Mexico: Subnational Fiscal Topics
Programmatic Approach (P156737)
Final Review

I. Introduction

1. **This report describes the activities and outputs delivered under the project Mexico: Subnational Fiscal Topics Programmatic Approach (PA).** This review note is structured as follows**:** This introductory section recaps the project development objectives, the structure of the project and the main outputs and expected results defined at the concept note stage. Section II reports the progress obtained in the setting up of the legislation regulation subnational indebtedness and recent trends in subnational public finances which has been the focus of this project. Section III presents a summary of the main findings of a report on intergovernmental transfers that was prepared under the project. Section IV describes the implementation of the activities and outputs delivered during the 3 years of this project. Section V gives an assessment of the progress achieved so far towards the PDOs. Section VI informs the allocation of resources spent in FY16-FY18 across activities, the Bank's team composition and other project's information.

2. **The project concept note discussed in March 2016 defined as the PDOs the support to enhancements in the sustainability of subnational public finances and the efficiency of the intergovernmental fiscal relations in Mexico**. In particular, this PA project aimed at providing policy proposals to: (i) improve subnational debt regulations and ensure the sustainability of subnational state governments; (ii) increase the ability to collect taxes and own revenues by subnational governments; and (iii) enhance the efficiency and equity of the intergovernmental transfers system.

3. **To support the achievement of the PDOs, this proposed PA project consists of four planks**

   A. **Subnational debt regulations:** technical support to the preparation of subnational indebtedness legislation by the federal government;

   B. **Medium term fiscal frameworks (MTFFs) and fiscal adjustment programs:** design and support the preparation of MTFFs and fiscal adjustment agreements for highly indebted SNGs**;**

   C. **Subnational taxation**: explore options to enhance the collection of subnational taxes both on tax policy (new tax bases for SNGs) and tax administration, and;

   D. **Intergovernmental** provide analytical underpinnings and practical implementation inputs to improve the equity and efficiency impacts of intergovernmental transfers.

4. **This PA project was designed as a 3-year activity to be implemented in FY16-18[1].** Activities in FY16 and FY17 were focused on planks (A) and (B). In particular, they supported the preparation of the Fiscal Responsibility Law for Subnational Governments (*Ley de Disciplina Financiera para Entidades Federativas y Municipios, LDFEFM*) its by-laws accompanying and the preparation of MTFFs for selected state governments. Activities in FY18 were planned to complete the work under (A) with the dissemination and training activities for SNGs on the new fiscal discipline legislation and (B) preparation of MTFFs for other states and the design of fiscal adjustment programs underpinning the agreements to be signed by the

[1] The project activity initiation summary was approved in Q2 FY16 and the project concept note was approved in Q4 FY16.

federal government and highly indebted states. For plank (C) it was planned the preparation of a report assessing policy options to improve subnational tax collection. For plank (D) it was contemplated the preparation of an assessment of the intergovernmental transfer system, including an evaluation of the federal capital transfer to municipalities for basic social infrastructure (*Fondo de Aportaciones para la Infraestructura Social, FAIS*) and the assessment of the role of discretional transfers under agreements between the federal and state government under *Ramo 23*. Due to the Presidential and Governors election period activities under B and C were not undertaken as planned.

Table 1: Outputs and Expected Results by Plank

Plank	Outputs	Expected Results by 2018
A. Subnational debt sustainability	Technical assistance for the preparation of LDFEFM and by-laws	Adoption of sound legislation regulating subnational borrowing
B. Preparation of MTFFs and fiscal adjustment programs and debt restructuring operations for SNGs	Design of MTFFs Design of fiscal adjustment agreements Mechanisms for the monitoring of fiscal adjustment agreements	Increased capacity for fiscal planning by SNGs Highly indebted states with debt restructuring operations and fiscal adjustment agreements Ability of federal government to monitor progress of fiscal adjustment agreements
C. Subnational taxation	Relevant diagnostics of the key issues of the Mexican subnational taxes: *Tenencia* and *Predial*	Improvements in tax administration of *Tenencia* and *Predial*
D. Intergovernmental transfers	Analytical foundations to improve the design of intergovernmental transfers	Improvements in the efficiency of intergovernmental transfers

II. The Mexican SNGs indebtedness control framework[2]

5. **In the 1990s, subnational borrowing in Mexico was oriented by a market approach but moral hazard and soft budget constraints associated to the perception that the federal government will rescue SNGs in debt distress, undermined market based fiscal discipline.** The framework was based on the concept of the *mandato* (mandates) which consisted in the federal government acting as a trustee in servicing subnational debts that had been collateralized with the unconditional revenue-sharing transfers known as *Participaciones*. In practice, the *mandato* was perceived by the markets as a guarantee by the

[2] This section is based on the note prepared under this project entitled Mexico: Ensuring Subnational Fiscal Sustainability.

federal government on subnational debts. This perception of a very likely federal bailout created two problems: (a) banks had the incentive to lend to subnational governments without assessing the borrower's repayment capacity since they perceived them to be risk free (*moral hazard*); and (b) subnational governments also had the expectation of a bailout since it was not credible that the federal government would in fact reduce transfers in case of a debt crisis (soft budget constraints).

6. **Mexico's subnational debt framework was reformed in 2000 to reinforce the market based approach by alleviating moral hazard and soft budget constraints distortions.** The reforms regarding the new regulatory framework for SNGs debt were based on two main mechanisms: a new system aimed at enabling lenders to correctly assess idiosyncratic subnational risks and an explicit no-bail-out commitment by the federal government. These objectives were pursued through (a) the elimination of the *mandatos* and the creation of subnational governments' Master Trust Funds; (b) establishment of a link between the capital risk weighting of bank loans to subnational governments and their credit rating; (c) and a requirement to register subnational loans with the Ministry of Finance, conditional on being compliant on financial transparency requirements.

7. **The establishment of the Master Trust Fund (MTF) was a key factor to reduce risks and the expansion of the private credit market for SNGs borrowing.** The regulations for the establishment of Master Trust Funds defining debt contracting and repayment procedures using federal general transfers to be directly transferred to creditors reduced risks and handled the expansion of the SNGs private credit market. Each subnational government would set up its own master trust, adjusted to its specific legal environment. The states transfer the flow of federal general transfers (*Participaciones*) to the master trust through an irrevocable instruction to the federal treasury. The irrevocable nature of the transfer of present and future tax participations to the master fund eases the legal analysis of the securitized debt, as it allows the isolation of the payment source from the borrower. The legal analysis of the master fund flows (the so-called *structure*) has been crucial to assess the probability that a state government could try to deviate flows to cover expenses rather than the debt service from the credits contracted through the master fund.

8. **Credit ratings and supply side regulations also reinforced the framework for subnational borrowing based on a market approach.** By 2010, all states and around 50 municipalities had been assigned credit ratings by at least one recognized rating agency. As a result, SNGs public finances have been subject to growing surveillance and scrutiny by private markets and rating agencies. In addition, regulations form the National Banking and Securities Commission (CNBV) on provisions for SNGs lending operations by banks based on credit ratings and expected losses impose constraints to the supply of credit to SNGs.

9. Despite the strengthening of the SNG debt framework that resulted in the strong expansion of the credit market, important weaknesses of the system were:

a) **Focus on the master trust funds and not on the borrower fiscal situation.** Given the critical role of the master funds as irrevocable use of federal transfers for debt repayment commitment, the fiscal position of SNGs passed to exert a secondary role in the credit risk assessment. Creditors focused just on the legal structure of the master funds and on the expected flows of federal transfers to the MTF. Thoughtful assessments of the fiscal situation of SNGs were considered as complementary or even unnecessary. On the other side, borrowers had few incentives to improve their fiscal sustainability conditions to obtain better credit conditions.

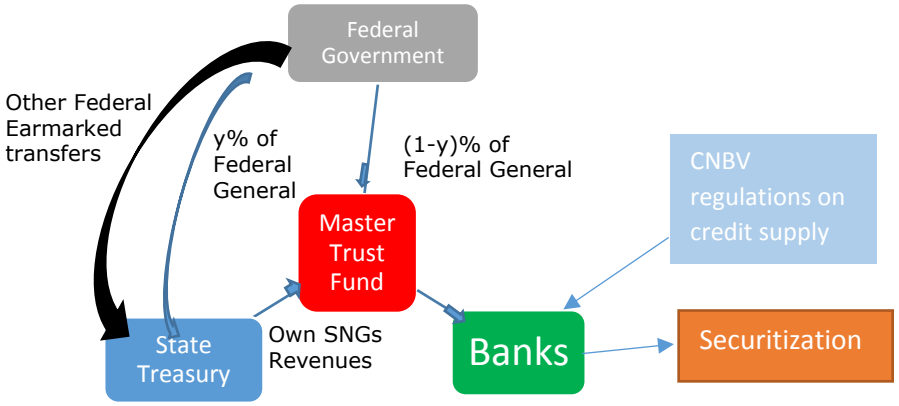
b) **Reduction of credit risks not translated to borrowing costs.** The irrevocability of the MTFs and the fact that they are financed by federal transfers, implies that debt repayment risks using

this mechanism should be similar to the one of the federal debt, risk premiums for SNGs borrowing have been considerable.

c) **Proliferation of trust funds and excessive commitment of federal transfers for debt service.** Encouraged by the successful experience of the MTF in expanding the access to private credit, subnational governments and creditors created new trust funds for specific operations pledging own tax or other revenues or in some cases using federal general transfers which resulted in an excessive commitment of federal transfers and other revenues to debt service payments.

d) Weak fiscal management by SNGs. Shortcomings on fiscal data availability and reliability, reduced coverage of public sector agencies and lack of registration of short term obligations and other liabilities of SNGs, such as obligations from Public Private Partnership (PPP) contracts, hamper the efforts to assess accurately the financial solvency of SNGs.

Figure 1: Subnational Borrowing in Mexico in the 2000s



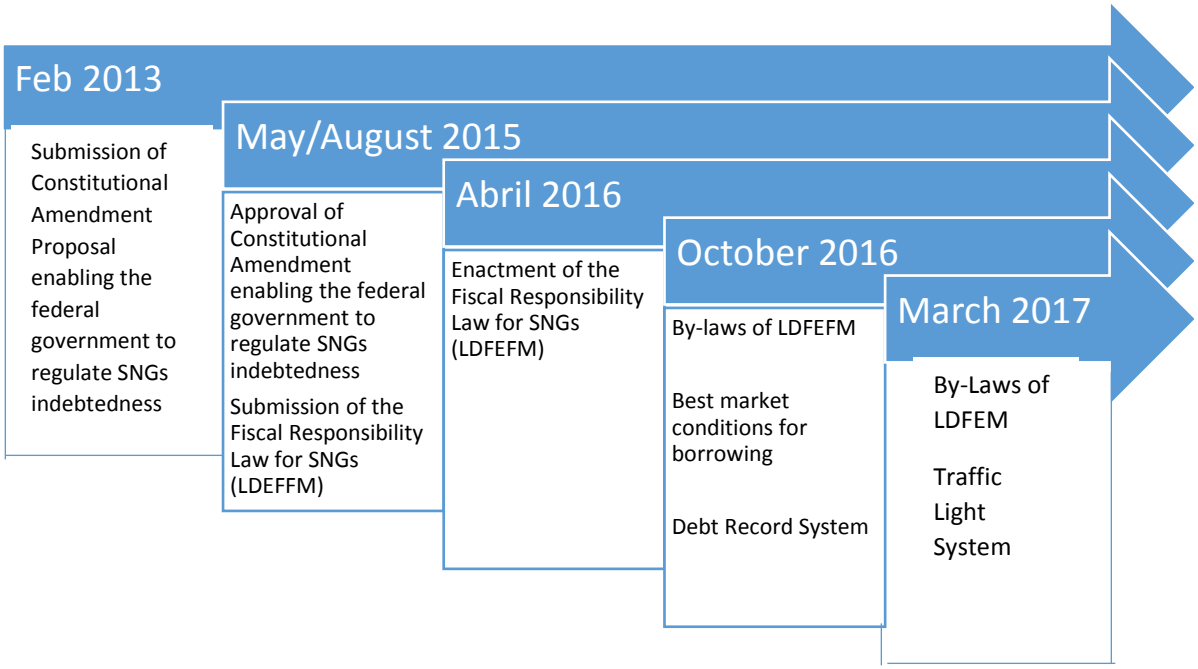
Source: World Bank Staff

10. **Easier access to credit and the deterioration of subnational public finances resulted in an increase of subnational debt from 1.7 percent of GDP in 2008 to 3.1 percent in 2013**. In the wake of the global financial crisis the Mexican economy suffered an abrupt deceleration that negatively affected subnational revenues. Faced with large mandatory spending obligations and a limited capacity to boost own-source revenues, states increased their borrowing, and thus subnational debt rose from 1.7 percent of GDP in 2008 to 2.2 percent in 2010. This trend continued even when the effects of the crisis subsided and SNGs revenues recovered, with debt reaching 3.1 percent of GDP in 2013. Moreover, rising debt service obligations put under risk fiscal sustainability of several state governments. In 2014, 7 states have debt-to-non-earmarked revenues ratios exceeding 100 percent. At the same time, a growing reliance on short-term debt created liquidity problems and events of default on short term debt have happened. The strong use of federal transfers and SNGs' own revenues into MTFs and other trust funds, led thems to increase their short-term borrowing.

11. **Aware of the fiscal risks from increasing SNGs debts, the federal government has set up an institutional framework to control SNGs indebtedness through a Fiscal Responsibility Law for SNGs as its center piece.** Recognizing that a market based approach for fiscal discipline needs to be complemented by a hierarchical or institutional approach in which the federal level set rules, borrowing restrictions and monitoring and control devices to prevent unsustainable indebtedness of lower levels of

government, federal authorities have taken important steps in this direction in last four years. In February 2013, federal authorities submitted to the Congress a draft Constitutional Amendment that grants to the federal level authority to regulate SNGs borrowing[3]. In May 2015, this constitutional amendment was adopted paving the road for the adoption of a Fiscal Responsibility Law for SNGs. In August, 2015, federal authorities submitted the draft of the Fiscal Responsibility Law for SNGs, the *Ley de Disciplina Financiera de las Entidades Federativas y los Municipios (LDFEFM)*. After the approval of the draft by the Congress in March 2016, the federal government enacted the LDFEFM in April 2016. Complementary regulations were issued from October, 2016 to March 2017, completing the new institutional framework regulating SNGs indebtedness in the country (see **Figure 2**). This new regulatory framework is expected to being adopted by SNGS since 2018.[4]

Figure 2: Milestones of the Setting Up of the SNGs' Indebtedness Control Framework



Source: Ministry of Finance (SHCP)

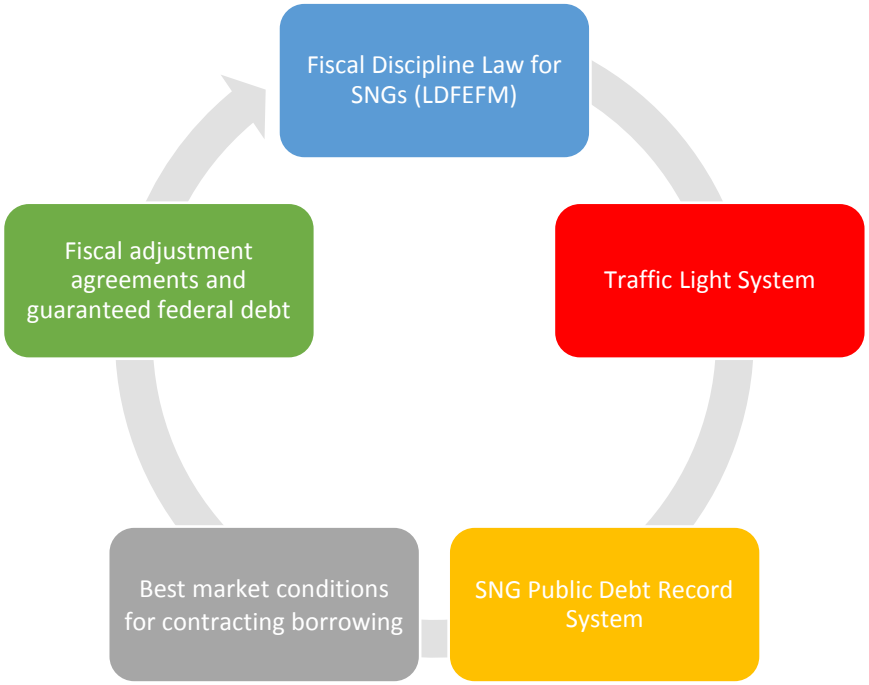
12. **Before the legislative approval of the new institutional framework, the federal government had been supporting SNGs fiscal adjustment efforts in an indirect and ad-hoc way.** As the previous legislation prevented the involvement of the federal level in SNGs fiscal and indebtedness policies, the federal government participated indirectly in debt-restructuring operations between state governments in debt distress and private banks through its National Development Bank (BANOBRAS). The participation of BANOBRAS had a twofold objective: (i) ensure that the debt restructuring will help to correct fiscal

[3] Before the enactment of this Constitutional Amendment, subnational governments were fully autonomous on their indebtedness policies and legislation and the federal government had not authority to regulate them.
[4] State governments should begin to follow the statutory requirements of the LDFEFM since 2018 and local governments since 2019.

disequilibria by including in the restructuring agreements covenants defining targets for fiscal indicators to be achieved by SNGs and; (i) reduce refinancing costs given BANOBRAS's lower financing costs. Up to 2016, five debt refinancing agreements were signed with BANOBRAS participating in the refinancing scheme. However, the leverage of the federal government to impose fiscal adjustments to states that restructured their debts has been limited and their fiscal performances have not significantly improved.

13. **The institutional system for subnational borrowing controls consist of five components**: (1) the LDFEFM, three complementary regulations, including (2) a traffic light system, (3) a public debt registration system, (4) a regulation defining conditions for contracting debts at the lowest cost, and (5) access to guaranteed federal debt (*deuda federal garantizada*) to be used in debt restructuring operations between SNGs and creditors conditional to the signature of fiscal adjustment agreements. (see **Figure 3** below).

Figure 3: SNG's Indebtedness Control Framework

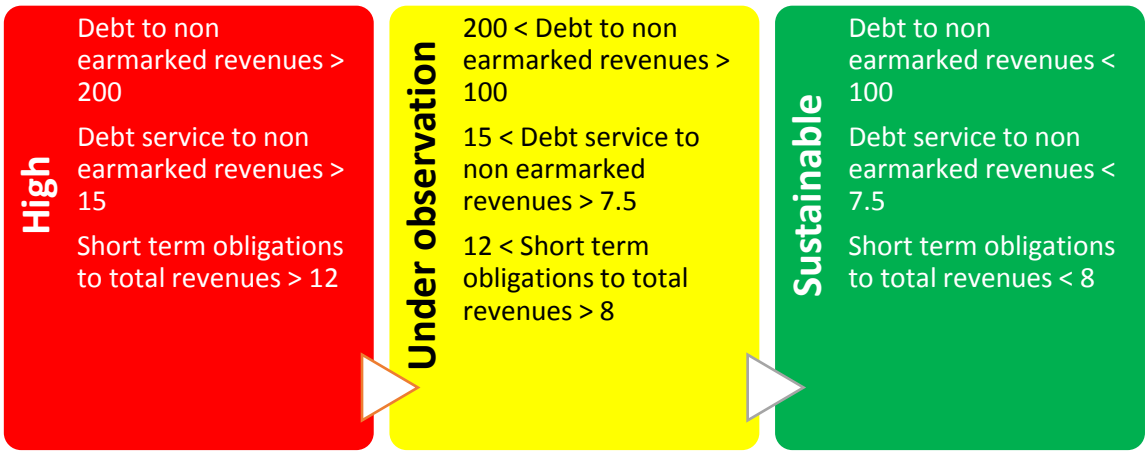


Source: Ministry of Finance (SHCP) and Bank's staff

14. **The main aspect of the LDFEFM is the definition of a fiscal rule for SNGs that links their fiscal balances to debt levels reflected in their ratings in the traffic light system.** The traffic light system defines three levels of indebtedness: sustainable (green), in observation (yellow) and high (red). For each level, it defines a ceiling (cap) on net financing which is equivalent to the overall balance. For SNGs with sustainable indebtedness, the ceiling was set at 15 percent of non-earmarked revenues, for SNGs with debt levels in observation, the net financing ceiling is 5 percent, and for highly indebtedness SNGs, the ceiling on net financing is zero, which implies that they should have a balanced budget (**Figure 4**). The compliance with this rule ensures sustainable SNGs public finances as it will impose fiscal adjustments to debt distress SNGs while enabling to contract debt within a prudential interval to solvent SNGs. The LDFEFM also

requests the accomplishment of the golden rule to ensure that borrowing does not finance recurrent spending or current deficits but productive investment. Moreover, the LDFEFM also defines caps for the growth of personnel spending and other current spending. It also includes an escape clause to accommodate infrequent shocks.

Figure 4: Traffic Light System and the Fiscal Rule in the LDFEFM



Classification	Rule: Ceiling on Net Financing
	**Net Financing cap of 0% of non-earmarked revenues** **Net financing cap of 5% of non-earmarked revenues** **Net financing cap of 15% of non-earmarked revenues**

Source: World Bank staff

15. **The LDFEFM also defines budgetary preparation and execution regulations to enhance public finance management**. In particular, the LDFEFM states the mandatory preparation and submission of medium term fiscal projections and procedural rules for budget execution such us use of revenues exceeding budget projections or spending categories to be adjusted in case of revenue shortfalls. Finally, the LDFEFM contemplates sanctions for entities and civil servants who fail to comply with the LDFEFM regulations.

16. **The regulation on the public debt record system sets obligations for borrowers and creditors on the registration of borrowing operations in a centralized debt record system developed by the Unit of Coordination of Federative Entities (UCEF) at the Ministry of Finance (SHCP).** It aims at having standardized record of the public debt of the federative entities so that taxpayers, market agents, subnational

managers and the federal government themselves have reliable and up-to-date information on the obligations of each state and municipality and make their decisions on the basis of a common information framework. The public debt registration system also contains provisions for the registration of PPPs obligations and contingent liabilities related to them.

17. **The LDFEFM also include regulations on the debt contracting procedures to ensure market competition and transparency in the contract of credit operations**. The goal of this regulation is to reduce borrowing costs by enhancing competition among creditors. These regulations mandates to contract debt through competitive auctions with minimum number of participants, guidelines to define borrowing costs, publication of offers, criteria for the selection of the lowest financial costs and publication of results.

18. Finally, an important aspect of the LDFEFM is that it enables the direct participation of the federal level in debt restructuring operations. The law defines the conditions for the use of federal guarantees linked to fiscal adjustment agreements in debt restructuring operations. In exchange for granting guarantees in debt restructuring operations, the federal and subnational governments will sign fiscal adjustment agreements which consist in the definition of multi-year targets for fiscal balances, spending levels and own revenue generation. Moreover, the LDFEFM turns mandatory for high indebtedness states the acceptance of their fiscal adjustment plans by SHCP. Therefore, federal guarantees for debt restructuring operations are expected to enhance the leverage of the federal government on the fiscal performance of subnational entities and reduce borrowing costs.

19. Overall the LDFEFM and its regulations gives a sensible framework for controlling subnational indebtedness. The fiscal rule included in the LDFEFM is simple, transparent and its compliance is easy to be verified. The LDFEFM also has important budget preparation and execution rules, in particular the mandatory submission of MTFFs is expected to support medium term fiscal planning and prevent long lasting deterioration trends in fiscal accounts. The public debt record system is expected to give reliable and updated information to market participants and the traffic light system will not only define the net financing ceilings for the operation of the fiscal rules, but also will provide information to creditors and taxpayers on the fiscal solvency of SNGs. Regulations to contract under best market conditions will bring transparency to debt contracting and lower financing costs. Federal guarantees for debt restructuring operations are expected to enhance the leverage of the federal government on the fiscal performance of subnational entities and reduce borrowing costs.

20. While the technical design of the LDFEFM is sound there are two aspects that may be revised to ensure its ability to prevent excessive indebtedness and improve fiscal management.

a) Adjustments to the thresholds of the traffic light system: thresholds are too high weakening the ability of the traffic light system to differentiate fiscal situations and prevent excessive indebtedness[5].

b) Reduce the number of regulations imbedded in the LDFEFM: too many rules can complicate SNGs fiscal management and result in overlap and inconsistency of targets, some rules such as the ones regulating excess and shortfall in revenues may be dropped.

[5] The note mentioned in footnote 2, provides simulations of possible changes to the intervals of the traffic light system.

c) Use of federal guaranteed debt and fiscal adjustment agreements: there is need for more explicit regulations on the concession of the federal guarantees and how the fiscal adjustment agreements will be designed, executed and monitored.

21. The LDFEFM is already facing implementation challenges that are related to the reliability of fiscal information and the lingering presence of soft budget constraints. The effective and efficient operation of the fiscal rules requires the availability and transparency of fiscal and debt information for the SNGs. Improvements in financial accounting and fiscal reporting are critical for the effective adoption and verification of the fiscal rule embedded in the LDFEFM and other provisions. Despite the improvements brought about by the implementation of the General Governmental Accounting Law, shortcomings on data availability and data harmonization among SNGs and transparency issues on fiscal accounting and registration of debt, including short-term debt such as debt in arrears, and delays in the publication of fiscal accounts contribute to the opacity of the fiscal position of subnational governments and may hamper the LDFEFM implementation.

22. Harden budget constraints on SNGs is also critical for the credibility of the LDFEFM. The evolution of federal discretionary transfers (*convenios*) suggests some softening of budget constraints as these transfers have been used to close financial gaps of SNGs. To enhance the credibility of the LDFEFM and harden the budget constraint faced by SNGs, it is necessary that the federal government to reduce discretion on transferring resources to SNGs with permanent liquidity problems which reflects deeper problems of insolvency. The participation of BANOBRAS needs also to be revisited and it is expected that the adoption of the LDFFEM and the use of federal guaranteed debt in debt restructuring operations in a more direct and transparent way will reduce the need for its participation in these operations.

23. **While an evaluation of the effects of the LDFEFM is premature as its main regulations have not been implemented yet, there are encouraging signals that its full adoption will enhance fiscal discipline to SNGs.** Since the initial steps in the building up of the institutional framework for controlling SNGs borrowing in 2013, the increasing indebtedness trend has been interrupted. Improved fiscal balances and increased awareness on the implications of the forthcoming application of borrowing controls have been reflected in the reduction of nominal debt accumulation (**Error! Reference source not found.**) and the stabilization of debt to GDP ratios (**Error! Reference source not found.**).

Figure 5: The Subnational Debt Stock, 2005-2017 (billions of 2017 MXN)

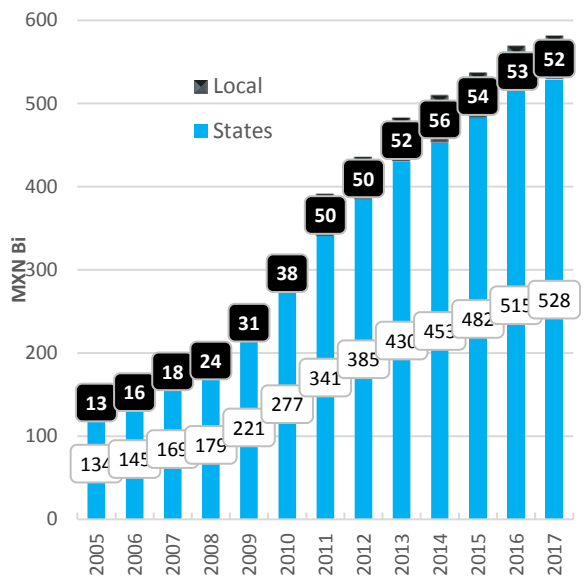
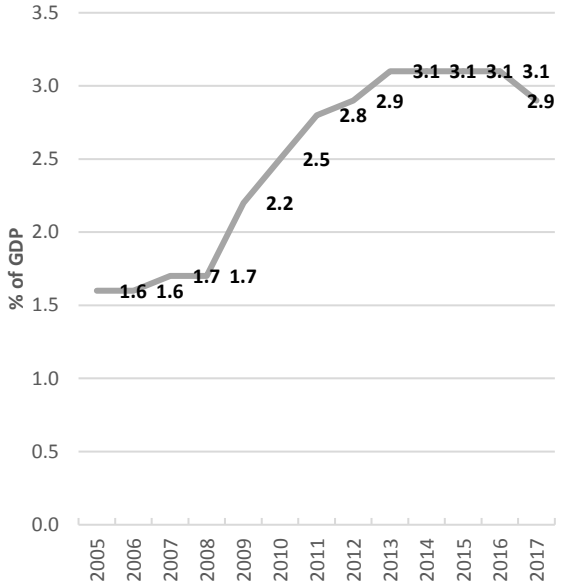


Figure 6: The Subnational Debt Stock, 2005-2017 (% of GDP)



Source: SHCP

III. Mexico's Intergovernmental Transfer System

24. **Intergovernmental transfers can be classified into four types according to their policy objectives.** These include: (i) revenue-sharing transfers used to close the vertical fiscal gap; (ii) equalization or compensatory transfers used to reduce the horizontal fiscal gap; (iii) conditional or earmarked transfers used to finance expenditures that advance national development objectives or generate positive spillovers across jurisdictions; and (iv) capital transfers used to overcome subnational credit constraints that would otherwise inhibit public investment. Some countries have also established regional development funds designed to promote economic growth in underdeveloped areas. A hybrid of types (ii) and (iii), these funds typically provide equalization transfers that are earmarked for specific expenditure categories.

25. Mexico has a massive intergovernmental transfers system that has the four types of transfers mentioned above:

Revenue-sharing transfers: The largest source of revenue-sharing transfers (*participaciones*) to Mexico's state governments is the General Fund for Revenue-Sharing Transfers (*Fondo General de Participaciones*, FGP). The FGP is financed by 20 percent of all federal tax revenue and federal income from extractive industries. States, in turn, are required to transfer at least 20 percent of FGP resources to municipalities, and each state establishes its own allocation criteria. In addition, the Revenue Collection and Auditing Fund (*Fondo de Fiscalizacion y Recaudacion*) receives 1.25 percent of projected federal sharable revenue (*recaudación federal participable*); the Fund for the Promotion of Local Governments (*Fondo de Fomento Municipal*) receives 1 percent; and the Fund for Municipalities Located along the Border or in Coastal Areas (*Fondo para Municipios Colindantes con la Frontera o los Litorales)* receives 0.136 percent, which it allocates according to the value of international trade processed at seaports and border crossings in each

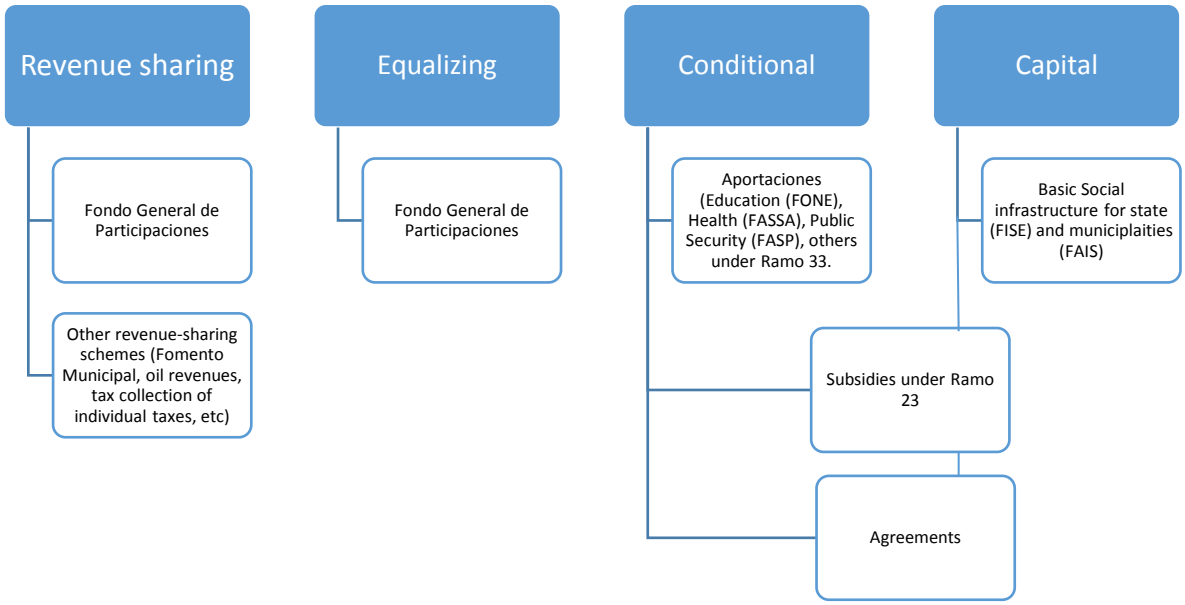
municipality. Additional revenue-sharing mechanisms also apply to specific federal taxes and other revenue streams, including excise taxes, taxes on gasoline, taxes on the oil industry, customs duties, income taxes paid by civil servants, etc.

Equalization transfers: In addition to covering the vertical fiscal gap, the revenue-sharing transfers described above help to equalize expenditures across jurisdictions. The federal revenue shared through the FGP is primarily collected in Mexico's most-developed regions, and less-developed regions tend to receive more than they contribute. However, the FGP is not designed to achieve fiscal equalization, and many of its sub-transfers are based on policy goals other than equalization.

Conditional transfers: Mexico's fiscal federalism framework also includes conditional transfers (*aportaciones*) that finance sector-specific spending by SNGs. These transfers are distributed through eight funds under the *Ramo* 33 budget line, and the largest finance education, health, and public security services provided by state governments. Conditional transfers also include discretionary transfers under *Ramo* 23, which subsidize state programs that contribute to national objectives. Finally, federal resources are channeled to state governments through agreements (*convenios*) negotiated on a case-by-case basis.

Capital transfers: Capital transfers finance investment in basic social infrastructure by state and local governments. These transfers are conditional and distributed according to equalization criteria. The subsidies provided under *Ramo* 23 and the resources transferred through agreements with state governments can also be used to finance capital spending.

Figure 7: Taxonomy of Mexico's Intergovernmental Transfer System



Source: Fiscal Coordination Law, SHCP

26. **While the massive intergovernmental transfers system addressed the vertical imbalance, it has very limited equalization power to reduce horizontal imbalances (among SNGs) despite positive reforms.** Established in 1978, the *Participaciones* system was originally designed to compensate SNGs for

the centralization of tax bases that were previously within the purview of state governments. The distribution formula of *Participaciones* was revised in the early 1990s and the reimbursable or devolution principle was watered down. In 2007 a new formula was introduced and was based on the state-level economic growth as a proxy for federal collections in each state (devolution component) and for the growth of states' own-source tax collection (tax collection effort incentive) and the level of states' own-source tax collection (compensate for revenue efforts made by the states in the past). A "hold harmless" clause was also introduced to ensure that no subnational entity will suffer an absolute loss relative to the level of transfers it previously received.

27. **Although, that the formula aimed to reward economic activity as a proxy of federal collections in each state and the states' own tax effort, the effectiveness of these terms is muted because these components are weighted by the states' population shares, making unclear the distributive impact of *Participaciones***. Indeed, because each state's population share directly influences all variables in the 2007 formula, relative population size drives the distribution of *Participaciones.* The population-based component of *Participaciones* has a modest equalizing effect, as a large share of federal taxes is collected in the most-developed regions and distributed across the country on an equal per capita basis. However, the revised formula had not had strong equity impacts, as the distribution criteria had not taken into consideration indicators that reflect expenditure need, economic conditions or the low revenue capacity. Moreover, the hold harmless clause slows down the transition to an equal per-capita transfer and makes difficult to indetify what are the factors driving the horizontal distribution of *Participaciones*. In fact, the overall distribution of *Participaciones* remains regressive, as reflected by the direct relationship between per capita transfers and per capita GDP. In 2016, the amount of *Participaciones* per capita received by Campeche was twice the amount received by Chiapas, Guerrero, and Oaxaca.

28. **While some *Aportaciones* have clear equalizing effects, the overall system of *aportaciones* does little to correct horizontal fiscal imbalances.** The Earmarked Transfer Fund for Social Infrastructure (*Fondo de Aportaciones para la Infraestructura Social*, FAIS) finances investment in social infrastructure by state and local governments via the Social Infrastructure Fund of the States (*Fondo para la Infraestructura Social de Estados*, FISE) and the Social Infrastructure Fund of Municipalities (*Fondo para la Infraestructura Social de Municipios*, FISM). FISM represents about 88 percent of FAIS. FAIS distributes 2.5 percent of federal taxes (equivalent to 0.3 percent of GDP) to the states through a formula based on poverty indicators and unmet basic needs. State governments then distribute funds to municipalities according to a similar formula. However, while FAIS clearly favors less-developed states, it does not necessarily favor less-developed municipalities, as a relatively poor municipality in a relatively wealthy state could receive less than a relatively wealthy municipality in a relatively poor state. Moreover, the loose definition of "investment in social infrastructure" and the fragmentation of resources reduce the efficiency of FAIS transfers, and a World Bank evaluation of FAIS found that it has had a limited impact on monetary and nonmonetary poverty indicators.[6] In addition, the Earmarked Transfer Fund for Strengthening Federative Entities (*Fondo de Aportaciones para el Fortalecimiento de Entidades Federativas*, FAFEF) distributes 1.4 percent of federal taxes (or 0.2 percent of GDP) to the states according to the inverse of their average per capita economic output. However, because FAFEF resources finance

[6] World Bank, (2017). *El Efecto del Fondo de aportaciones para la Infraestructura Social FAIS* en el Desarrollo Regional de Mexico. Mimeo. Washington DC: The World Bank.

SNG debt obligations, pension liabilities, and institutional and technical capacity-building, the fund has no direct impact on regional fiscal disparities.

29. **The effectiveness of *Participaciones* transfer could be improved by dividing their pool of funds into a pure revenue-sharing component and an equalization-transfer component**. The formula for the pure revenue-sharing component could be designed to ensure that transfers reflect the amount of tax revenue collected within the administrative boundaries of SNGs (i.e., a derivation or origin-basis criterion). As most federal taxes that finance *Participaciones* cannot be apportioned to states (e.g., VAT and corporate income tax), states' economic output can be used to approximate the federal revenue collected in each state. The distribution criteria for the equalization component of *Participaciones* could be designed to cover the gap between the expenditure needs and fiscal capacity of SNGs. Expenditure needs (not actual expenditures) are defined as the amount each SNG would need to spend to provide a standard level of public services based on the size of its population, local socioeconomic conditions, and the costs of providing the necessary public services. Revenue capacity (not actual revenue collection) is the ability of a government to raise own-source revenues based on an average level of administrative effort, adjusted for the size of the government's assigned tax bases and the funds received through pure revenue-sharing *Participaciones*. This equalization transfer would increase with SNG expenditure needs and decrease with SNG revenue capacity. Allocating equalization transfers according to expenditure needs and revenue capacity would eliminate perverse incentives that encourage excessive or inefficient spending and discourage collection efficiency. This formula would also need a very strong coefficient to reflect fiscal effort (i.e., improvements in collection above the average of what would be expected given the revenue capacity of the state.

30. **In terms of the large aportaciones transfers for education and health, the overall recommendations is the need to include in their distribution formula demand side criteria rather than the existent supply-side ones.** For example, Aportaciones transfers for education (FONE) resources could be distributed on a per-student basis, adjusted to reflect expenditure needs and the costs of service delivery, and they could include an equalizing factor designed to accelerate the convergence of education indicators in lagging states. Aportaciones to the heath sector (FASSA) would follow a similar approach by using client-demand criteria such as uninsured population **in each state.** FASSA should continue to partially fund *Seguro Popular*, with each state covering the difference.

31. **Prospective adjustments to other *Aportaciones* could yield additional efficiency gains, but require** further **assessment.** Merging FISE with FISM could reduce the fragmentation of the *Aportaciones* system. Because FISE represents a very small share of FAIS, and municipal governments implement most social infrastructure projects, which mainly deliver local benefits with limited spatial spillovers, merging the two transfers could yield a modest efficiency gain. The authorities would need to simplify the two-stage distribution rule to prevent two municipalities with identical conditions from receiving different amounts just because they are located in different states.

IV. Bank's contribution to the LDFEFM: activities and outputs delivered in FY16-FY18

32. **The Bank has intensely contributed to the design of the LDFEFM**. With the enactment of the Constitutional Amendment of May 2015 enabling the federal level to regulate SNGs borrowing and indebtedness, between May to August, 2015 UCEF prepared a draft LDFEFM that was submitted to the Congress at the end of August, 2015. The Bank decisively influenced the design of the LDFEFM's fiscal balance rule described above, the definition of escape clauses, the choice of the indicators for the traffic light system. In addition, the Bank's technical assistance has been decisive in the streamlining of the initially very complex LDFEFM regulations.

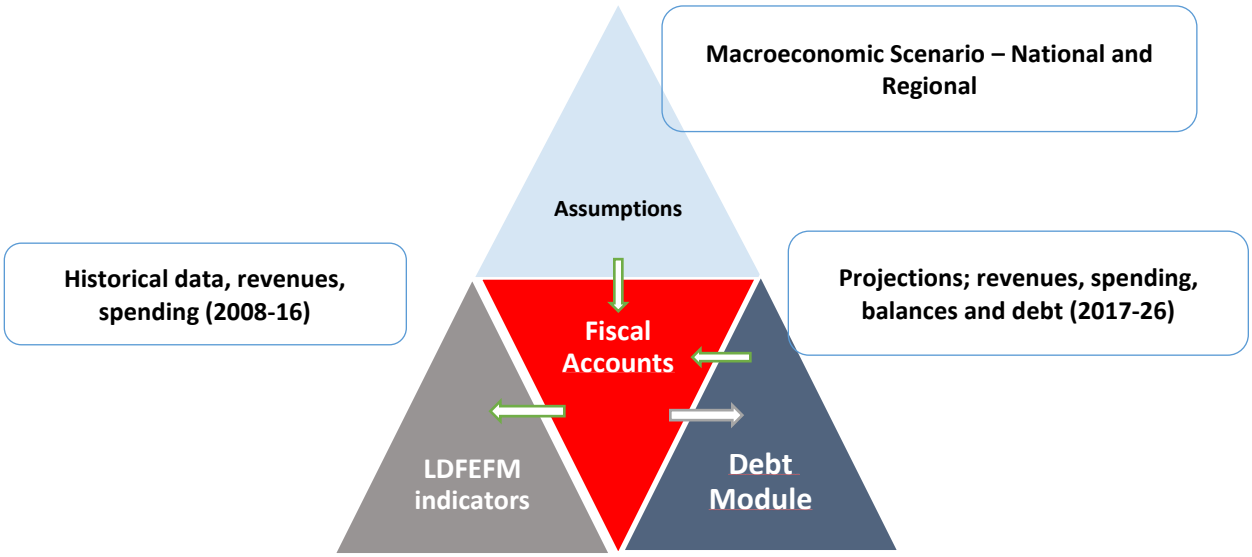
33. **In FY17, activities under plank A supported the preparation of the LDFEFM by-laws and the design of MTFFs for selected states.** Given the priority of the implementation of the LDFEFM, the preparation of the by-laws complementing in 2016-17, the project activities were focused on the technical support to the preparation of these pieces and the design of MTTFs to be requested for the 2018 SNGs budgets. The preparation of the regulations for the debt record system, the market conditions for borrowing and the traffic light system occurred between October 2016 and March 2017. The Bank's team also supported UCEF in the preparation of the regulation for the traffic light system, simulating options of its threshold levels and provided detailed comments to the regulation regarding the best market conditions to be followed by SNGs in contracting new credit operations.

34. **In FY17, the Bank has also supported the dissemination of the LDFEFM and complementary regulations.** Jointly sponsored with UCEF, dissemination and training seminars on the LDFEFM, its regulations and preparation of MTFFs have been organized in 2016-2017. The audience of the seminars were public officials of the state and municipal secretariats of finance and the seminars were delivered by Bank and UCEF staff. To reach regional audiences, the seminars were held in the states of Nuevo Leon and Quintana Roo which the participation of five neighbors' states. The audience for these seminars reached around 300 officials from state and local governments. Two other seminars were organized by the Bank and Moody's with the participation of private banks, state and municipal authorities, researchers and authorities of the Ministry of Finance. Other seminars have been planned for the states of Guerrero, Sonora and Guadalajara between October and December, 2017 before the implementation of the LDFEFM in 2018.

35. **The Bank also supported the design of the MTFFs by piloting MTFFs exercises in selected states.** As mentioned before, the LDFEFM mandates the preparation of MTFFs to be attached to the presentation of the budget law proposals of state and municipal governments beginning in the fiscal year of 2018. Federal authorities prioritized high indebted states that are likely to request debt restructuring agreements using federal guarantees. In this regard, in FY17, in partnership with the Ministry of Finance, the Bank prepared 3 pilots MTFFs for the state governments of Michoacan, Nuevo Leon and Quintana Roo[7]. The outcome of the pilot exercise is a standardized MTFF tailored to the LDFEFM definitions that will be applied in other states. Indeed, the MTFFs designed by the Bank have been presented in the training seminars referred above.

[7] The pilot exercise also included the state government of Coahuila, however the electoral calendar in the state prevented the completion of its MTFF.

Figure 8: Structure of MTFFs for SNGs in Mexico



Source: World Bank staff

36. **In addition, it is expected that these MTTFs will inform the fiscal adjustment agreements that will be signed between SHCP using federal guarantees in their restructured debts.** The objective of this component is to prepare MTFFs that will provide inputs and policy options for fiscal adjustment plans to ensure the return to a sustainable path for fiscal accounts and to enhance the credibility of the fiscal adjustment programs with the definition of realistic adjustment paths. A related area of collaboration included the preparation of regulations for the debt restructuring operations using federal guarantees and the standardization of the fiscal adjustment agreements expected to be signed after the enactment of the LDFEFM.

37. **Other activities related implemented in FY17-FY18 were the organization of a seminar on PPPs for subnational governments and fiscal risks co-sponsored with the IFC and the update of the social discount rate for the evaluation of public investment projects.** The two activities were follow up actions from the previous PA project Mexico Fiscal Challenges (P143967) and were requested by the Unit of Public Investment (UIP) at SHCP. Delivered in five days, the workshop on PPPs informed to public officials the new simplified guidelines already adopted by the federal level for the preparation and execution of PPP projects, including the registration of PPP obligations as part of the public debt and the assessment of fiscal risks. Aiming at their adoption at the state and local levels, more than 100 officials form 14 state governments participated from the training activity. Special focus was devoted to the assessment of fiscal risks and contingent liabilities derived from PPP contracts and how these liabilities should be registered under the LDFEFM accounting system. Finally, in view of significant macroeconomic developments and structural reforms in 2014-2017, the Mexican government requested for the second time since 2012, the

World Bank's assistance in updating the Mexican social discount rate and the methodology used for its cost benefit analyses of public investment projects. The preparation of this updated counted with the intense involvement of technicians from UIP and included training sessions to build capacity on this topic.

Table 2: List of Activities and Outputs by Fiscal Year			
Activities and Outputs	**FY16**	**FY17**	**FY18**
A. Subnational debt sustainability			
1. Support to the preparation of the *Ley de Disciplina Financiera de Entidades Federativas y Municipios - LDFEFM*	X		
2. Support to the preparation of the regulations for the traffic light system and for the best market conditions to contract debt under the *Ley de Disciplina Financiera de Entidades Federativas y Municipios – LDFEFM*	X		
3. Two international workshops co-sponsored with Moody's on the LDFEFM and fiscal responsibility legislations worldwide and on the LDFEFM ancillary regulations	X	X	
4. Four dissemination/training seminars co-sponsored with UCEF on LDFEFM for SNGs officials covering 6 states and more than 100 municipalities in Nuevo Leon, Quintana Roo, Sonora and Jalisco.	X	X	X
MTFFs and fiscal adjustment programs and debt restructuring operations for SNGs			
5. Preparation of 4 Medium Term Fiscal Framework (MTFFs) for Michoacan, Nueva Leon and Quintana Roo		X	
6. Technical assistance on fiscal adjustment plan for Quintana Roo		X	
B. Intergovernmental Transfers			
7. Preparation of a report on international best practices in capital matching grants and reform options for FAIS[8]		X	
8. Preparation of a note on equity impacts of the general transfer system			X
Other activities			
9. Seminar on PPP methodologies with the participation of 14 SNGs		X	
10. Update of the Social Discount Rate for Public Investment Projects		X	

[8] The assessment of FAIS was undertook by staff of GPOV04, GGOLP and GSP04 under the P156617 MX Poverty and equity PA.

I. Progress towards the achievement of the PDOs

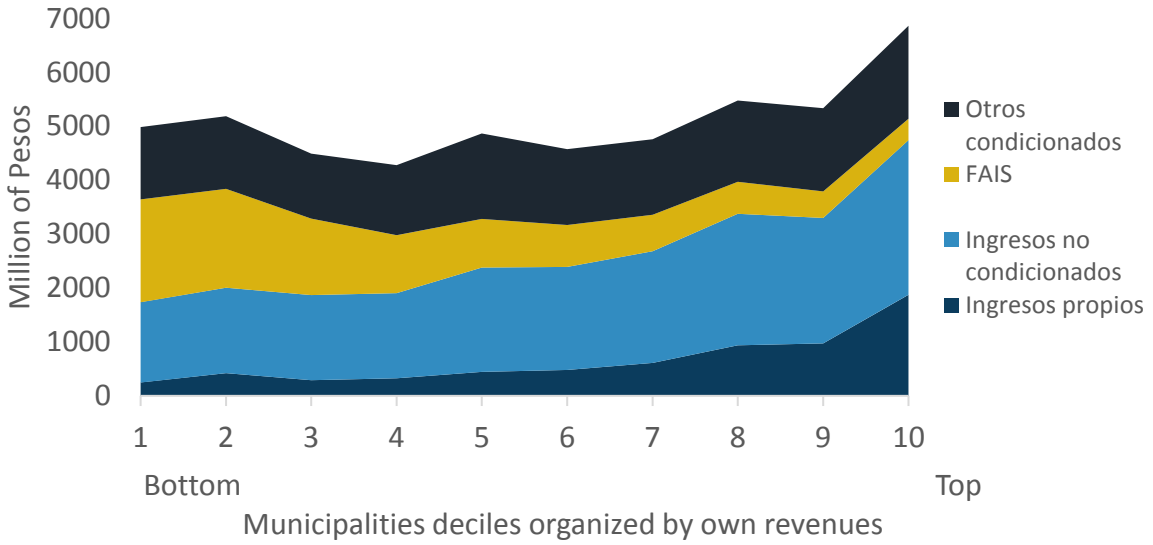
38. **As defined in the concept note, the project development objective is to support enhancements in the sustainability of subnational public finances and the efficiency of the intergovernmental fiscal relations in Mexico.** In particular, this PA project aimed at providing policy recommendations to: (i) improve subnational debt regulations and ensure the sustainability of subnational state governments; (ii) increase the ability to collect taxes and own revenues by subnational governments; and (iii) enhance the efficiency of earmarked transfers that finance investment projects implemented by subnational governments.

39. **Satisfactory progress has been obtained in (A) and (B). The LDFEFM and its auxiliary legislation provide a modern and sound basis for controlling SNGs indebtedness and is highly consistent with the market-based approach for subnational credit that Mexico has followed since the 2000s.** As mentioned before, the Bank's team has worked with the Ministry of Finance in designing the LDFEFM's main fiscal balance rule which is straightforward and if adopted will ensure sustainable finances for SNGs. The inclusion of well-defined escape clauses and the regulation defining conditions for the use of federal guaranteed debt in debt restructuring operations for highly indebtedness SNGs provide the flexibility needed to deal with infrequent situations. In addition, the traffic light system, the public debt record system and the regulations on best market conditions to be pursued by SNGs contracting borrowing operations are expected to give information to market players and favor reduction in risk premiums. Since 2018, as requested by the LDFEFM, SNGs should prepare MTFFs accompanying their annual budget laws. The MTFFs pilots in the 4 states undertaken by the Bank in collaboration with the States' Finance Secretariats and UCEF served as a basis for the preparation of MTFFs not only for these states but also as a model for other ones that submitted their budget proposals for 2018 and 2019 following the pilots.

40. **While activities under plank C supporting progress regarding enhanced subnational taxation and more efficient capital transfers have not been implemented in FY16-18, there are positive developments in this area.** The preparation of MTFFs in four states governments opened the opportunity to initiate policy dialogue with SNGs authorities on tax policy options to increase SNGs own revenue collection. At the federal and state level, there is a growing consensus that the next step in the agenda of ensuring SNGs fiscal sustainability is the implementation of a tax reform directed to broaden the tax base assigned to SNGs or the exploration of options to increase tax instruments by SNGs within the existing tax code that enables the use of certain remaining tax bases. In this regard, the state government of Nuevo Leon has asked the bank the preparation of a study to identify and assess options to expand its tax base. The new administration authorities at UCEF and the tax policy unit (UPI) have also requested technical support on property taxation which is being implemented under the project MX Fiscal, Trade and Competitiveness (P167919) initiated in FY19.

41. **Regarding plank D on intergovernmental transfers, positive developments were recently observed.** The report on FAIS prepared by GPOV04 has had strong impact on the policy dialogue with the Ministries of Finance (SHCP), Social Development (SEDESOL) and the National Council of Evaluation (CONEVAL). Authorities of the new administration expressed interest on the report on the equalizing effects of intergovernmental transfers and follow up activities are expected to be agreed in the forthcoming months.

Figure 9: FAIS in the revenue structure of municipal governments, 2015



II. Budget and Team

42. **Budget.** The Program is being funded by BB funds. Table 4 provides the budget execution in each plank in FY16 and FY17.

Table 4: Budget Allocations (FY16-17)

	Budget (FY16)	Budget (FY17)	Budget (FY18)	TOTAL
Plank A: **Subnational Debt**	$150,000	$100,000	55,000	$315,00
Plank B: **MTFFs and Fiscal Adjustment and debt restructuring operations for subnational governments**		$180,000	30,000	$210,000
Plank C: Subnational Taxation				
Plank D: Intergovernmental Transfers			40,000	40,000
Other activities: **Seminar on PPPs** **Update Social Discount Rates**		38,000 32,000	60,00	70,000
Total	$150,000	$350,000	185,000	$685,000

43. **Bank Team.** The core team consist of Fernando Blanco (TTL, Lead Economist, GMFDR), Jozef Draaisma (Senior Country Economist, GMFDR), Elisa Hernandez (Junior Professional Associate,

GMFDR), Ana Maria Jul (Consultant), Ariel Melamud (Consultant), Miriam Villarroel (Program Assistant) and Alejandra Ramon (Program Assistant).