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MEXICO

PROGRAM TO TO STRENGTHEN FISCAL MANAGEMENT IN FEDERATIVE ENTITIES AND MUNICIPIOS

(ME-L1253)

LOAN PROPOSAL

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ABBREVIATIONS

ASF	Auditoría Superior de la Federación [Federal Supreme Audit Office]
CHC	China Cofinancing Fund for Latin America and the Caribbean
CNBV	Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission]
CONAC	Consejo Nacional de Armonización Contable [National Accounting Standards Board]
IMF	International Monetary Fund
INDETEC	Instituto para el Desarrollo Técnico de las Haciendas Públicas [Institute for the Technical Development of Public Financial Administrations]
LCF	Ley de Coordinación Fiscal [Fiscal Coordination Law]
LDF	Ley de Disciplina Financiera [Financial Discipline Law]
LGCG	Ley General de Contabilidad Gubernamental [General Government Accounting Law]
LGDP	Ley General de Deuda Pública [General Public Debt Law]
LIBOR	London Interbank Offered Rate
NAFIN	Nacional Financiera Sociedad Nacional de Crédito, Institución de Banca de Desarrollo
PBL	Policy-based loan
PBP	Programmatic policy-based loans
PES	Performance evaluation system
PRODEV	Program to Implement the External Pillar of the Medium-term Action Plan for Development Effectiveness
RBB	Results-based budget
ROEEM	Registro de Obligaciones y Empréstitos de Entidades y Municipios [Registry of Federative Entity and Municipal Obligations and Borrowings]
RPU	Registro Público Único [Single Public Registry]
SHCP	Department of Finance and Public Credit
UCEF	Unidad de Coordinación con Entidades Federativas [Unit for Coordination with Federative Entities]

PROJECT SUMMARY

MEXICO
PROGRAM TO STRENGTHEN FISCAL MANAGEMENT IN FEDERATIVE ENTITIES AND MUNICIPIOS
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Financial Terms and Conditions

Borrower: United Mexican States			
Executing agency: Secretaría de Hacienda y Crédito Público [Department of Finance and Public Credit] (SHCP)			
Source	**Amount (US$)**	**%**	
IDB (Ordinary Capital)	612,400,000	94	
China Cofinancing Fund for Latin America and the Caribbean (CHC) [c]	37,600,000	6	
Total	650,000,000	100	

Flexible Financing Facility[a]	
Amortization period:	Bullet payment 12.75 years after signature
Original WAL:	12.75 years
Disbursement period:	12 months
Grace period:	Bullet payment 12.75 years after signature
Inspection and supervision fee:	[b]
Interest rate:	LIBOR-based
Credit fee:	[b]
Approval currency:	U.S. dollars charged to the Ordinary Capital and the CHC

Project at a Glance

Project objective/description:

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

This operation is the first in a programmatic policy-based loan (PBP) series, to be comprised of two contractually independent, but technically linked loans.

Special contractual clauses precedent to the first and only disbursement:

Special contractual conditions precedent to the first and only disbursement of the loan for the first operation in the series will be: (i) a signed trust agreement between the borrower and Nacional Financiera, Sociedad Nacional de Crédito, Institución de Banca de Desarrollo, as the financial agent; and (ii) compliance with the policy reform conditions set forth in the Policy Matrix (Annex II), as well as other conditions established in the corresponding loan contract (see paragraph 3.4).

Exceptions to Bank policies: None.

Strategic Alignment

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

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

[b] The credit fee and the 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 applicable policies.

[c] This loan segment will be governed by the provisions of document GN-2686-4. The terms and conditions for this loan segment will be the same as those for the loan segment using the Bank's Ordinary Capital, including the applicable provisions of the Flexible Financing Facility.

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

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

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1. Recent economic performance

1.1 In recent years, the Mexican economy, despite facing an unfavorable external environment, has grown at a moderate pace, expanding at an average rate of 2.1% between 2013 and 2016. This moderate growth is expected to continue in 2017 and 2018, with median growth rate projections of 1.6% and 2.2%, respectively.[1] Nonetheless, the projections face uncertainty today as the result of possible changes in the bilateral relationship between Mexico and the United States.

1.2 On the financial front, increased volatility on the international markets is not expected to entail significant risks for the sustainability of Mexico's financial system. A recent stress analysis by the International Monetary Fund (IMF) indicates that the financial system is resistant to various combinations of external shocks.[2] In addition, despite nominal depreciation of the peso by 19.5% in 2016, annual inflation was 3.4% and inflation expectations are contained.[3]

1.3 On the fiscal front, as a result of deficits in recent years[4] in addition to moderate GDP growth, the debt-to-GDP ratio at the end of 2016 was nearly three percentage points higher than at the end of 2012. To contain growth of the debt, the federal government has announced various measures to control public spending[5] and has presented fiscal consolidation targets intended to stabilize the expanded measure of the fiscal deficit at 2.5% of GDP as from 2018 and reduce the debt-to-GDP ratio.[6] This spending control will entail reduced growth in transfers specifically to the federative entities (that is, the states and federal district) and municipios. Moreover, revenue transfers (*participaciones*) are expected to continue growing at a high rate, as a result of expected growth in the collection of non-petroleum tax revenues. These revenues have been growing at a rapid rate, partially as a result of the fiscal reform of late 2013 and improvements in tax administration.[7]

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1 *Encuesta sobre las expectativas de los especialistas en economía del sector privado* [Survey of expectations of private sector economists], Bank of Mexico, March 2016.

2 Mexico. Financial System Stability Assessment. IMF Country Report No. 16/361. May 2016.

3 The Bank of Mexico's survey of expectations mentioned above puts median expected inflation for 2017 and 2018 at 5.4% and 3.8%, respectively. Increased inflation expected in 2017 is primarily due to the increase in gas prices, as a result of the liberalization of prices in that market.

4 In the last five years, public sector financial requirements represented, on average, 3.8% of GDP.

5 In early 2016, the federal government announced a preventive adjustment in public spending for 2016 equivalent to 0.7% of GDP. In mid-2016 it announced a new cut of 0.17% of GDP. In addition, the Federal Expenditure Budget for 2017 approved by the Congress includes a real reduction in public spending of 0.4% compared to the budget approved for 2016 and the first primary surplus in nine years (0.4% of GDP).

6 The deficit targets presented and the assumptions made by the Department of Finance and Public Credit (SHCP) regarding GDP growth indicate that the amount of the debt as a percentage of GDP would begin to fall starting in 2017, reaching 47.7% in 2022.

7 The tax reform and improvements in tax administration had technical support from the Bank, through a programmatic policy-based loan series (see Public Finance Strengthening Programs I and II, loans 3201/OC-ME and 3676/OC-ME).

Table 1. Selected Economic Indicators

	2011	2012	2013	2014	2015	2016
Real GDP growth (% change)	4.0	4.0	1.4	2.2	2.5	2.3
Unemployment (% economically active population)	5.2	4.9	4.9	4.8	4.3	3.9
Inflation (end of period and as a %)	3.8	3.6	4.0	4.1	2.1	3.4
Non-petroleum revenues (% of GDP) [a]	13.9	13.6	15.3	16.0	18.9	20.2
Petroleum revenues (% of GDP) [a]	8.6	8.9	8.4	7.1	4.7	4.2
Total expenditure (% of GDP) [a]	25.0	25.1	26.0	26.3	27.0	27.2
Primary expenditure (% of GDP) [a]	23.1	23.1	24.0	24.3	24.7	24.6
Public sector fiscal deficit [a,b] (% of GDP)	3.4	3.8	3.7	4.6	4.1	3.0
Public sector debt [a,c] (% of GDP)	37.5	37.7	40.4	43.2	47.6	50.5

Source: National Institute of Statistics and Geography, Bank of Mexico, and SHCP.

[a] Refers to the federal public sector.

[b] Refers to Public Sector Financial Requirements.

[c] Refers to the historical balance of the Public Sector Financial Requirements, which represents the broad definition of public debt.

2. Mexico's fiscal federalism and the public finances of federative entities and municipios

1.4 **Fiscal federalism in Mexico**. Mexico is a federal republic consisting of 32 federative entities (31 states and Mexico City). The Political Constitution of the United Mexican States (the "Constitution") establishes that the states are free and sovereign in all matters related to their internal regime. The states have the power to govern themselves according to their own laws and have their own constitutions, which may not contradict the Constitution. The states are divided administratively and politically into municipios. There are 2,442 municipios in Mexico.

1.5 In order to make tax collection and public spending more efficient, the federative entities have signed agreements with the federal government to coordinate in the area of taxes. In those agreements, all the federative entities agreed not to collect specific taxes and duties in their jurisdictions, delegating their collection exclusively to the federal government. The federal government currently has exclusive power to collect broad-based taxes (such as income and value-added tax) and major duties (such as petroleum duties). Consequently, federative entities and municipios have limited ability to collect their own revenues. As compensation for delegating collection powers for certain taxes, the federative entities receive various transfers from the federal government.

1.6 The principal mechanisms for fiscal coordination between the federal government and the federative entities and municipios are defined in the Ley de Coordinación Fiscal [Fiscal Coordination Law] (LCF). This law determines the transfers based on the share corresponding to the federative entities and municipios from the collection of federal revenues and establishes the federal contributions, which are funds that the federal government transfers to them, with spending contingent upon the achievement of specific ends.[8] The LCF also establishes the agencies responsible for refining the fiscal coordination system, including the Instituto para el Desarrollo

8 Federal funds are also transferred to the federative entities and municipios through various budgetary programs, which have specific operating rules.

Técnico de las Haciendas Públicas [Institute for the Technical Development of Public Financial Administrations] (INDETEC).[9]

1.7 **Public finances of federative entity and municipal governments.** As a result of the fiscal arrangements on collections, federative entity and municipal finances in Mexico are highly dependent on federal government transfers.[10] A typical federative entity's own revenues represent about 9% of total revenues, while for municipios this figure averages 22%.[11] Despite these low levels of own revenues, the federative entities and municipios execute about 37% of total public spending in Mexico.[12] This imbalance between own revenues and expenditures is largely offset by transfers from the federal government, which can either be unrestricted (revenue transfers)[13] or for specific purposes (contributions[14] and other transfers).

1.8 Public spending by federative entities and municipios is highly concentrated in current primary expenditure. Between 2010 and 2015, the federative entities devoted an average of 84.4% of their total spending to this type of expenditure, while for the municipios this figure was 63.7%. Most current primary expenditure is used to pay salaries.[15] Due to the high amounts used for current expenditure, there are limited funds available to finance investments. Investment spending represents an average of 7.6% of total spending by the federative entities and 27.1% by the municipios.

1.9 **Fiscal sustainability of federative entities and municipios.** In Mexico, federative entities and municipios have the ability to contract debt without prior authorization from the federal government,[16] and their debt levels increased significantly between 2008 and 2013. During that period, their debt increased from 1.7% to 3.1% of GDP,[17]

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9 INDETEC is a public agency with its own legal status and assets; its functions include acting as a technical consultant on public finances, promoting the technical development of municipal public finances, and training tax specialists and officials.

10 Transfers to federative entities and municipios represented 9% of GDP in 2015 and one third of the federal government expenditure (SHCP).

11 The data on federative entity and municipal revenues and expenditures, unless another source is noted, are in-house estimates based on data from the Instituto Nacional de Estadística y Geografía [National Institute of Statistics and Geography]. In the case of the public finances of federative entities, some data come from their public accounting documents, which can be found on the official sites of the finance departments.

12 Fourth Government Report 2015-2016.

13 Revenue transfers (*participaciones*) are unrestricted funds allocated to the federative entities and municipios by the federal government, and they correspond to transfers of federal revenues and economic incentives. These funds are allocated under the terms established in the LCF and the Agreements on Accession to the System for Fiscal Coordination and Federal Fiscal Administrative Collaboration. They represented 3.6% of GDP in 2016 (SHCP, Estadísticas Oportunas de Finanzas Públicas).

14 Contributions are specific-use funds allocated by the federal government to the federative entities and municipios to strengthen their response capacity and meet demand on government in education, health, security, public infrastructure, among other areas. These funds are allocated in accordance with the terms established by the LCF. Contributions represented 3.4% of GDP in 2016 (SHCP, Estadísticas Oportunas de Finanzas Públicas).

15 For the federative entities, payroll represents about 90% of current primary expenditure, while for the municipios this figure is 65%.

16 Mexico City cannot freely contract debt; it must have prior approval from the Congress.

17 The data related to the debt of federative entities and municipios are produced by the SHCP.

after growing at a real average annual rate of 13.4%.[18] Although this level of debt was relatively low and did not represent a significant macroeconomic risk, that increase represented exponential growth of the debt in some federative entities and municipios, where it caused serious problems of fiscal sustainability, a matter of concern for the authorities who assumed the federal government in 2012. In this context, the new administration proposed a reform of the legal framework in order to strengthen the financial discipline of federative entities and municipios.[19]

3. Reform agenda to strengthen the fiscal management of federative entities and municipios

1.10 **Constitutional reform.** Reforming the above-mentioned legal framework represented an extremely complex task, given that it meant enacting laws that affected the sovereignty and autonomy of the federative entities and municipios, modifying Mexico's fiscal federalism. In addition, given that the Constitution did not empower the Congress to legislate on the subject of the financial discipline of federative entities and municipios, changing the legal framework would require passage of a constitutional amendment that would give the Congress that legislative power.[20] After lengthy political negotiations, the constitutional reform was approved in mid-2015.[21]

1.11 **Implementation of the constitutional reform.** The major challenge in implementing the constitutional reform was preparing and approving the legal text for strengthening the fiscal management and financial discipline of the federative entities and municipios, given the wide range of areas that had to be strengthened. In particular, there were and continue to be deficiencies in local legislation with respect to budgetary preparation and execution, contracting of debt, fiscal transparency, oversight of the use of funds, and accountability. These deficiencies create harmful short- and medium-term incentives that discourage financial discipline. As a result, there are fiscal management practices in the federative entities and municipios that have a negative impact on fiscal sustainability. To address these, the federal government approved the Ley de Disciplina Financiera [Financial Discipline Law] (LDF) for federative entities and municipios and amended the Ley General de Deuda Pública [General Public Debt Law] (LGDP).[22] The Bank supported the process of reforming the regulatory framework from its initial design, later providing technical advice to the SHCP during reform of the LGDP and drafting

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[18] Between late 2013 and 2016, borrowing by federative entities, municipios, and their agencies slowed, growing at an implicit real annual rate of 2.9%. At the end of 2016, the debt recorded in the SHCP for the federative entities, municipios, and their agencies represented 3.1% of national GDP.

[19] High debt levels are still a significant problem for some federative entities and municipios. In five federative entities, the debt recorded with the SHCP exceeds 100% of the amount of their own revenues and unrestricted transfers. In addition, several municipios have recently faced serious difficulties meeting their short-term debt payment obligations, and some have defaulted on payment of their credit obligations.

[20] Article 135 of the Constitution establishes that the Constitution can be added to or amended. Doing so requires that the Congress, through each of its two chambers, pass the proposed amendments or additions by a two-thirds vote of those present. In addition, said amendments or additions must be approved by an absolute majority of the legislatures in the federative entities. The approval mechanisms vary from entity to entity as they depend on local legislation. Most require approval by a two-thirds vote.

[21] The Constitutional amendment on the financial discipline of federative entities and municipios was published in the Official Gazette of the Federation on 26 May 2015.

[22] The LDF and reform of the LGDP were published in the Official Gazette of the Federation on 27 April 2016.

of the LDF and their respective regulations (see paragraphs 1.23 and 1.24). This reform of the regulatory framework coincided with the preparation of this program with the Bank and is a part thereof. To effectively implement the aforementioned regulatory framework and the measures of this programmatic loan, the following are required: (i) national regulations for approved legislation; (ii) standardizing the different legislation of the federative entities with the federal legislation, primarily with respect to contracting debt and preparing budgets; and (iii) building the institutional capacities of the federative entities and municipios for effective implementation of the new legislation.

1.12 The following paragraphs describe the main deficiencies found in local legislation and in fiscal practices before adoption of the LDF and other program measures began. It should be noted that certain provisions of the LDF have already taken effect, while others will in 2018.

1.13 **Financial discipline in the federative entities and municipios.** According to the economic literature, there are various mechanisms that produce political incentives for increased public spending or reduced tax revenues, which leads to lower fiscal balances and the accumulation of public debt.[23] One instrument that may prove effective in controlling these problems of perverse incentives is the introduction of both procedural and numerical fiscal rules.[24] Although the federal government has had fiscal responsibility rules for years, most federative entities have not imposed financial discipline rules on themselves or their municipios. This allowed practices to emerge that had negative effects on fiscal balances. The lack of legal limits on the amount of debt that a federative entity or municipio could contract in a given year allowed several of them to rapidly increase their debt levels, thus compromising their fiscal sustainability.[25] In addition, the lack of restrictions on funds used to pay floating debt (debt from prior fiscal years) led several to increase this type of debt, increasing the risks of financial unsustainability because of liquidity issues.[26] The lack of restrictions on spending for personnel services also led to a significant increase in those expenses.[27] To address these problems, the LDF establishes limits on the net financing that a federative entity or municipio can acquire in a given year and on the growth of spending in personnel services. These limits take effect in 2018. The LDF also establishes limits on the amounts used to pay debts from prior fiscal years.

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[23] Some of these mechanisms are related to problems seeking revenue and common funds, incomplete information, and intergenerational redistribution, among others. In Mexico, rent-seeking and common pool mechanisms are particularly important, given federative entity and municipal governments' high dependence on federal transfers (see paragraph 1.7). There are also significant problems with incomplete information (see paragraph 1.19 et seq.). For a full discussion of these mechanisms, see the manuscript of Alesina and Passalacqua, The Political Economy of Government Debt, prepared for the Handbook of Macroeconomics.

[24] See IMF document, Fiscal Rules—Anchoring Expectations for Sustainable Public Finances.

[25] In the last 10 years, there were five cases of federative entities that increased their debt by more than 50% of their shares from one year to the next.

[26] According to the data from the federative entities' public accounts, at the end of 2015 short-term accounts payable represented 8.7% of total revenues of an average state and 22.5% of unrestricted revenues.

[27] In the last 10 years, the average real annual growth in total payroll expenditure was 6.6% in the federative entities and 4.8% in the municipios. During that period, real average annual growth of the economy was 2.5%.

These limits are already in force for the federative entities and will take effect for municipios starting in 2018.

1.14 Budget preparation processes also presented certain deficiencies that discouraged control of public spending. Unlike the provisions in analogous legislation for the federal government, there was no requirement to accompany proposed spending increases with offsetting initiatives to increase revenues or reduce other expenditures. Nor was there any requirement to estimate the budgetary impact of legislative initiatives prior to their approval by the local legislature, so that the fiscal cost of the measures being legislated upon was often unknown. In addition, public spending showed efficiency problems due in part to the absence of a requirement to evaluate budgetary programs and investment projects. The LDF establishes procedural rules for addressing these deficiencies (see paragraph 1.33). These rules are already in effect for the federative entities and will begin to apply as of 2018 for the municipios.

1.15 Another important deficiency in the legislation related to budgetary execution was the absence of guidelines on the use of revenues exceeding budgeted levels. This led to a frequent practice of under-projection of revenues, in order to generate excess revenues the use of which was not previously allocated in the budgets approved by local congresses. In 2015, accrued revenues in the federative entities averaged 18% more than the amounts projected in their revenue laws. To address this problem, the LDF includes a rule on how excess revenues can be used (see paragraph 1.33), which is already in effect.

1.16 The preparation of revenue and expenditure budgets was also significantly deficient given the absence of a requirement for those budgets to be accompanied by medium-term fiscal projections. This made it impossible to demonstrate the short- and medium-term impacts of public policies on fiscal outcomes and fiscal sustainability.[28] The latter was also compromised by the lack of analysis of fiscal risk and contingent liabilities, so that federative entities and municipios were usually ill-prepared to deal with foreseeable adverse scenarios. They also failed to periodically update actuarial analyses of pension systems, so that various federative entities and municipios and public entities found it difficult to pay pensions or ran into fiscal sustainability problems due to the insolvency of their pension systems.[29] These aspects were regulated in the LDF and are already applicable for the federative entities. Those regulations take effect for the municipios in 2018.

1.17 The processes for contracting public debt had gaps that encouraged increases in the debt stock. In particular, there was no requirement that debt contracting authorizations issued by local congresses be accompanied by an analysis of repayment capacity. Nor was there any requirement that debt contracting processes

[28] A study by Vlaicu, Verhoeven, Grigioli, and Mills (Journal of Public Economics, 2014) analyzes a panel database of 181 countries over a period of 17 years and finds that having medium-term budgetary projections improves financial planning and that, as a result, governments improve their fiscal balances by about two percentage points of GDP.

[29] A 2013 study by the Organisation for Economic Co-operation and Development finds that in at least 10 Mexican federative entities the public pension system had less than five years of self-sufficiency. This means that they will be forced to increase their current spending to pay accrued pension commitments. In addition, a study by Aguirre Farías (2012) estimates that the federative entities' pension liabilities could amount to 13% of national GDP.

follow competitive procedures, which limited access to financing under the best market conditions. In addition, executive branches had discretion to contract short-term obligations, which led several federative entities and municipios to increase this type of debt and subsequently face liquidity problems.[30] In addition, outgoing governments were not required to settle short-term obligations before the end of their administrations nor were there any safeguards to prevent them from contracting new obligations in the final months of their term. This usually meant transferring those charges to incoming governments, reducing the available fiscal space. These elements were regulated in the LDF and are already in effect for both federative entities and municipios.

1.18 Finally, the federal government was only empowered to guarantee Mexico City's debt and was unable to guarantee that of states and municipios.[31] Without this legal prerogative, it was difficult to coordinate among the various levels of government, and the federal government had no way to increase incentives for agreeing on fiscal consolidation plans to strengthen the sustainability of public finances in the federative entities and municipios. Following reform of the LGDP, the federal government now can grant these guarantees.

1.19 **Transparency, oversight, and accountability.** Information asymmetries between the government and its citizens weakened accountability mechanisms. In the fiscal arena, information asymmetries reduced the political cost of achieving lower fiscal outcomes and accumulating higher levels of public debt. For this reason, there is a political economic incentive to exacerbate information asymmetries. In Mexico, information asymmetry problems are particularly acute at the federative entity and municipal levels, making it difficult to analyze their public finances and reducing accountability. An important problem in this area, which the LDF seeks to resolve, is the failure to record a significant portion of obligations, making it difficult for citizens to know the total amount of their governments' debts. In addition, in Mexico, accountability is weakened as the result of inadequate oversight and evaluation of how funds from federal transfers are used.

1.20 With respect to the problem of recording obligations, before passage of the LDF the legislation only required registration with the SHCP of those obligations for which federal government transfers served as the guarantee and source of payment. Thus, the Registro de Obligaciones y Empréstitos de Entidades y Municipios [Registry of Federative Entity and Municipal Obligations and Borrowings] (ROEEM) did not record a large number of obligations. Given that short-term obligations had no specific source of payment, there was no systematic registration of obligations related to financial leasing contracts, factoring operations, or supply chains, guarantees and public-private partnerships.[32] This lack of transparency regarding short-term obligations encouraged the use of these financial instruments and compromised the liquidity situation of federative entities and municipios. In addition, there was no systematic information on the debt of public entities, so that the contingent liabilities of the federative entities and municipios associated with these

[30] In late 2015, short-term debt in an average federative entity represented 38.8% of its total liabilities.

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

[32] According to SHCP estimates, 3,123 loans were not recorded in late 2016, totaling approximately US$1.834 billion, equal to 5.4% of total recorded debt.

entities were unknown. The LDF strengthened regulations in this area, requiring that all obligations and borrowings be recorded.

1.21 With respect to oversight of funds, the use of revenue transfers was audited only by local senior audit entities, which have less capacity and management autonomy than the Auditoría Superior de la Federación [Federal Supreme Audit Office] (ASF),[33] which did not intervene in the process. In addition, with respect to federal transfers from contributions, the ASF oversaw the execution of these funds up to the point when they were distributed to the federative entities, in order to verify that the distribution complied with the provisions of relevant regulations. However, it did not oversee the execution of those funds by the federative entities and municipios nor did it evaluate the results achieved. The lack of oversight by the ASF affected how municipios allocated their budgetary resources.[34] To address these problems and establish a mechanism outside the Executive Branch to oversee compliance with the LDF, the federal government adopted the new Ley de Fiscalización y Rendición de Cuentas [Oversight and Accountability Law] and amended the LCF.[35] Both measures were approved within the context of preparing this program and take effect in 2017, during the review and oversight of fiscal year 2016.

1.22 **Capacities in federative entity and municipal governments**. Many municipios and several federative entities do not have the qualified personnel needed to implement reforms promoted by the federal government that affect them. For example, this was the case with respect to the Ley General de Contabilidad Gubernamental [General Government Accounting Law] (LGCG) that started the process of accounting standardization and implementation in the federative entities and municipios of the Results-based Budget (RBB) and the Performance Evaluation System (PES). In both processes, the implementation period had to be extended considerably due to difficulties the federative entities and municipios encountered in adopting the approved measures.[36] According to a 2016 study by the SHCP, the level of progress made in implementing the RBB and PES is lower in smaller municipios with less technical capacity. Given this lack of technical capacity, it is important to train public employees in the federative entities and municipios on the

[33] A study by the Instituto Mexicano para la Competitividad and the University of Guadalajara finds that the main weaknesses of the local senior oversight bodies involved problems of autonomy, insufficient economic resources, lack of a career oversight service, and lack of continuity in work plans.

[34] A study by De la O and Martel García (2016) finds that in Mexico the allocation of public funds in the municipios is affected by the fact that the municipios will be audited by the ASF. This effect is not found in those cases where the municipio is only audited by an oversight body at the federative entity level. In addition, the study finds that ASF audits recover substantially more money than those done by federative entity oversight bodies. Both results indicate greater accountability when the audit is conducted by the ASF.

[35] The Oversight and Accountability Law and amendment of the LCF were published in the Official Gazette of the Federation on 18 July 2016.

[36] The SHCP recently strengthened its strategy for implementing accounting standardization. More specifically, the LGCG was amended to create federative entity accounting standardization boards responsible for: (i) advising the municipios in each state on public accounting matters; (ii) establishing coordinating actions between the federative entities and their respective municipios, to comply with the provisions of the LGCG; and (iii) requesting information from public entities and the federative entities and municipios regarding advances made in the implementation of accounting standardization rules issued by CONAC. These boards have already been formed and are in operation.

new regulatory framework in the area of fiscal responsibility, transparency, and accountability, in order to encourage timely implementation.

1.23 **The Bank's value-added and operational and technical support.** In 2012, the Bank indicated that a LDF for federative entities and municipios entities needed to be introduced and has since been providing technical assistance throughout that legislative process. In an initial stage, when constitutional reform was being discussed, in 2013, the Bank presented international best practices and developed proposals for their implementation in Mexico, creating significant value-added for the government. In 2014, the Bank promoted the sharing of experiences with Colombian government officials (ATN/OC-14781-ME), to discuss lessons learned from implementation of subnational financial discipline laws in that country and create recommendations to be incorporated into Mexico's legislation, to strengthen it and promote effective implementation. In 2015, after the constitutional reform was passed, the Bank advised the SHCP during the various stages of drafting the LDF bill, strengthening the proposal. Lastly, in 2016 and 2017, the Bank provided advising during the drafting of the LDF's various regulations and recommended that a massive training program be established for civil servants to ensure effective implementation of the new law. The Bank and the Inter-American Institute for Economic and Social Development (INDES) are working with the SHCP to develop that training program.

1.24 The Bank is currently collaborating on implementation of the approved legislation and its instruments. A technical cooperation operation is now being executed (ATN/OC-15559-ME), aimed at strengthening the fiduciary systems of the SHCP and the institutional capacities of the federal government and federative entity and municipal governments for implementing the new legislation. This technical cooperation is supporting, among other things: (i) development of the Registro Público Único [Single Public Registry] (RPU) (see paragraph 1.36) and the alert system (see paragraph 1.36), which will increase transparency and facilitate coordination between the federal government and subnational governments; and (ii) the preparation of regulations for the LDF (see paragraphs 1.33, 1.34, and 1.38). The Bank plans to continue supporting the implementation process for the new regulatory framework through support and technical advising during the early stages of issuing guaranteed state debt (see paragraph 1.34) and training federative entity and municipal civil servants on the new law. In addition, resources from a regional technical cooperation operation (ATN/KR-15268-RG) will be used to develop action plans to strengthen public financial management in Mexican federative entities.

1.25 The Bank has also been working with Mexican federative entities and municipios on strengthening fiscal management. Using resources from the Program to Implement the External Pillar of the Medium-term Action Plan for Development Effectiveness (PRODEV), six federative entities[37] were supported between 2008 and 2015 on issues related to implementation of the RBB, the strengthening of investment systems, the development of medium-term fiscal frameworks, among other things. In addition, through various programs with the Banco Nacional de Obras y Servicios

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[37] The federative entities given support were: Baja California (ATN/OC-11970-ME); Campeche (ATN/OC-12940-ME); Mexico City (ATN/OC-11237-ME); Michoacán (ATN/OC-11971-ME); Tabasco (ATN/OC-11923-ME), and Yucatán (ATN/OC-11851-ME).

Públicos (BANOBRAS)[38] financing was provided, among other initiatives, for making improvements in fiscal and investment management in the federative entities and municipios.

1.26 **Sector knowledge.** Various lessons are drawn from analysis of the economic literature examining the impact on fiscal performance of the various characteristics of a regulatory framework for subnational government debt. The most relevant lessons for the Mexican context include the following: (i) controls on subnational debt are more effective when there is strong monitoring by the federal government and a commitment to enforce those controls by imposing the respective penalties; (ii) where financial markets are not well developed and subnational governments' financial information is fragmented and deficient, market control[39] may not be effective by itself for containing subnational debt, and thus strong control and monitoring by the federal government are required; and (iii) when subnational governments are heavily dependent on federal transfers, market control tends to be less effective, as a result of the assumption that the federal government will financially rescue insolvent subnational governments.[40] These lessons were incorporated into this program.

1.27 This programmatic series benefits from, among other things, the lessons learned from the Fiscal Consolidation Programs for the Brazilian States (PROCONFIS) regarding the importance of adopting fiscally relevant policy measures that prove to be effective in improving subnational management. It also benefits from the lessons learned from PROFISCO operations in Brazil on the importance of implementing transparency measures and improving subnational public spending. The series also takes into account the lessons learned from technical cooperation operations under the subnational PRODEV in the region, particularly in Mexico (Michoacán, Yucatán, Campeche, Baja California, Tabasco, and Mexico City) on the importance of adopting medium-term fiscal plans or other fiscal sustainability analysis instruments in order to program subnational public spending in a manner consistent with debt targets. In addition, the series benefits from experiences in other PBLs that have incorporated components with a subnational approach, such as the Programs to Consolidate Subnational Fiscal Responsibility in Colombia,[41] with respect to the importance of establishing central level alert systems to monitor and control the debt of subnational entities, promoting standardized classification and treatment practices, and thus promoting a culture of transparency and fiscal responsibility in subnational governments.

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[38] In 1999, two operations were approved on the strengthening of states and municipios (1313/OC-ME and 1314/OC-ME). Between 2001 and 2011, two investment operations were executed under the Multiphase Program for Investment and Financial and Institutional Strengthening of States and Municipios (1383/OC-ME and 1744/OC-ME). In addition, three operations have been approved since 2010 (2053/OC-ME, 2550/OC-ME, and 3313/OC-ME) under the Conditional Credit Line for Investment Projects in States and Municipios (ME-X1002). The first two operations have already been fully executed, while the third is currently being executed.

[39] Market control refers to the financial discipline that capital markets (and ratings agencies) may impose on governments, via access to financing and the costs thereof. This is the market control approach that Mexico's federal government applied to its federative entities and municipios prior to passage of the LDF.

[40] These conclusions are drawn from the study by Deza Delgado and Rasteletti (2016) (Índice de Estudios Sectoriales).

[41] Loans 2341/OC-CO and 2744/OC-CO.

1.28 **Strategic alignment.** The program is consistent with the Update to the Institutional Strategy 2010-2020 (document AB-3008), aligning with the cross-cutting area of Institutional Capacity and the Rule of Law, through the institutional strengthening of the SHCP, and improvement in the regulatory framework on financial discipline in the federative entities and municipios. The program will also contribute to the Corporate Results Framework 2016-2019 (document GN-2727-6), through the indicator on government agencies benefiting from projects that strengthen technological and management instruments to improve the delivery of public services; and the additional indicators on strengthened accountability institutions and subnational governments benefiting from decentralization, fiscal management, and institutional capacity projects.[42] In addition, the program is aligned with the objectives of the country strategy with Mexico 2013-2018 (document GN-2749), in that it contributes to the improvement of subnational public management, by promoting fiscal responsibility and control of debt,[43] and the program is included in the 2017 Operational Program Report (document GN-2884). The program is also consistent with: (i) the Strategy on Institutions for Growth and Social Welfare (document GN-2587-2), by strengthening the administrative and fiscal management of subnational governments and establishing institutional mechanisms for promoting transparency and accountability; and (ii) the Subnational Governments and Decentralization Sector Framework Document (document GN-2813-3), by supporting greater coordination of intergovernmental arrangements and strengthening transparency and accountability in fiscal management.

B. Objectives, components, and cost

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

1.30 The series is structured as two programmatic policy-based loans (PBPs) that seek to address the main challenges facing the country with respect to effective implementation of the constitutional reform on the financial discipline of the federative entities and municipios and the strengthening of transparency and accountability. This first programmatic operation is primarily intended to establish the legal and regulatory bases of the constitutional reform, through the issuance of laws, regulations, and guidelines. The legal reforms included in this first operation were approved in 2016, as part of preparation of this operation, and for this reason they are part of the Policy Matrix.

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

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

1.31 **Component I. Macroeconomic stability.** The objective of this component is to ensure the maintenance of a macroeconomic context consistent with program objectives as established in the Policy Matrix and Sector Policy Letter.

1.32 **Component II. Strengthening the fiscal responsibility of the federative entities and municipios.** The objective of this component is to increase the financial discipline of the federative entities and municipios and their public entities, to strengthen their fiscal sustainability.

1.33 To achieve this objective, the first operation supports approval of the LDF, which would establish financial discipline measures, including limits on contracting new debts[44] and on the amount of funds that can be used for fiscal debts from prior years,[45] restrictions on the use of surplus revenues,[46] and the required preparation of medium-term fiscal projections, risks analyses, and actuarial studies of pension systems. The LDF also provides for greater control and efficiency in public spending, by introducing limits on the growth of spending on personnel services,[47,48] the required identification of sources of financing for additional expenditures, and the obligation to establish specialized areas in the economic analysis of programs and projects in the federative entities and municipios.[49] In addition, the LDF introduces changes in the contracting of obligations, including the requirement to analyze payment capacity before approving the contracting of obligations, the requirement to introduce competitive procedures when contracting debt above a certain amount, greater control over short-term debt, and the establishment of the mechanism for accessing federal guarantees on debt.

1.34 The first operation in the programmatic series also supports various measures to encourage the timely implementation of the LDF. They include normative or regulatory conditions, such as: (i) approval of a legal reform empowering the federal Executive Branch to guarantee obligations representing the public debt of federative entities and municipios; (ii) approval of at least 10 amendments to regulatory frameworks for the fiscal management of federative entities, to make them

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[44] The maximum amounts of net financing that federative entities and municipios and their public entities can access could be equivalent to 15%, 5%, or 0% of unrestricted revenues, depending on the rating received in the alert system.

[45] The limit is 2% of total revenues for federative entities and 2.5% for municipios, although there is a transition period during which higher limits are permitted.

[46] The LDF stipulates that at least 50% of surplus revenues are to be used for early repayment of debt or other obligations or to contribute funds to deal with natural disasters and pensions. The remaining funds must be used for productive public investment or to create a fund intended to offset the decline in unrestricted revenues in subsequent years.

[47] Real growth in expenditures on personnel services may not exceed the lesser of 3% or real GDP growth indicated in the General Economic Criteria for the fiscal year being budgeted. The General Economic Criteria are contained in a document prepared annually by the SHCP that includes medium-term projections of the principal macroeconomic variables and fiscal outcomes. This document presents the bases on which initiatives are prepared for the Law on Revenues of the Federation and the Budget of Expenditures of the Federation.

[48] To control growth in spending, the LDF also requires accompanying proposals to increase or create expenditures with offsetting initiatives to boost revenues or reduce expenditures.

[49] This requirement does not apply to small municipios with fewer than 200,000 inhabitants. The law also establishes the requirement to perform a cost-benefit analysis for investment programs or projects that exceed ten million investment units. Investment units are units of value established by the Bank of Mexico, the evolution of which is determined by changes in the consumer price index.

consistent with the LDF; (iii) development of a methodology for calculating the lowest financial cost of borrowings and obligations; (iv) the establishment of disclosure requirements regarding expenses related to the offer of securities to be issued, to be followed by federative entities and municipios and their public entities in the respective placement prospectus; and (v) approval by the Consejo Nacional de Armonización Contable [National Accounting Standards Board] (CONAC) of criteria for standardized preparation and presentation of the financial information and forms referenced in the LDF. In addition, in order to ensure that federative entities and municipios have better financial planning, the preparation of the design of a digital platform is included as a measure to allow the federative entities and municipios to: (a) develop medium-term projections (at least five years) of fiscal revenues, expenditures, and debt levels; and (b) perform debt sustainability analyses.

1.35 The second operation of the programmatic series will continue to support implementation of the LDF. Measures provided in the second operation include the entry into effect of the provisions for the preparation of budgets considered in the LDF in municipios with more than 200,000 inhabitants and in their respective public entities.[50] In addition, to corroborate improvements in debt contracting procedures, a verification measure is established to the effect that when recording their obligations in the RPU the federative entities and municipios and their public entities must confirm that payment capacity has been analyzed.[51] The following are included with respect to the implementation of measures related to federal guarantees: (i) the signing of at least three coordination agreements between the federal government and a state government; and (ii) verification that the total balance of state debt guaranteed by the federal government is less than 3.5% of GDP.[52] In addition, to confirm that the federative entities' legal frameworks have been harmonized with the LDF, a measure is established requiring the approval of at least 20 amendments to regulatory frameworks for fiscal management in the federative entities. In addition, to corroborate that the federative entities and municipios are financed under the best market conditions, a measure is included to verify that they and their public entities demonstrated when recording their obligations in the RPU that the loans and obligations were contracted through competitive processes.[53] Regulatory measures are also included, such as amendment of the provisions applicable to credit institutions that empower the Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission] (CNBV) to order the establishment and maintenance of higher than normal loan loss reserves if the loan is not recorded in the RPU and approval by CONAC of the classifiers by revenue category and financing sources, for calculating the budgetary balance of available resources.[54]

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[50] According to National Population Council projections, Mexico has 99 municipios and 14 *delegaciones* (districts) in Mexico City with more than 200,000 inhabitants. Debt of the 99 municipios represents 76.6% of the total debt of Mexico's municipios.

[51] The analysis must be done before obligations are approved by the respective federative entity legislature or municipal council.

[52] This limit is established in the LDF.

[53] Competitive processes must be carried out for borrowing in excess of 40 million investment units, in the case of federative entities and their public entities, and 10 million investment units, in the case of municipios and their public entities.

[54] The LDF establishes that, under normal conditions, federative entities and municipios must submit a non-negative budgetary balance of available resources.

Finally, with respect to the platform for the development of medium-term fiscal projections and debt sustainability analyses, a measure is included on their development and implementation.

1.36 **Component III. Strengthening transparency and accountability in the federative entities and municipios.** The objective of this component is to strengthen transparency and oversight, to enhance accountability mechanisms.

1.37 To achieve this objective, the first operation supports approval of a legal framework on fiscal responsibility for federative entities and municipios that increases transparency through: (i) the creation of the RPU to replace the ROEEM so as to ensure the transparency of all borrowings and obligations for which the federative entities and municipios and their public entities are responsible; (ii) the requirement to input in the RPU any financial leasing contracts and factoring operations, guarantees, derivative instruments with a payment obligation beyond one year, and public-private partnership contracts; and (iii) the requirement that the SHCP publish and update daily on its website all borrowings and obligations in effect for the federative entities and municipios and recorded in the RPU. In addition, that legal framework should, in the area of transparency and accountability in the financial management of the federative entities and municipios, require the creation of an alert system to evaluate the debt level of the federative entities and municipios that have contracted borrowings and obligations recorded in the RPU.[55] The issuance of regulations establishing the requirements for recording, amending, and cancelling all borrowings and obligations contracted by federative entities, municipios, and their public entities is included as a measure to encourage timely implementation of the RPU and the alert system.

1.38 With respect to strengthening oversight, the first operation supports: (i) approval of the legal reform that empowers the ASF to oversee compliance with the LDF, activities in the current fiscal year, and the exercise of: (a) federal revenue transfers to federative entities and municipios; (b) federal revenue transfers and resources administered by public and private trusts, funds, and mandates, or any other legal instrument; and (c) resources from public debt guaranteed by the federation; and (ii) approval of the legal reform empowering the ASF to audit the federal contributions received by federative entities and municipios.

1.39 The second operation will continue to support implementation of the new regulations on transparency, oversight, and accountability through: (i) the development of a methodology for calculating the fiscal performance indicators included in the alert system and reporting of those indicators for federative entities and municipios and other public entities that have contracted financing and obligations recorded in the RPU; (ii) the issuance of guidelines for the RPU system and its implementation; and (iii) regulation and internal reorganization of the ASF to grant it powers to oversee compliance with the scopes set forth in the LDF with respect to auditing subnational public debt and finances.

1.40 **Component IV. Institutional strengthening of federative entities and municipios in the area of fiscal responsibility, transparency, and**

[55] The alert system will classify the federative entities and municipios and their public entities in three levels: sustainable debt; debt under observation; and heavy debt. These three levels will have net financing ceilings of 15%,10%, and 0%, respectively, for unrestricted revenues.

accountability. The objective of this component is to build the institutional capacity of federative entities and municipios for timely application of approved regulations on fiscal responsibility, transparency, and accountability.

1.41 This will be done by designing and developing a medium-term mass training program for civil servants in federative entities, municipios, and their public entities, on the above-mentioned subjects, for subsequent implementation. The first operation includes measures on: (i) signing of a cooperation agreement between INDETEC and a specialized institution to design a training program on fiscal responsibility, transparency, and accountability in the federative entities and municipios; and (ii) development of a training plan on the content and application of the LDF and other laws and secondary regulations addressed in the program.

1.42 The second operation includes measures on: (i) establishing an agreement between the SHCP and INDETEC, for the latter to implement training sessions on fiscal responsibility, transparency, and accountability in federative entities and municipios, over the medium term; and (ii) moving ahead with implementation of the above-mentioned training plan.

C. Key outcome indicators

1.43 The program's expected outcomes and impacts are listed in the Results Matrix. The impact indicators included are the balances of obligations and borrowings of federative entities and municipios as a percentage of GDP. The outcome indicators included are: (i) the increase in the total number of federative entities and municipios rated at the heavy debt level, in accordance with the alert system regulations; (ii) the federative entity level average real rate of growth in spending for personnel services; (iii) the federative entity level average of the differential between the weighted average interest rate paid by the federative entities on their obligations and the interbank equilibrium interest rate; and (iv) the amount of debt recorded in the CNBV that is not recorded in the SHCP, as a percentage of recorded debt.

1.44 **Economic analysis.** The financial returns related to implementation of some of the financial discipline measures included in this program (Economic Analysis of the Project) were analyzed. A dynamic debt simulation model is used to estimate the present value of financial savings for the federative entities based on reduced payment of interest on their debt.[56] There are three sources of the lower interest payment. First, as a result of better fiscal balances from implementing the net financing limits, federative entities accumulate lower debt levels and thus spend less on interest payments. Second, the lower level of debt makes the federative entities more solvent, so they pay a lower risk premium for their debt. Third, the introduction of the federal guarantee also reduces the risk premium that states must pay for their debt. The base scenario, using conservative assumptions and considering only the effect on the federative entities' public finances, yields a present value of savings on interest payments of approximately Mex$68 billion, which is equal to about 0.39% of Mexico's GDP and 13% of the total amount of the debt of federative entities and

[56] This methodology was also used for the economic evaluation of the Public Finance Strengthening Program II (loan 3676/OC-ME). For more detail on the methodology, see Acosta, J., Barriex, A. and A. Rasteletti. 2016. Metodología de Estimación del Ahorro Financiero Fiscal.

municipios.[57] More than 80% of this figure is due to the savings generated in five federative entities that have relatively high debt levels. The sensitivity analyses show that the result of significant fiscal savings is robust when changes in the key assumptions are introduced in the analysis.

1.45 **Internal and external validation.** There is ample evidence in the economic literature regarding the effectiveness of the main measures included in the program. In the United States, Poterba (1994)[58] finds evidence that states with stronger fiscal rules have higher fiscal balances. In Brazil and India, countries where, as in Mexico, the federal government exerts significant control, Martell (2008)[59] and Kishore and Prasad (2007),[60] respectively, find that the restrictions imposed on the coordination arrangements were effective in increasing fiscal discipline. In Spain, Cabasés, Pascual, and Vallés (2007)[61] find that institutional restrictions on debt increased financial discipline in the debt policies adopted by local governments. In Colombia, Chamorro Narváez and Urrea Bermúdez (2016)[62] find that the implementation of an alert system and debt control strengthened the fiscal sustainability of subnational entities. In Mexico, the federal government's guarantee has been very effective in reducing the cost of financing for Mexico City (Economic Analysis of the Project).

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 **Financial instrument.** This operation has been structured as a programmatic policy-based loan (PBP) and corresponds to the first operation of a programmatic series to consist of two contractually separate but technically linked loans, consistent with document CS-3633-1 on the preparation and implementation of PBPs. The programmatic approach was selected to: (i) provide medium-term support to the government's program of fiscal policy reforms; (ii) promote ongoing dialogue; and (iii) facilitate the monitoring and refinement of the implementation strategy, given the highly complex nature of the reform involving policy actions at various levels of government.

2.2 **Amount and currency.** This operation will be for US$650 million, US$612.4 million of which will be financed by the IDB from the Ordinary Capital and US$37.6 million by the China Cofinancing Fund for Latin America and the Caribbean (CHC).[63] The

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[57] The analysis only considers measures related to the imposition of net financing ceilings through the alert system and the reduction of interest rates resulting from the federal guarantee on the federative entity's debt.

[58] Poterba, J. M. 1994. *State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics*. *Journal of Political Economy* 102(4): 799–821.

[59] Martell, C. R. 2008. *Fiscal Institutions of Brazilian Municipal Borrowing. Public Administration and Development* 28(1): 30–41.

[60] Kishore, A., and A. Prasad. 2007. *Indian Subnational Finances: Recent Performance. International Monetary Fund Working Paper* 07/205.

[61] Cabasés, F., P. Pascual, and J. Vallés. 2007. *The Effectiveness of Institutional Borrowing Restrictions: Empirical Evidence from Spanish Municipalities. Public Choice* 131(3): 293–313.

[62] Chamorro Narváez, R. A., and A. F. Urrea Bermúdez, A. F. *Incidencia de las reglas fiscales en la sostenibilidad de la deuda pública territorial en Colombia*. Cuadernos de Economía, 35(67), 207-251.

[63] The IDB and the People's Bank of China approved the CHC to support public and private sector projects that promote sustainable economic growth in the region.

funds will be disbursed in a single tranche. The amount of this operation is justified by Mexico's broad fiscal resource need, although it is not directly related to reform-associated costs to be borne by the borrower, as per the Policy-based Loans: Guidelines for Preparation and Implementation (document CS-3633-1, paragraph 3.27 (b)). The Public Sector Financial Requirements for 2017 are estimated to be about US$31 billion. This operation meets 2.1% of those requirements and 11.0% of expected external federal public sector financing.

B. Environmental and social risks

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

C. Fiduciary risks

2.4 No fiduciary risks associated with the operation were identified. Funds for this operation will go directly to the treasury single account to cover the federal government's financing needs, for which the executing agency has the necessary financial management instruments and control systems.

D. Other project risks

2.5 **Macroeconomic risk.** The main macroeconomic risk, classified as medium, relates to an adverse international context, with continuing uncertainty regarding trade relations and low oil prices. This could lead the federal government to reduce transfers to the federative entities and municipios, hampering compliance with the program's financial discipline measures. Although this risk cannot be fully controlled, the federal government will continue to use the Federative Entity Revenue Stabilization Fund to reduce volatility in transfers to the federative entities and municipios and will alert those governments regarding any future reductions in transfers, to reduce their impact. It should be noted that the new financial discipline regulatory framework strengthens the fiscal sustainability of federative entities and municipios and the overall public sector, which strengthens the country's response capacity should the aforementioned macroeconomic risk materialize.

2.6 **Development risk.** The main development risk, classified as medium, relates to the possibility of delays in developing and implementing the RPU and the alert system. Funds will be used from technical cooperation operation ATN/OC-15559-ME to contract programmers and analysts to support the development and implementation of these systems.

2.7 **Public management and governance risks.** There are various public management and governance risks, all classified as medium. They relate to: (i) failure on the part of civil servants in the federative entities and municipios and their public entities to attend the training courses; (ii) provision of incorrect information for calculating the alert system indicators; and (iii) the inability of the ASF to effectively audit compliance with the LDF and the use of funds from revenue transfers and contributions in the federative entities and municipios. The main mitigating actions for these risks relate to: (i) publicizing the course via various methods; (ii) training for civil servants on reporting information, computer codes for detecting inconsistencies, and publication of the information used to calculate the

indicators, so that the press and civil society can detect and report any errors in the information used; (iii) coordination between the ASF and local oversight entities to monitor the use of transferred funds and the transfer of more resources for the ASF to conduct its oversight activities.

2.8 There is also a public management and governance risk, classified as medium, related to delays in implementing the financial discipline measures in the law, based on the upcoming federal and federative entity elections to be held in 2018. Although the main laws have already been approved at the federal level, federative entity and municipal governments are responsible for complying with the established discipline rules. This risk is mitigated by the fact that the ASF will audit compliance with the measures included in the LDF and will publish its findings. In addition, the federal government will publish the evaluations of public finances through the alert system, as well as the cooperation agreement signed with the states. This greater transparency may reduce pressure on the federal government to delay implementation of the LDF.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 **Borrower.** The borrower will be the United Mexican States, through the Department of Finance and Public Credit (SHCP).

3.2 **Executing agency.** The borrower will executive the program through the SHCP's Unit for Coordination with Federative Entities (UCEF), with support from the SHCP's International Financial Affairs Unit. The borrower will have support from Nacional Financiera Sociedad Nacional de Crédito, Institución de Banca de Desarrollo (NAFIN), as the federal government's financial agent responsible for administration of the loan. The SHCP will have technical responsibility for execution and agrees as follows: (i) to itself maintain and deliver or maintain and deliver through NAFIN official communication with the Bank and the reports and evidence of compliance with the conditions of the operation, and any other reports the Bank may request by the deadlines and under the conditions agreed; (ii) to promote actions to achieve the policy objectives defined in the program; and (iii) complete, file, and deliver to the Bank all information, indicators, and parameters allowing the Mexican government and the Bank to monitor, measure, and evaluate the program's results.

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

3.4 **The following will be special conditions precedent to the first and only disbursement of the loan for the first operation in the series: (i) the signing of a trust agreement between the borrower and Nacional Financiera Sociedad**

Nacional de Crédito, Institución de Banca de Desarrollo, as the financial agent;[64] and (ii) compliance with the policy reform conditions as established in the Policy Matrix (Annex II), as well as other conditions established in the corresponding loan contract.

B. Summary of results monitoring arrangements

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

3.6 **Evaluation**. The evaluation strategy will consist of two parts. First, the results of reform of the regulatory framework will be analyzed, in terms of how public finances of the federative entities and municipios evolved following implementation of the measures in the program. Second, the impact of certain specific measures that are part of the program will be analyzed. The proposed studies would estimate: (i) the effect of the federal government's guarantee on the cost of financing for the federative entities and municipios; and (ii) the impact of financial planning on municipal fiscal balances (Monitoring and Evaluation Plan). A project completion report will also be prepared. Both the studies mentioned and the project completion report will be prepared at the end of the programmatic series' execution.

IV. POLICY LETTER

4.1 The policy letter reiterates the Mexican government's commitment to the objectives and actions set forth for all programmatic operations and the consistency of national policies for achieving enhanced fiscal management in the federative entities and municipios.

[64] Article 17, Section XXVI of the SHCP Bylaws establishes that the Public Credit Unit of the SHCP, in coordination with the International Financial Affairs Unit of the SHCP, has the power to designate financial agents and to sign mandates related to operations arising from Inter-American Development Bank loans. This is the Mexican government's customary mode of operation.

Development Effectiveness Matrix		
Summary		
I. Corporate and Country Priorities		
1. IDB Development Objectives	**Yes**	
Development Challenges & Cross-cutting Themes	**-Institutional Capacity and the Rule of Law**	
Country Development Results Indicators	**-Government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery (#)* -Subnational governments benefited by decentralization, fiscal management and institutional capacity projects (#)* -Accountability institutions strengthened (#)***	
2. Country Development Objectives	**Yes**	
Country Strategy Results Matrix	**GN-2749**	**Support the strengthening of public management at the federal and subnational levels.**
Country Program Results Matrix	**GN-2884**	**The intervention is included in the 2017 Operational Program.**
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability	**Evaluable**	
3. Evidence-based Assessment & Solution	**8.8**	
3.1 Program Diagnosis	**3.0**	
3.2 Proposed Interventions or Solutions	**2.8**	
3.3 Results Matrix Quality	**3.0**	
4. Ex ante Economic Analysis	**8.0**	
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis	**0.5**	
4.2 Identified and Quantified Benefits	**2.0**	
4.3 Identified and Quantified Costs	**2.0**	
4.4 Reasonable Assumptions	**2.0**	
4.5 Sensitivity Analysis	**1.5**	
5. Monitoring and Evaluation	**9.0**	
5.1 Monitoring Mechanisms	**1.5**	
5.2 Evaluation Plan	**7.5**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Medium**	
Identified risks have been rated for magnitude and likelihood	**Yes**	
Mitigation measures have been identified for major risks	**Yes**	
Mitigation measures have indicators for tracking their implementation	**Yes**	
Environmental & social risk classification	**B.13**	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, Accounting and Reporting, External Control, Internal Audit. Procurement: nformation System.**
Non-Fiduciary		
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Gender Equality		
Labor		
Environment		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**The Bank has supported with technical assistance the elaboration of the Financial Discipline Law, norms and guidelines for states and municipalities. A technical cooperation (ME-T1310) is also in execution to support the implementation of this law.**
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan	**Yes**	**Evaluations will be carried out to measure: i) the effect of federal guarantees on financing costs of states and municipalities; and ii) the effect of financial planning on public finances.**

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

The goal of the Project is to strengthen fiscal management in the States and Municipalities in Mexico (SM). The diagnostic identifies three main factors that contribute to the problem. The first factor is weak financial discipline resulting from the absence of regulations on expenditure and debt. The second factor is the lack of information as an obstacle for transparency and accountability. The third factor is the heterogeneity in the institutional and technical capacity across the SM. The dimensioning of the problem and the three contributing factors is based on data from the National Institute on Geography and Statistics (INEGI) and the Secretariat for Finance and Public Credit (SHCP).

The vertical logic in the results matrix is clear. The relationship between the product and result indicators is based on national and international evidence. However, this evidence is not used to link the proposed solution to the magnitude of the proposed targets. The ex-ante evaluation of the project is based on quantifying savings derived from the debt limit and the reduction of the cost of capital resulting from access to guarantees. The estimated savings is 0.39 percent of the GDP in the base scenario. The evaluation of other components in the project is excluded due the complexity to assess its benefits and costs.

The monitoring of the project relies on the publication of results on the official government website. An independent consultant will be hired to centralize and analyze the information. He will inform on the progress of the operation. Three ex-post evaluations are proposed. The first evaluation is a before-after comparison without attribution on public finances. The second evaluation aims to estimate the effect of guarantees on financing costs. The third evaluation aims to estimate the effect of financial planning on municipal public finances. The latter two evaluations propose a regression discontinuity methodology to estimate impacts.

The main risks are the low participation in training courses and delays due to the federal and state elections in 2018.These risks will be mitigated through the dissemination of information to promote interest for training courses and making results public to create public pressure to avoid delays.

POLICY MATRIX

	Programmatic Loan I	Programmatic Loan II
	Policy Conditions	**Triggers for Programmatic Loan II**
Macroeconomic stability	Maintenance of a macroeconomic context consistent with the program objectives as established in the Policy Matrix and the Sector Policy Letter.	Maintenance of a macroeconomic context consistent with the program objectives as established in the Policy Matrix and the Sector Policy Letter.
Strengthening the fiscal responsibility of federative entities and municipios	1.1.a Approval of a legal framework on fiscal responsibility for federative entities and municipios that provides for: (i) The establishment of financial discipline measures, including limits on the contracting of new debt and the amount of funds used for tax debts from earlier years, restrictions on the use of surplus revenues and the requirement to prepare medium-term fiscal projections, risk analyses, and actuarial studies of pension systems; (ii) Greater control and efficiency in public spending, by introducing limits on growth in spending on personnel services, the requirement to identify financing sources for additional expenses and the obligation to establish specialized areas in the economic analysis of programs and projects in the federative entities and municipios; and (iii) Changes in processes for contracting obligations, including the requirement to perform analyses of payment capacity before approval of the contracting of obligations, the obligation to introduce competitive processes in the contracting of debt in excess of a certain amount, greater control over short-term debt, and establishment of the mechanism for accessing federal guarantees on debt.	1.1.a Entry into effect of the LDF provisions on fiscal responsibility in municipios with more than 200,000 inhabitants and their respective public entities, under the terms established therein, for the preparation of budgets. 1.1.b Verification that the federative entities and municipios and their public entities certified when recording their obligations in the Single Public Registry (RPU) that the payment capacity was analyzed before those obligations were approved by the respective state legislature or municipal council.
	1.2 Approval of a legal reform empowering the Federal Executive Branch to guarantee obligations constituting public debt of the federative entities and municipios.	1.2.a Signing of at least three cooperation agreements between the federal government and a state government, following the provisions of the LDF for the subscription of guaranteed state debt. 1.2.b Verification that the total balance of guaranteed state debt is less than 3.5% of Mexico's nominal GDP, as established in the law.

	Programmatic Loan I	Programmatic Loan II
	Policy Conditions	**Triggers for Programmatic Loan II**
	1.3 Approval of at least 10 reforms to regulatory frameworks on fiscal management in federative entities, to make them consistent with the LDF.	1.3 Approval of at least 20 reforms to regulatory frameworks on fiscal management in federative entities, to make them consistent with the LDF.
	1.4 Development of the methodology for calculating the lowest financial cost of financing and obligations.	1.4 Verification that the federative entities and municipios and their public entities certify when recording their obligations in the RPU that loans and obligations exceeding 40 million investment units in the case of federative entities and their public entities and 10 million investment units in the case of municipios and their public entities were contracted based on competitive processes.
	1.5 Establishment of disclosure requirements with respect to expenses related to the offer of securities to be issued that federative entities and municipios and their public entities must meet in the respective placement prospectus.	1.5 Amendment of the provisions applicable to credit institutions empowering the CNBV to order the establishment and maintenance of higher-than-normal loan loss reserves when a loan is not recorded in the RPU.
	1.6 Approval by CONAC of criteria for the standardized preparation and presentation of financial information and forms referenced in the LDF.	1.6 Approval by CONAC of the classifiers according to income categories and financing sources, for calculating the budgetary balance of available resources.
	1.7 Development of a digital platform design that allows federative entities and municipios to: (i) prepare medium-term projections (at least five years) for fiscal revenues, outlays, and debt levels; and (ii) perform debt sustainability analyses.	1.7 Development and implementation of the platform for preparing medium-term fiscal projections and debt sustainability analyses.
Strengthening of transparency and accountability in federative entities and municipios	2.1 Approval of a legal framework on fiscal responsibility for federative entities and municipios that provides for: In the area of transparency and accountability regarding public debt: (i) Creation of a Single Public Registry (RPU) to replace the Registry of Federative Entity and Municipal Obligations and Borrowings, to lend transparency to all financing and obligations for which federative entities and municipios and their public entities are responsible. (ii) Requirement to record in the RPU financial leasing contracts and factoring operations, guarantees,	2.1 Development of the methodology for calculating the fiscal performance indicators included in the alert system and reporting of those indicators for the federative entities and municipios and other public entities that have contracted financing and obligations recorded in the RPU.

<table>
<tr><th></th><th>Programmatic Loan I</th><th>Programmatic Loan II</th></tr>
<tr><th></th><th>Policy Conditions</th><th>Triggers for Programmatic Loan II</th></tr>
<tr><td></td><td>derivative instruments leading to a payment obligation greater than one year, and public-private partnership contracts.
(iii) Requirement that the SHCP publish and update daily on its official website all financing and obligations in effect in the federative entities and municipios recorded in the RPU.
In the area of transparency and accountability regarding the financial management of federative entities and municipios:
(iv) Requirement to create an alert system to evaluate the debt levels of federative entities and municipios that have contracted financing and obligations recorded in the RPU.</td><td></td></tr>
<tr><td></td><td>2.2 Issuance of regulations establishing the requirements for recording, amending, and settling in the RPU all financing and obligations contracted by federative entities and municipios and their public entities.</td><td>2.2 Issuance of system guidelines for the RPU and implementation thereof.</td></tr>
<tr><td></td><td>2.3.a. Approval of legal reform empowering the Federal Supreme Audit Office (ASF) to oversee compliance with the LDF, activities of the current fiscal year; and the use of: (i) federal revenue transfers received by federative entities and municipios; (ii) federal payments and resources administered by public or private trusts, funds, and mandates, or any other legal instrument; (iii) public debt resources guaranteed by the Federation.
2.3.b. Approval of the legal reform empowering the ASF to audit federal contributions received by federative entities and municipios.</td><td>2.3 Regulation and internal reorganization of the ASF to grant it powers to exercise oversight of compliance with the scopes provided by the LDF with regard to auditing subnational public debt and finances.</td></tr>
</table>

	Programmatic Loan I	Programmatic Loan II
	Policy Conditions	**Triggers for Programmatic Loan II**
Institutional strengthening of federative entities and municipios in the area of fiscal responsibility, transparency, and accountability	3.1 Signing of a cooperation agreement between INDETEC and a specialized institution to design a training program on fiscal responsibility, transparency, and accountability in the federative entities and municipios.	3.1 Establishment of an agreement between the SHCP and INDETEC for the latter to implement training on fiscal responsibility, transparency, and accountability in federative entities and municipios, in the medium term.
	3.2 Development of a training plan on the context and application of the LDF and other laws and secondary regulations addressed in the program.	3.2 Progress made in implementing the training plan.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/17

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

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the United Mexican States, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a program to strengthen fiscal management in federative entities and municipios. Such financing will be for the amount of up to US$612,400,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ __________ 2017)

LEG/SGO/CID
ME-L1253

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/17

Mexico. Loan ____/CH-ME to the United Mexican States
Program to Strengthen Fiscal Management
in Federative Entities and Municipios

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, acting as Administrator of the China Cofinancing Fund for Latin America and the Caribbean, to enter into such contract or contracts as may be necessary with the United Mexican States, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a program to strengthen fiscal management in federative entities and municipios. Such financing will be for the amount of up to US$37,600,000 from the resources of the China Cofinancing Fund for Latin America and the Caribbean, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ __________ 2017)

LEG/SGO/CID
ME-L1253

Program to Strengthen Fiscal Management in Federative Entities and Municipios

ME-L1253

Certification

The Grants and Co-Financing Management Unit (ORP/GCM) certifies that the operation meets the requirements for financing by the **China Co-Financing Fund for Latin America and the Caribbean (CHC**) for the amount of up to **US$37,600,000.00** confirmed by Xintong Liu of the State Administration of Foreign Exchange (SAFE), March 22, 2017.

ORIGINAL SIGNED	March 30, 2017
Sonia M. Rivera Chief Grants and Co-Financing Management Unit ORP/GCM	Date