Report No. PID11530

Project Name	Mexico - Chiapas-Programmatic Economic... Development Loan (PEDL)
Region	Latin America and the Caribbean Regional Office
Sector	Public Sector
Project ID	P074751
Borrower (s)	Banco Nacional de Obras y Servicios Públicos, S.N.C. (Banobras) Federal Government
Implementing Agency	Secretary of Finance of Chiapas, xxx
Date PID prepared	December 16, 2002
Projected appraisal date	April 21, 2003
Projected Board Date	June 17, 2003

1. Country and Sector Background

Although the State of Chiapas has abundant natural resources--water for agriculture and hydroelectricity, rich agricultural land and seacoast--it has been the poorest state in Mexico for the past thirty years. In GDP per capita the state has fallen farther behind the national average. The 4 million inhabitants are less urbanized and suffer from low economic growth, high poverty rates, low health outcomes and education enrollment, with lower than average access to basic infrastructure and social services. Although adult illiteracy has declined since 1990, it is still almost one-quarter, twice the national average.

This poverty ultimately reflects the failure of productive sectors in Chiapas--agriculture, rural industry, urban industry, tourism--to generate enough well-paying jobs, small enterprises, and farms. The reasons for failure include cultural conflicts, poor education, inadequate transport and communications, and alleged "lack of entrepreneurial spirit." One-fourth of the population is indigenous and speak indigenous languages at home--a share four times larger than elsewhere in Mexico--and almost one-tenth does not speak Spanish at all. The state faces a special challenge to provide them with opportunities both to participate in the nation's growth and to advance their own cultural tradition.

The Zapatista uprising, starting in 1994, has marked the politics of the state, bringing into the open conflicts that are present to some extent in most of Mexico. As a result, a number of dispersed rural communities, with up to 300,000 in population, have rejected the authority and the resources of the formal government and instituted to varying degrees their own social programs and public security. While there are many problems with the isolationism and disruption of governance and regular social services, the movement does indicate a sense of local responsibility and willingness to pay for services that could inspire more accountability and true decentralization in the traditional public sector.

The traditional state economy rest on three legs--agriculture for self-consumption, coffee and cattle for market sale (mostly from large farms), and the public sector. The rest of the economy is local services, plus a little tourism. The world coffee market has collapsed, other markets in agriculture stagnate, and rapid population growth in rural areas is making subsistence agriculture unsustainable. Spending by the state and municipalities is over

20 percent of state GDP, which is 95% funded by federal transfers. Direct federal spending adds another xx percent making the public sector by far the largest source of external purchasing power for the state. This large economic presence has not, however, resulted in good public services or economic infrastructure. Quality and coverage in education and health services are among the lowest in the nation; producers lack good transport connections within the state, to the rest of Mexico, and to the world. Partly this failure of the public sector was political--a lack of accountability of the government to the people. As everywhere in Mexico, no one can be reelected, so politicians in office, and with career ambitions, pay attention to the party bosses who will decide their next job. Furthermore, in Chiapas more than most places, those elected to offices rarely stay their whole term and are replaced by appointees. For instance, almost none of the governors of Chiapas has stayed for the full term of six year, and over the last century there has been a change of governor on average once a year. Hence, patronage more than public service has been the norm for the state government in the past. These problems in the private and public sector are hardly unique to Chiapas, although they are more extreme than in most other states.

Patronage politics of a corporate type largely account for weak management and administration in the public sector and under-provision of basic public services. Although usually short-lived, every new state administration brought along a new crop of cabinet members and high level administrators. Changes at the highest levels were followed by rotating positions all the way down to the lowest paid echelons. Nevertheless, rotation from one position to the other disguises the influence of special interests that persist in their control of important parts of the state administration, including labor and procurement contracts. The state developed widely diversified and highly stratified compensation and social security systems for public employees. State assets are poorly maintained and often abandoned. The state has tolerated practice of discretionary donations of real estate and other state assets to special interests, municipalities, and NGOs.

Distorted public administration practices are not only at the core of inefficiencies in resource allocation and production but are partially responsible for distrust among levels of government as well. Weak state management capacity and clientele-dominated administrative culture have not only affected state resources but federal and municipal as well. Federally funded subsidies for rural development, for instance, end up distributed by state authorities following the same clientele-based criteria, lack of transparency and discretionary decisions other state resources are. Although municipalities have become as important recipients of federal transfers as the states, lack of transparency and accountability has made it difficult for the state to lead local governments towards coordinated investment and service operation.

The state government of Chiapas is starting to reverse this situation. The current governor was elected in 2000 as part of the break with one-party rule in Mexico, and his government is committed to reforming the state administration, advancing social services and developing the productive sectors to replace the public sector as the engine of growth and poverty reduction. This was reflected in the comprehensive agenda of state-level reforms envisioned in the Plan de Desarrollo Chiapas 2001-06. This Programmatic Economic Adjustment Loan (PEDL) for US$[40] million will be the first stage of the Bank's response to the Chiapas state government's commitment to reform its programs to support poverty reduction through economic development. The ambitious policy agenda that the operation will

support--to be elaborated in the government's Letter of Development Policy--has been discussed and designed over a series of technical missions starting in early 2002.

2. Objectives

Primarily this program of reforms in Chiapas aims to improve the quality, quantity and targeting of public services, toward the ultimate objective of promoting poverty reduction through economic growth. The program will include strong attention to problems with governance that have subverted public sector activities in the past, and will address the problems in the specific sectors that are most relevant for poverty reduction and growth. The measures to strengthen sector programs and reform public administration will have fiscal as well as political costs, so it is important to include in the program the necessary reforms of fiscal management to assure sustainability.

The objectives of the loan go beyond Chiapas, as all state governments in Mexico need to enhance their fiscal position and improve service delivery. This is an essential condition for the federal government's decentralization policy to work in the long run.

3. Rationale for Bank's Involvement

The underlying rationale that unifies these reforms is to install, for the first time in the modern history of Chiapas, a state administration that provides basic social and infrastructure services with enhanced transparency and efficiency, utilizes effectively the potential public-private partnerships for mobilizing community resources, and creates a positive overall environment for business and investment. For these new management principles to work, this project addresses four broad reform areas: (i) Governance: transparency and social participation create conditions for legitimate government and help direct spending where it can be most effective; (ii) Social Sectors (health and education): it is expected that better spending in these two areas will contribute significantly to the reduction of poverty by giving people access to knowledge and by improving their well-being; (iii) Economic Planning and Development: reforms in this area will create the framework conditions in which the private sector constitutes the engine for growth; (iv) Public Finance and Management: the reforms that the state government envisions must be financially sustainable; consequently, increasing own revenue, reforming state-municipal relations and adjusting the internal working of the public sector in Chiapas are crucial conditions for the success of this operation.

4. Description

This extraordinarily difficult economic development program will take several years and require a series of reforms, some of which can only be designed fully after seeing how the initial steps proceed. To support this process, the government has requested a series of up to three adjustment operations in a programmatic framework. The first proposed operation, for the equivalent of US$[40] million, would mainly cover the actual costs of adjustment and transition--retraining, paying severance for redundancies, recapitalizing the pension fund, investing in capacity building to reach isolated communities with health services, providing one-time financial incentives for the creation of a new fee-for-services water culture at the local level, etc. The subsequent operations would cover other such reform costs in the future and perhaps the eventual expansion of the public investment program if the state chooses to do so, with strong public support and adequate increases of

resources to support it.

5. Financing

The loans in the Chiapas program will be only US$[40] million per year, at least for the first two years, leaving more that adequate headroom for other operations, even at the state level.

6. Implementation

This project will be implemented by the Ministry of Finance of the State Government, as well as by the corresponding sector agencies committed in certain reform areas. Overall reporting on the Project implementation will be the responsibility of the Ministry of Finance.

7. Sustainability

This project intends to ensure feasibility and sustainability of this package of reforms by strengthening fiscal capacity, assessing the adequacy of government actions and minimize the risks of the government's comprehensive package of multi-sector reforms. If successfully implemented and maintained after the change of administration, Chiapas should have a public sector that is at least as responsive, accountable and participatory as any other state in Mexico. It would also be comparable with the most advanced subnational administrations in Latin America and the Caribbean in terms of public-private synergies and partnerships.

8. Lessons learned from past operations in the country/sector

Chiapas fulfills an important role since it is the poorest state of the Mexican federation. By showing the other states of the Mexican federation that structural adjustment is possible and rewarding, even in the state that is often regarded as the most backward, the Chiapas program will constitute an unprecedented example. Other states will possibly imitate and follow a similar path. This will further add to the Mexican experience of successful structural adjustment on subnational levels, as is currently the case with the states of Mexico and Puebla. So this loan carries a nation-wide significance and provides a good example for states to be able to improve their fiscal position despite an adverse economic context. The federal Secretary of Finance (SHCP) anticipates covering a maximum of four state with programs similar to the one carried out with the state of Mexico and now proposed for Chiapas.

9. Environment Aspects

Another meeting has to be scheduled to further analyze if the safeguards are triggered.

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Note: This is information on an evolving project. Certain components may not be necessarily included in the final project.

To mention just one indicator, Chiapas is ranked last in the country in terms of fixed telephone lines in households, with only 11.8% coverage, compared with the 66% in the Federal District or 57.5% in Nuevo León.

A collection of detailed sector/issue policy notes underpinning the agenda was produced for the government and is available on request.

Chiapas ranked second to last in foreign direct investment by state for 1994-2000. Out of a total of 71 billion dollars of foreign direct investment in Mexico in the 32 federal entities, Chiapas received only 7.1 million (the last one was Oaxaca, with only 2.1 million).

This PID was processed by the InfoShop during the week ending January 10, 2003.