Development Objectives	0.7	10
Country Diversification	0.7	2
Corporate Initiatives	0.0	2.5
Harmonization and Alignment	0.0	3.5
Beneficiary Target Population	0.0	2
2. Country Strategy Development Objectives	7.8	10
Country Strategy Sector Diagnosis	5.4	6
Country Strategy sector objective & indicator	2.4	4
<i>II. Development Outcomes - Evaluability</i>	Highly Satisfactory	
3. Evidence-based Assessment & Solution	9.3	10
4. Evaluation & Monitoring Plan	4.8	10
5. Cost-Benefit or Cost-Effectiveness	7.0	10
6. Risks & Mitigation Monitoring Matrix	7.5	10
<i>III. IDB's Role - Additionality</i>		
7. Additionality	7.0	10
Technical Assistance provided prior the project	3.0	3
Improvements in management of financial, procurement, monitoring or statistics internal controls	4.0	4
Improvements in environmental, health and labor performance	0.0	3

I. Strategic Relevance: The project is part of a policy based programmatic loan (PBP). It is the first loan of a series of two. Mexico is an A country. The program is part of the Bank's interventions in the area of Public Finance, which was added as a sector in the update of the country strategy in May of 2010. The CS update and the CPD do not provide a results indicator for the sector. There is no evidence of use of country systems.

II. Evaluability: The program has a detailed results matrix with outcome indicators for the policy reforms in the revenue area. The fiscal risk and management capacity components have output indicators. The vertical logic is clear. The project has an economic analysis for the macroeconomic stability and tax administration and policy components which leads to an increase in the PIB of 1.37% after one year of implementation of all the reforms. The triggers for the second operation are clearly spelled out. The team has budgeted resources for a consultancy to undertake a reflexive evaluation and verify the triggers of the second operation.

III. Additionality: Through PRODEV the Bank has supported the development of improved capacity for revenue collection and resource administration at the subnational level, as a way to reduce the dependency of these levels of government on resources from the central government. In addition, this PBL supports the implementation of processes and systems developed in the area of expenditure management with loan 2043/OC-ME. This program will improve the financial management of the central government supporting the implementation of a single treasury account, among others.

Policy Matrix and Expected Actions

Problem and Objectives		Operation I	Operation II	
			Interim actions ¹	Expected policies
Policy area I: Macroeconomic Stability and Reactivation of Growth				
Subcomponent I. Macroeconomic stability				
The reduction in oil production raises uncertainty about the medium-term strength and sustainability of fiscal policy, and this could compromise growth.	Strengthen the sustainability of fiscal policy, guarantee financial and macroeconomic stability, and make more efficient and transparent use of public sector resources, with emphasis on the quality of fiscal and budgetary management and the efficiency of tax administration.	Maintain an appropriate policy framework consistent with program objectives, through measures to strengthen public finances and maintain a stable macroeconomic and financial environment. <i>Means of verification:</i> <ul style="list-style-type: none">▪ Macroeconomic indicators for 2009 and the first half of 2010.▪ Independent Macroeconomic Assessment (IMA) by the Bank and IMF Article IV report (2010).	At least, maintain the level of the consolidated primary deficit of the federal government and federal government entities under direct budgetary control as a proportion of GDP, in the draft 2011 revenue and expenditure budgets to be submitted to Congress.	Maintain an appropriate policy framework consistent with program objectives, through measures to strengthen national public finances.

¹ Intermediate actions are milestones or triggers for moving on to the second operation. The expected policies are policy actions that would be reviewed and agreed on once the intermediate actions are completed (document CS-3633).

Problem and Objectives		Operation I	Operation II	
			Interim actions ¹	Expected policies
Subcomponent II. Reactivation of growth				
The international financial crisis sparked a severe economic contraction that not only depressed employment and real incomes but also resulted in a drop in non-oil revenues, exerting pressure on public finances.	Sustain the fiscal stimulus and apply a countercyclical policy that will support a revival of economic activity and allow for a gradual restoration of budgetary balance in the public sector, consistent with the Federal Budget and Fiscal Responsibility Act (LFPRH).	<p>Implement a countercyclical stimulus policy through use of nonrecurring revenues and maintain a public deficit sustainable over the medium term, pursuant to article 17 of the LFPRH, and consistent with restoring budgetary balance in 2012 when GDP will have returned to its medium-term potential growth rate.</p> <p><i>Means of verification:</i></p> <ul style="list-style-type: none">▪ Evidence that the 2009 deficit of the federal government and federal government entities under direct budgetary control is not greater than 0.2% of GDP.▪ Independent Macroeconomic Assessment (IMA) by the Bank and IMF Article IV report (2010).	Maintain a countercyclical policy, with the deficit of the federal government and federal government entities under direct budgetary control not exceeding 0.7% of GDP in 2010 ² , with an acceptable deviation of +/-0.3% of GDP, and a reduction in the deficit proposed in the 2011 revenue and expenditure budgets to be presented to Congress, consistent with restoring budgetary balance in 2012.	Maintain a countercyclical fiscal policy through use of nonrecurring revenues and a fiscal deficit sustainable over the medium term, pursuant to article 17 of the LFPRH, and consistent with restoring budgetary balance in 2012.
Policy Area II: Tax and Customs Policy and Administration				
Subcomponent I. Tax reform				
High dependency on oil revenues generates economic and fiscal vulnerability.	Increase non-oil revenues to reduce fiscal vulnerability resulting from high dependence on oil revenue.	<p>The following steps have been taken to improve the collection of non-oil revenues:</p> <p>1. One percentage point increase in the general and border VAT rates over the 2009 rate.</p>	Implement the legislation containing tax measures approved for fiscal year 2010 and published in the <i>Diario Oficial</i> .	Continue to implement the tax measures approved for fiscal 2010.

² Excluding physical investment by PEMEX.

Problem and Objectives		Operation I	Operation II	
			Interim actions ¹	Expected policies
		<p>2. Temporary two percentage point increase in the corporate income tax rate and in the top personal income tax marginal rate (leaving untouched the first five brackets), to be restored in stages to 2009 levels by 2014.</p> <p>3. Increase of at least 50% in the Cash Deposits Tax rate and reduction of at least 40% in the nontaxable minimum balance.</p> <p>4. A permanent increase in the tobacco excise tax, temporary increase in the alcoholic beverages and beer excise tax, and creation of a new selective tax on telecommunications.</p> <p>5. 10% increase in the excise tax on gambling and lotteries.</p> <p>6. Adjustment to the domestic price of gasoline and diesel oil in order to augment public revenue from these items.</p> <p>Means of verification</p> <ul style="list-style-type: none"> ▪ Publication in the <i>Diario Oficial de la Federación</i> of the 2010 federal revenue budget, to include measures 1 to 5. ▪ Executive Decree ordering publication of reforms, additions, and deletions to provisions of the Federal Income Tax Act, the Cash Deposits Tax Act, the Value Added Tax Act, the Federal Fiscal Code, and the Decree establishing the obligations that may be denominated in Investment Units and amending provisions of the Federal Fiscal Code and the Income Tax Act. <i>Diario Oficial de la Federación</i>. ▪ Decree to amend the Special Goods and Services Tax Act. <i>Diario Oficial</i>. ▪ The 2010 Federal Revenue Act. <i>Diario Oficial</i>. ▪ Report to the Bank on gasoline and diesel prices and adjustments between the second half of 2008 and the first half of 2010. 		

Problem and Objectives		Operation I	Operation II	
			Interim actions ¹	Expected policies
Subcomponent II. Enhancing the efficiency of tax and customs administration				
Shortcomings in tax administration, including weaknesses in the supervision of large taxpayers and considerable levels of evasion, particularly for VAT and income tax.	Improve tax and customs administration and step up efforts to reduce evasion.	<ol style="list-style-type: none">1. Increase by more than 10% the number of registered taxpayers (base: December 2007).2. Ensure that at least 90% of tax returns are filed via Internet.3. Implement the electronic portal for micro-enterprises.4. Create the Tax and Customs Intelligence Center (CITA) for analysis and management of evasion risks, operational risks, and national security risks.5. Design a pilot test for the risk analysis processes for selecting taxpayers for audit, using objective criteria: (i) VAT refund risk management model for small and medium-scale taxpayers (MODEVO); (ii) VAT balance risk management models for large taxpayers (MORSA); (iii) an Automated a Priori Customs Analysis System (SAAPA); and (iv) a Foreign Trade Risk Analysis System (SARCE). <p>Means of verification:</p> <ul style="list-style-type: none">▪ Independent consultant report showing that actions 1 to 5 are being applied.	<p>Strengthen the evasion detection and audit capacity of the SAT:</p> <ol style="list-style-type: none">1. Implement the CITA.2. Present studies on evasion and SAT efficiency.3. Sign the Mexico-Guatemala bilateral agreement to establish joint operational control systems for international goods transit (TIM).	<ol style="list-style-type: none">1. Implement electronic invoicing for large taxpayers at least.2. Conclude the development stage of the risk models for selecting taxpayers for audit mentioned in item 5 of section 1 of this component and for large taxpayers, relating to transfer pricing, consolidations, government sector, and financial sector.3. Implement direct collection of tax debts in financial institutions.4. Apply the TIMs³ systems at the main border crossings with Guatemala, including the bilateral agreement for establishing joint operational control systems.

³ Pursuant to the agreement signed by Belize, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua and Panama on 1 December 2005 in Guatemala City at the conclusion of the Second Mesoamerican Workshop of Experts on International Goods Transit and Computer Specialists in the Context of the Customs and Border Crossings Modernization Projects. The agreements are available at www.tim.sieca.org.gt.

Problem and Objectives		Operation I	Operation II	
			Interim actions ¹	Expected policies
Policy Area III: Fiscal Rules and Fiscal Responsibility Subcomponent I. Fiscal rules				
The adjustment mechanisms for the oil revenue stabilization funds stipulated in the LFPRH must be boosted to mitigate the impacts of oil price fluctuations on public finances.	Eliminate the caps on the savings from the oil price stabilization funds to better protect public finances against oil price fluctuations.	In the 2010 budget exercise, eliminate in the federal revenue budget the caps on savings in the oil revenue stabilization fund. Means of verification: <ul style="list-style-type: none">Federal revenue budget for fiscal year 2010.	In the 2011 budget exercise, maintain in the federal revenue budget the waiver on caps on savings accruing during the year in the oil revenue stabilization funds.	Eliminate the caps on savings in the oil revenue stabilization fund based on surplus revenue accruing during each budget year.
Subcomponent II. Managing fiscal risks				
The fiscal risk posed by natural disasters is high. Such events can cause significant material losses to the public sector through: (i) the costs of replacing public infrastructure; (ii) heavy expenditures for victim relief; and (iii) disruptions in the public sector's management and operating capacity for delivering public goods and services.	Develop a system for managing fiscal risks generated by natural disasters so as to reduce the likelihood of fiscal losses from damage to and replacement of public infrastructure and the expenses of victim relief, by diversifying and transferring risks to the market through the use of financial instruments, without generating distortions caused by moral hazard.	1. Continue and expand the system for managing fiscal risks through the use of financial instruments (catastrophe bonds and index-linked insurance) so as to diversify and transfer to the insurance and capital markets the fiscal risks caused by natural disasters (earthquakes and hurricanes, initially) so as to reduce the potential material losses from damage to public infrastructure and the expenses of victim relief, without generating moral hazard. Means of verification: <ul style="list-style-type: none">Report to the Bank certifying that the action described in item 1 has been taken.Evidence that the 2009 MultiCat Catastrophe Bond has been placed.	1. Undertake a feasibility study for incorporating index-linked insurance for flood risks. 2. Work out the details for expanding risk management relating to public highway infrastructure and the education sector. 3. Develop a risk administration and transfer system based on index-linked insurance to protect the dwellings of extremely poor households in high-risk zones.	1. Prepare studies on risk assessment, fiscal feasibility and financial modalities (cat-bonds or index-linked insurance) for expanding: (i) the scope of public infrastructure to be protected, (ii) the range of risks caused by natural disasters (flooding, landslides, earthquakes and hurricanes). 2. Expand the use of financial instruments (cat-bonds and index-linked insurance) to protect a greater proportion of public assets.
Policy Area IV: Quality of Fiscal and Budgetary Management Subcomponent I. Harmonization of accounting rules and budget records				
The presentation of the public accounts of the three levels of government in	Establish a public accounting system that is uniform, reliable, relevant,	Approve a plan and schedule for APF implementation of the actions established under the General Law on Government Accounting	Present evidence of progress with the timetable for implementing the harmonized	Continue implementation of the accounting system in the federal and state

Problem and Objectives		Operation I	Operation II	
			Interim actions ¹	Expected policies
Mexico is not uniform and does not follow the same accounting rules. This impedes the analysis of budgetary execution, undermines transparency and accountability, and makes it difficult to measure and assess the quality and efficiency of public expenditure.	timely, and transparent.	<p>(LGCG), including at least:</p> <ol style="list-style-type: none"> (1) An implementation schedule for implementing a harmonized accounting system in no more than three years (2012). (2) Establishment of a National Council on Accounting Harmonization (CONACO), to coordinate and implement the new public accounting system. <p>Means of verification:</p> <ul style="list-style-type: none"> ▪ Evidence that a schedule has been approved for implementing the harmonized accounting system within three years (2010-2012). ▪ Evidence that CONACO has been created, as published in the <i>Diario Oficial de la Federación</i>. 	accounting system, including the program for issuing new accounting rules for the federal, state, and municipal public administrations.	<p>governments:</p> <ol style="list-style-type: none"> (a) Lists of accounts aligned with the chart of accounts. (b) Harmonized budget classifiers. (c) Catalogs of goods and their respective conversion matrices. (d) Rules and procedures to determine the time for recording revenues and expenditures. (e) Indicators for measuring physical and financial progress in the use of federal funds. (f) Publish periodic accounting and budgetary information under the administrative, economic, and functional-programmatic classifications.

Problem and Objectives		Operation I	Operation II	
			Interim actions ¹	Expected policies
Subcomponent II. Single Treasury Account				
The bulk of federal revenues and expenditures are handled in a decentralized way through numerous bank accounts. Consequently, the control and monitoring of those flows is costly, inefficient, complex, and nontransparent.	Make the financial administration of federal funds more efficient by instituting a Single Treasury Account (CUT) that will reduce financing costs, optimize the handling of cash balances, and establish greater transparency in and control over expenditure.	<p>Approve the draft law establishing the CUT system, to include at least:</p> <p>(1) General provisions and the CUT system.</p> <p>(2) Accounts authorized by exception, including: a) the procedure for opening new accounts and; b) changes to those accounts.</p> <p>(3) Provisions for the receipt, payment, and administration of funds</p> <p>(4) Description of the public trusts not considered (parastatal entities, mandates and similar contracts).</p> <p>Means of verification:</p> <ul style="list-style-type: none">▪ Executive Decree published in the Diario Oficial ordering publication of the reforms or deletions to the Federal Financial Responsibility and Budget Act, the Federal Public Administration Act, the Public Sector Procurement, Leasing, and Services Act, and the Public Works and Services Act establishing the CUT system, and including actions t to 4.▪ Guidelines designed to regulate the Treasury Master Account System and to establish significant exceptions. Diario Oficial.	<p>Present evidence of action relating to:</p> <p>(1) replacing the "reciprocity" system with fixed fees to compensate the banks for their tax collection services.</p> <p>(2) the system for paying federal employees directly through the TESOFE to their bank accounts (covering 50% of Central AFP employees).</p> <p>(3) consolidation of federal revenues in the CUT (50% of the federal revenue budget);</p> <p>(4) automation of federal funds accounting (establishment of the Integrated Federal Funds Accounting System (SICOFFE)).</p>	<p>Prepare a new Treasury Service Act and its regulations, to include at least:</p> <p>(1) The CUT system.</p> <p>(2) Redefinition of TESOFE auxiliaries.</p> <p>(3) Adaptation of federal funds accounting to the new government accounting act.</p> <p>(4) Amendments to the Treasury Reimbursements Guarantee Fund (FOGAREF).</p> <p>(5) Redefinition of the functions of cash and securities surveillance.</p> <p>(6) Redefinition of the TESOFE functions in the administration of movable and immovable assets transferred by the SAT.</p>