

## Project Information Document

Project name Mexico-Decentralization Adjustment Loan (DAL)

Region Latin America & the Caribbean

Sector Multi-sector

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Borrower Banco Nacional de Obras y Servicios Publicos,  
S.N.C.

Guarantor United Mexican States

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## Country and sector background

Helped by its economic recovery, Mexico is progressing rapidly toward more autonomy and fiscal responsibility at subnational levels of government. This process is being driven by heightened political competition and by the desire of the federal authorities to broaden political participation and enhance fiscal efficiency. The Federal Congress has reinforced these trends by enhancing municipal autonomy and local resources as well as strengthening control institutions. However, the country is not yet realizing all the potential benefits of decentralization. Its overall model is still evolving, and an appropriate institutional infrastructure for the management of subnational spending, taxes, transfers, and borrowing is still lacking. These are serious shortcomings not only because they reduce the efficiency with which public services are delivered to final users, but also because they have major implications for Mexico's fiscal and macroeconomic stability.

The federal authorities are well aware of weaknesses in the existing framework. They have therefore implemented a number of policy initiatives that, while in their early stages, provide a good platform for reform as follows:

? A recent constitutional reform will strengthen the autonomy of municipalities and make them more transparent and more accountable, establishing the basis for a clear division of responsibilities between states and municipalities vis-à-vis federal resource transfers through the budget line item of Ramo 33. Concurrently, the Government, in agreement with the states, has been promoting consistent and transparent subnational financial management systems through the definition and implementation of uniform rules and practices on accounting, budgeting and reporting as well as supporting institutional strengthening programs for state-level

budgetary oversight entities, the state Contadurías (reporting to the legislative) and Contralorías (reporting to the executive).

? The federation has also taken steps to further define its evolving fiscal relationships with the states, with the aim of enhancing state fiscal and political autonomy and reducing dependence on federal transfers. This, however, has produced limited results due to perceived political cost and perverse incentives (more own tax revenue, less federal transfers) at the state level. At the level of municipalities, more is happening, particularly with the property tax-some large municipalities and particularly the Federal District have strengthened that tax's collection through better assessment and administration.

? To underscore its commitment to fiscal discipline and transparency of resource allocation, the Government has been eliminating extraordinary transfers almost entirely (the largest portion of recent transfers were through bailout packages following the 1995 crisis). In addition, SHCP has been active in disclosing the rules to access the federal matching grant ("pari passu") programs, thereby strengthening the signals and incentives and leveling the field for equitable state access to this type of federal grant. On their part, states and the Federal District have shown increasing interest in clarifying roles and accepting accountability for the program-specific transfers that go to subnational governments. SHCP also leveraged its fiscal bailout program to enter into debt disclosure agreements with each of the states (except the Federal District); this instrument, however, is quickly losing its effectiveness in the context of the economic recovery and increasing political autonomy.

These achievements only mark the first steps in a long and complex decentralization process for which the Government has demonstrated full commitment. It has requested the assistance of the World Bank to support the process of decentralization through the definition and implementation of a number of fundamental and sustainable reforms.

#### Project objectives

The core objective of the proposed operation is to support the Government's efforts to introduce reforms that would move Mexico's decentralization toward an efficient and sustainable path. This is an urgent task, if decentralization is not to translate into fiscal mismanagement of spending, taxes, transfers, and borrowing, rendering the business of government less, rather than more, transparent and accountable to citizens. The DAL will also play an important macroeconomic role, as it will help the Government reduce Mexico's vulnerability to external financial shocks and loss of confidence that in the past have been associated with the country's presidential elections, thus potentially avoiding the social and economic costs (particularly in terms of poverty increases) that are usually associated with these crises.

#### Project description

The operation is based on the Government's broad decentralization program and will support its commitment to meet four main objectives: (i) imposing hard budget constraints on federal resources provided to states and municipalities; (ii) reducing moral hazard in subnational borrowing; (iii)

increasing the transparency and public accountability of subnational fiscal and financial management and of the overall decentralization process; and (iv) setting up pilot mechanisms to enhance efficiency in decentralized expenditures in the environment and health sectors. Specific reform initiatives to achieve these objectives include the following:

? The Government effectively eliminated most discretionary transfers in its 1999 budget and intends to further tighten this provision in the 2000 budget which it will propose to Congress in November 1999. It will further increase transparency in its pari-passu programs to give full account of public expenditures.

? To meet objectives (ii) and (iii), the operation relies heavily on the introduction of market-based incentives as the main tool for increasing transparency and passing on to subnational governments the full, non-federally-guaranteed cost of debt. SHCP will implement banking regulations and uniform financial management rules (including disclosure requirements) which will reduce, if not eliminate, moral hazard and introduce market-enforced discipline in the stewardship of subnational accounts.

? Pilot performance agreements will be written and implemented in the environment and health sectors. The results agreement for environment will offer a one-time federal matching grant for the year 2000 for a fund to finance development of the state's institutional capacity for environmental management, including technical training, regulatory and monitoring capacity, and reporting for intergovernmental coordination. Its performance will be jointly reviewed and a determination made by SEMARNAP (the Environment Ministry) on any design changes. The results agreement for health will offer to participating states a matching grant to support development of states' training and institutional capacity to facilitate and monitor the expansion of coverage of basic health services, financing, inter alia, technical and managerial training, monitoring and reporting capacity.

#### Project financing

The proposed loan will be for US\$600 million, to be disbursed in two tranches. It is anticipated that both tranches will be disbursed before the end of this administration.

#### Project implementation

SHCP is the implementing agency for the operation. It has the proper legal authority to propose and enforce the budgetary and financial management rules supporting the operation. It will work with the National Banking and Securities Commission on the enforcement of banking regulations as well as rely on private sector financial markets to promote the right incentives for fiscal discipline.

The federal government will establish a high-level Decentralization Committee within SHCP that will play a continuing public information role, based in part on the statistical disclosure generated by the incentives mentioned earlier. State-by-state and municipal fiscal and financial data published by the Committee will be complemented by the federal government's regular

disclosure of the territorial distribution of its resources. The Committee, which will be served by a permanent technical secretariat, will be responsible for technical analysis of the evolution of the decentralization process in order to guide federal policy on the matter.

#### Project sustainability

Because of uncertainties related to the presidential elections in June 2000, the operation limits itself to a number of reforms which can be implemented immediately, without the need for legislative action. Nevertheless, the initiatives to be supported were carefully designed to put in motion reforms which convey positive incentives to subnational governments and strengthen their relative autonomy and, in the process, begin to ensure cohesiveness and long-term sustainability of decentralization in Mexico.

To enhance ownership in the operation, wide consultation with state governments (including some governed by opposition parties), private sector banks, Mexican development banks, and international financial sector players was carried out. Simulation models were developed to assess macroeconomic and financial sector risks.

#### Lessons learned from past operations in the country/sector

Strong ownership and the need for consultation/information are the most important lessons applicable to the decentralization process worldwide. Country-specific experience has also been in the context of several ongoing operations which have been affected by the recent ramp-up decentralization process. This experience also points to the need to involve stakeholders early and directly in the process and more specifically, to seek to deal with states on an individual basis, respect their political and fiscal autonomy, and design operations accordingly.

#### Poverty category

The proposed operation would have important effects on poverty. On the one hand, by supporting the maintenance of viable fiscal accounts at the three levels of government, it will directly protect the poor, especially the extreme poor, from the potential effects of major macroeconomic fluctuations, which in the past have erased the country's achievements in poverty reduction (e.g., during the 1994/95 crisis). On the other hand, by augmenting the institutional efficiency and transparency of sub-national finances, it will help improve administration and delivery of the array of social expenditure programs that are currently decentralized.

#### Environmental aspects

In accordance with the Bank's Operational Directive on Environmental Assessment (OD 4.00, Annex A), the proposed operation has been placed in Category "C". While it does not have any direct effect on the environment, indirect benefits will accrue through the pilot program of institutional strengthening of environmental management at the subnational level.

#### Project benefits

The operation will carry two broad, core benefits. It will start to put

Mexico's rapid decentralization process on a more sustainable path (unlocking that process' long-term promise of better quality and efficiency in public service delivery and more transparent governance at levels closest to the user, and it will greatly contribute to preventing undue subnational pressure on the federal fiscal accounts and, more generally, on the country's macroeconomic framework, especially in the historically vulnerable period leading up to the coming presidential elections.

#### Project risks

In addition to its dependence on a solid macroeconomic foundation, the operation faces several types of operational risks: (i) the election calendar will make consensus around necessary reforms difficult to achieve; (ii) some states or municipalities might refuse to adopt recommendations or respond to incentives which they perceive as federal imposition; (iii) market failure may happen with states and/or banks defying rules and regulations; (iv) financial sector-related technical difficulties may jeopardize the program's objectives; and (v) the incoming administration may have a different perspective on how the direction of reforms. While real, these risks have been taken into consideration in the design of the operation, which puts emphasis on avoiding the need for new legislative action (outside of the annual budget process) and seeking to create positive incentives for stakeholders to want to abide by the decentralization framework.

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