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REPORT AND RECOMMENDATION

OF THE PRESIDENT

OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED ESTADO DE MEXICO STRUCTURAL ADJUSTMENT LOAN

IN THE AMOUNT OF US$505.06 MILLION

FOR

BANCO NACIONAL DE OBRAS Y SERVICIOS PUBLICOS, S.N.C. (BANOBRAS)

WITH THE GUARANTEE OF

THE UNITED MEXICAN STATES

November 16, 2000

Colombia-Mexico-Venezuela Country Management Unit
Latin America and the Caribbean Region

MEXICO–FISCAL YEAR

January 1–December 31

CURRENCY EQUIVALENTS

(as of 25 October 2000)

Currency Unit	=	Peso
9.62 Pesos	=	US$1

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

ADEFAS	Adeudos de Ejercicios Fiscales Anteriores
AFORE	Administradora de Fondos para el Retiro
BANOBRAS	Banco Nacional de Obras y Servicios Públicos, S.N.C.
CAEM	Comisión de Agua del Estado de México
CAS	Country Assistance Strategy
CETES	Certificados de la Tesoreria de la Federacion
CNA	Comisión Nacional del Agua
DAL	Decentralization Adjustment Loan
DECPG	Development Economics Prospects Group
DF	Distrito Federal
DIF	Desarrollo Integral de la Familia
DRD	Decentralization and Rural Development
EdoMex	Estado de México
EMSAL	Estado de México Structural Adjustment Loan
FY	World Bank Group's Fiscal Year
GDP	Gross Domestic Product
IDB	Inter-American Development Bank
IMF	International Monetary Fund
ISEM	Instituto de Salud del Estado de México
ISSEMYM	Instituto de Sistema de Salud del Estado de México y Municipios
LDP	Letter of Development Policy
MxP	Mexican peso
PACEM	Programa de Apoyo Crediticio a Estados y Municipios
PAYGO	Pay-as-you-go
SEDESOL	Secretaría de Desarrollo Social
SHCP	Secretaría de Hacienda y Crédito Público
TIIE	Tasa de Interes Interbancaria de Equilibrio
UDI	Unidad de Inversión
WBG	World Bank Group
WEO	World Economic Outlook

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LOAN AND PROGRAM SUMMARY

Borrower:	Banco Nacional de Obras y Servicios Públicos, S.N.C.
Guarantor:	The United Mexican States
Implementing Agency:	*Secretaría de Hacienda y Crédito Público*
Amount and Terms:	US$505.06 million fixed spread, disbursement-linked, U.S. dollar-denominated loan, with level repayments and no automatic interest rate fixation. Commitment charge: 0.85 percent for the first four years, and 0.75 percent thereafter. Front-end fee: 1 percent of the loan amount, capitalized.
Description:	The proposed operation will directly support the Mexican government in strengthening its decentralization reform process. This involves helping the states adjust to hard budget constraints, in terms of getting resources from the federal level or borrowing them from the financial system. It also involves preparing the states with the financial and technical ability to participate in forthcoming federal reforms to the tax and transfer system and for the provision of key social services, namely, education and health, that have been decentralized with transfers to the states. The operation would help Mexico to ensure macroeconomic stability, which is essential for reducing poverty, and to increase the resources for education and health services to the poor. With the EMSAL, the Federal Government will mobilize the technical resources of the World Bank and financial resources through BANOBRAS—in order to support the economic reform program of the government of the State of Mexico (Estado de México, EdoMex), the largest state in the federation. This program includes raising taxes and improving enforcement, commercializing appropriate state assets, protecting and rationalizing expenditure for education and health, strengthening the state pension system and making it more compatible with the private sector, raising rates and enforcing collections in the water sector, reducing deficits, limiting borrowing, and making

the state government more accountable in matters of budgeting and borrowing. Making these reforms in EdoMex will have the largest possible externality in setting a positive example for other states, demonstrating the necessity and feasibility of a strong structural adjustment program.

The EMSAL will be a key tool in delivering World Bank support for the three objectives that are central to the present Country Assistance Strategy (CAS as discussed by the Board of Executive Directors on June 8, 1999): effective public governance, growth and macroeconomic stability, and social sustainability. A subnational operation of this type was envisaged in the CAS, both in scope and timing, and its amount lie within the previously projected lending envelope and exposure limits.

Risks and Benefits:

Four types of risks will be operative: (a) the state could revert to the fiscal imbalances of the past; (b) the Federal Government could withdraw its support from EdoMex's reform program; (c) the state Congress, currently controlled by parties in opposition, could block one or several of the policy initiatives embedded in the adjustment program; and (d) the reform program could prove too formidable a task for the implementation capacity of EdoMex's government. The strong commitment of the federal and state governments, the design of the program, and the preparation of a EdoMex Technical Assistance Project, which will be sent to the Board later this fiscal year, help to mitigate these risks.

The EMSAL operation will carry three broad, core benefits: strengthening the public sector in EdoMex to serve the needs of 13 million people, making a strong example of structural adjustment to comply with the federal decentralization reforms, and preparing the groundwork for the next round of federal reforms.

Schedule of Disbursements:

The full amount of the loan (US$505,060,000) is expected to be disbursed in three tranches, of US$200 million in early 2001, US$100 million expected in mid-2001, and US$200 million expected in early 2002

Closing Date:

December 31, 2002

Project ID Number:

MX-PE-P070479

Banco Nacional de Obras y Servicios Publicos, S.N.C.,
with the Guarantee of the United Mexican States

ESTADO DE MÉXICO STRUCTURAL ADJUSTMENT LOAN

President's Report

I. BACKGROUND AND RATIONALE

1. Mexico has been rapidly decentralizing its public sector, with more political competition and fiscal authority at subnational levels. Governments at all three levels—federal, state and municipal—are active in this process, and they recognize the need to improve their capacity for the task and to improve coordination between the levels. In the fall of 1998 the Federal Government requested the assistance of the World Bank to prepare a diagnostic of the decentralization process and an agenda of reforms to be done at the Federal level. The Bank agreed that it would be best to start with diagnosis and recommendations at the Federal level and in April 1999 delivered this agenda to the Federal Government. They found the agenda useful and requested that the Bank publish it and the background papers as a book, which was done. [1]

2. The first phase of the federal-level reform agenda was to set hard budget constraints on transfers from the Federal Government to the states and to revise the financial sector rules for subnational borrowing, to create strong disincentives against lending to uncreditworthy subnational entities. In 1999, the Mexican authorities proceeded with the first phase of its reform agenda, which the Bank supported with a US$600 million Decentralization Adjustment Loan (DAL).[2] The first reforms have succeeded thus far. By steering clear of a subnational debt crisis like that of Brazil's Minas Gerais in 1999, Mexico has harvested the rewards of its conservative monetary and federal fiscal policies. The economy is currently growing at over 7 percent p.a., its inflation rate is in single digits and declining, its exports are booming, and its balance of payments current-account deficit remains manageable (below 3.5 percent of GDP). Such a remarkable economic performance, assisted by the exemplary political transition that is following the July 2000 presidential elections and by the strength both of the US economy and of international oil prices, has not gone unnoticed—Mexico's sovereign foreign debt is now considered investment grade, and all of its commitments under the existing IMF Stand-By Arrangement have been exceeded The country recently moved to pre-pay all its debt with the Fund—some US$3 billion—and to treat the Stand-By as purely precautionary. The benefits of this are more than macroeconomic, for continued progress in poverty reduction requires avoiding crises like the one in 1994–95 that brought poverty levels back to where they had been a decade before.

3. The success of these reforms was no less remarkable on the decentralization front itself. Through the December 1999 reforms, the Federal Government imposed a "hard budget" constraint on states and municipalities. It did so by renouncing its own power to hand out discretionary transfers and by establishing an innovative regulatory link between capitalization

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1. M. Giugale and S. Webb, eds., 2000, *Achievements and Challenges in Fiscal Decentralization—Lessons from Mexico*, World Bank, Washington DC.
2. Loan Number 7002-ME, approved by the Bank's Board of Executive Directors on December 14, 1999.

requirements for bank loans to sub-nationals and their independently determined credit ratings.[3] This has prompted a new attitude toward adjustment and transparency at the sub-national level, as states and municipalities have proactively moved to obtain and enhance their credit ratings (on which their credit access now depends). There is now healthy competition among subnational governments for the political rewards from high ratings. In less than a year since the reforms were put in place, the three largest international credit rating agencies have become active in Mexico and have rated, or are in the process of rating, almost all of the states and several municipalities.[4]

4. The next stage in Mexico's decentralization reform will have two tracks: one for helping states adjust to, rather than resist, the new constraints on subnational borrowing, and a second for the continued reform of Federal policy. The Federal actions on the second track will involve revising the tax and transfer system and reforming the role of the Federal Government in sector programs that have been decentralized to the states, especially education, health, and water. The Federal authorities are aware that sustaining the first phase of the federal reforms and moving on to the next phases will require the cooperation of the states: responding to the new incentive framework, dealing with a few cases of debt overhang, and developing more capacity to collect taxes and manage their finances and spending programs.

5. The States, however, find themselves in very diverse situations. Virtually all states need sector reform and investment; a few are not only willing to reform but also have the management capacity and creditworthiness to proceed immediately with increased borrowing for investment. Many states have the willingness to reform and not much debt at present, but lack the financial and program management capacity necessary for enlarged investment programs; they will need to get substantial technical assistance prior to or perhaps along with investment lending, to assure that funds are well used and that borrowing is not excessive. Finally, there are a few states that are overburdened by rapid growth in needs for public services and have fiscal situations deeply flawed by the inappropriate incentive framework of the past (for example, bloated fiscal expenditure and debt overhang, inspired by the practice of politically driven transfers from the federation). The Federal Government is rightly seeking to facilitate adjustment among such states. Such adjustment will be important to sustain public services in these states, mostly very populous, and to get them ready to participate in the next phase of the Federal Government's decentralization reform—revising the tax and transfer system and reforming the education, health, and water sectors. Adjustment of these states will also be important as a demonstration to encourage other sub-nationals to sustain fiscal restraint and as a way to build further national support (and avoid resistance) to its discipline-imposing reforms.

6. The Federal Government has three criteria for selecting the states it will support with adjustment lending: (a) the impact that a financial crisis in the state could have on the federal fiscal accounts, (b) the strength of the state's commitment to reform and ownership of the

3. For a detailed discussion of Mexico's new regulatory system for sub-national borrowing see M. Giugale, A. Korobow and S. Webb, A New Model for Market-Based Regulation of Sub-National Borrowing, *World Bank Policy Research Working Paper Series*, No. 2370, July 2000.

4. All DAL-related policy commitments have been met and, following delivery of various documentary evidence, the operation's second and final tranche (US$300 million) has been disbursed. A "Quality at Entry" Assessment performed on the DAL operation by an internal expert panel in March 14, 2000 found the quality of "...this task to be fully satisfactory with some elements of best practice."

program, and (c) the extent of the demonstration effect for other states. First among the states asking for, and in legitimate need of, adjustment assistance is *Estado de Mexico* (EdoMex), the country's largest, most populous and, in many aspects, leading sub-national entity. If EdoMex went into a debt crisis, it would not only impair the delivery of social services to millions there, but could also wreck the regulatory framework for subnational debt, perhaps even requiring a costly federal bailout, and would raise doubt in the markets about the debt of other states. If EdoMex did not adjust, many other states might doubt if they really need to. Thus, the Federal Government reacted positively to the state's request for assistance. The state has a new government, elected in 1999, that has publicly committed itself to structural reform, both in public statements and in numerous discussions with the current and incoming Federal administrations, some of which the World Bank has participated in. Adjustment by EdoMex will have a powerful demonstration effect on other states, showing them ways to deal with difficult fiscal issues.

7. For its efforts to facilitate an adjustment program for the state, the Federal authorities requested the technical and financial support of the World Bank. Some of that support has already come in the form of a comprehensive agenda of state-level reforms for EdoMex, prepared by the Bank.[5] The Federal Government also requested a (US$500 million) *Estado de México Structural Adjustment Loan* (EMSAL) to enable it to provide adequate financial support for the state's adjustment effort. Specifically, it would allow Banobras to lend to the state through the *Fondo de Apoyo a Estados y Municipios* (FOAEM), a *fideicomiso* that assists the development of subnational governments. This Report explains the objectives, content, and risks of the proposed EMSAL. There would also be a parallel *EdoMex Technical Assistance Project* (currently being identified).

8. The proposed EMSAL would be the first time in Mexico that the Bank has supported the Federal Government and Banobras in providing assistance for a state-level structural adjustment program.[6] It would deepen reforms already supported by the previously mentioned DAL. Like the DAL, the EMSAL would be a key tool in delivering the three pillars of the Bank's current Country Assistance Strategy (CAS) in Mexico[7]—effective public governance, macroeconomic stability, and social sustainability. With the increasing responsibility of subnational governments for delivering social services in Mexico, supporting reforms at that level becomes critical to the Bank's mission.

II. THE ECONOMIC POLICY CHALLENGES IN *ESTADO DE MEXICO*

9. EdoMex is the largest Mexican state, with a population of 13 million and still growing rapidly. Most of the EdoMex population live in the Mexico City metropolitan area, surrounding

5. The agenda, and the analytical work that underpins it, was produced and delivered by a multi-disciplinary World Bank team that worked with the EdoMex authorities during a series of visits to the state over the March–September 2000 period. Beyond extensive working sessions with sector Ministers, the preparation of the agenda included a two-day retreat with the full state Cabinet in May 2000, led by the state Minister of Finance, as well as ensuing policy presentations to the state Governor.

6. Similar state-level adjustment loans have been granted for Uttar Pradesh in India (report number P7365-IN), several provinces in Argentina, most recently Catamarca (report number P7381-AR), and several states in Brazil including Rio Grande Do Sul (report number P6982-BR).

7. Report Number R99-92 (IFC\R99-82), discussed by the Board of Executive Directors on June 8, 1999.

three sides of the Federal District (D.F.), but the state also includes a second urban center (Toluca) and many rural areas. It has a strong diversified economy, with an estimated GDP in 1998 of MxP365 million (10.4 percent of the country's GDP), growing at over 7 percent per year in real terms since the 1995 recession, and a proud tradition of providing public services. It was an early leader in areas such as education, health, social security services, and urban and regional planning. Because of its size and continued immigration, however, EdoMex has more poor people than any other state, about 7.7 million in 1996, with 2.9 million in extreme poverty, although the state's poverty rate (60 percent) is lower than the country's average (62 percent).[8]

10. Despite the state's overall economic success, the EdoMex government now has extreme versions of the problems facing all the major Mexican states—rapidly growing demand for education and health services and urban infrastructure, large numbers of public workers poorly allocated in a set of institutions inherited from an era of centralized federal dominance, antiquated budget practices, and a high debt burden, which make it difficult to provide much-needed social services and new infrastructure. These are serious shortcomings for a state that, because of its fast growth, is attracting immigrants from other states at the rate of 300,000 per year. In the absence of adjustment, this renders the state government, elected in 1999 for a six-year term, virtually unable to operate under the discipline that the federal authorities imposed on sub-national credit markets at the end of last year.

11. The fiscal situation in EdoMex is not healthy, despite the health of the local economy. For example, through 1999 the state could not generate a fiscal current account surplus, and virtually all public investment was funded with borrowing—a precarious practice. Furthermore, public investment was low in 1998-99, below the previous three years even in nominal terms and by all accounts far below what the growing economy needs. Limited, and rapidly shrinking, access to credit was at least part of the reason. More fundamentally, the state's problems are rooted in its inability to raise sufficient resources and spend them efficiently at the sectoral level. Those problems are briefly described below.[9]

12. CURRENT REVENUE. Like all Mexican states, EdoMex depends heavily on federal transfers—for, about 85 percent of its revenue, not counting funds that are passed automatically to municipalities. And, like the other large states, EdoMex gets, per capita, less such transfers than the national average. The federal fiscal pact restricts state revenues to a couple of potentially elastic taxes and a large number of fees and charges—most of them obsolete and inefficient. State tax policy and tax administration resulted largely from fears of tax wars with the D.F. and other states that surround the Mexico City metropolitan area. Own revenues come mainly from a payroll tax and annual fees (effectively a tax) for automobile registration. The payroll tax is paid by firms, at 2 percent of base salaries. There are many exceptions, most importantly for the self-employed and for firms with less than five workers, for the first year of new firms and new hires, and for compensation other than the base salary. Some firms, especially banks, pay the tax in the D.F. at the firm's headquarters rather than in the state where workers are located. The auto fees include a small charge for cars over 10 years old and a larger charge for newer cars, which is actually a federal fee the collection and revenue of which has

8. The state's extreme poverty rate is 22 percent (1996), below the national average of 30 percent.

9. A fuller diagnostic analysis of the problems is presented in the background documents produced by the EMSAL team during the preparation of the reform agenda. Those documents are available on request.

been totally delegated to the states. Many EdoMex residents now choose to pay their (new) auto fees in the D.F. or other states. Taken together, wage taxes and auto fees equal only 0.6 percent of state GDP and around 16 percent of expenditure before federal conditional transfers—much lower than in other states with strong industrial and commercial sectors, like Chihuahua and Nuevo León, where the own revenues equal 0.85 percent of state GDP and cover 30 percent of expenditure before federal conditional transfers. In the D.F., own revenue equals 2.6 percent of state GDP, the highest in the country. Lack of local fiscal effort has, in other words, contributed to making the fiscal problem in EdoMex more severe than in most other states. Tax administration has traditionally focused on collection (*recaudación*), with little attention to the higher revenue–cost potential of auditing and enforcement (*fiscalización*).

13. The limited state tax revenue is only partly due to lack of local fiscal effort. Another reason is the tax distribution arrangement between the federal and state governments, whereby the states delegated virtually all their taxing powers, including personal and corporate income and sales taxes, to the federation in exchange for formula-driven revenue shares (or *participaciones*). This arrangement suited the Mexican federation in pre-decentralization times (especially before 1997) because the states had little responsibility for expenditure decisions and their finances were de facto underwritten by the Federal Government. As more expenditure responsibilities are delegated to lower levels of government to capture the efficiency gains associated with closer proximity between decisionmakers and final users, it is natural that the tax system will have to be reformed in the future to devolve taxing powers to the sub-national governments. However, this will call for a nation-wide political agreement beyond the faculties of any individual state. In the meantime, EdoMex like other states has the scope and need to build up its administrative capacity and public acceptance for increased local taxation.

14. DEBT. EdoMex has a large stock of debt, especially relative to the resources effectively controlled by the state. Like most states, and in spite of a constitutional ban on sub-national borrowing from foreign sources or in foreign currency, it was overindebted prior to the national financial crisis of 1995, and its prior debt was restructured, with federal assistance, into inflation-indexed debt, still held by banks. This so-called UDI debt is about two thirds of the state's total. Unlike most Mexican states, which cut back their net borrowing or even paid off their debt after the 1995 crisis, EdoMex continued to run deficits. Part of the post-1995 debt is regular bank loans, from congressionally approved borrowing, but over half of the peso debt is arrears to suppliers and revolving credits—"floating debt"—well in excess of what would be normal for the size of the state's investment program. Annex C provides more details on the origin and structure of the debt, and a discussion of how the state's program and the proposed loan would reduce and refinance it.

15. Every year the EdoMex authorities are forced to seek large debt roll-overs (estimated at MxP2.5 billion for 2001). Those roll-overs are increasingly difficult for the state to obtain, especially after the December 1999 reform of the sub-national credit markets. It has witnessed a worrisome shortening of the average maturity of its debt (new loans are rarely for longer than a year) and an increase in average real interest rates. This has undermined the state's creditworthiness and the willingness of its existing lenders to continue extending credit, as their own exposure reaches prudential limits. A related institutional problem is the relative autonomy of the state executive in borrowing decisions. The annual budget law allows the government to borrow up to 5 percent of the estimated annual total revenue of the state; this 5 percent amounts,

however, to over half of the revenue raised by the state itself. Thus, the state faces strong financial pressures for structural adjustment.

16. EDUCATION. Education accounts for about 60 percent of programmable state spending, that is, net of debt service and municipal transfers. Coverage of basic education is good in EdoMex, with almost all children attending primary schools and significant recent increases in the number attending secondary. Despite the successes in reducing the number of students repeating grades or dropping out, many of the students completing primary and secondary school have not obtained the knowledge and skills envisaged in the curriculum or needed to succeed in the job market. In 1993 the Federal Government turned over almost all of its basic education activities to the state; at that time, EdoMex already had its own parallel system of comparable size, albeit relatively concentrated in rural areas. EdoMex, more than most states, has expanded the coverage of basic education, and still today has one of the highest per student expenditures in the federation.

17. The federal and EdoMex education systems continue to operate independently within the state, each with a full administrative superstructure and no effective coordination between them, even in planning. Competing for students on the basis of quality of instruction could be good, but the system does not work that way. The former federal system gets earmarked resources from the Federal Government on the basis of the cost of the pre-1993 system, with adjustments negotiated on the basis of inflation and state population, and implicitly political influence. The federal Secretary of Education negotiates teacher wages with the national union. Allocation of teachers within the former-federal system is supposedly based on demand factors, like number of students, although union rules limit the impact of such factors. The state system is even more explicitly driven by the supply of teachers, who have been effectively guaranteed a job if they graduate from teachers' schools (*escuelas normales*). In addition, they are allowed to choose their location after a few years seniority, often choosing administrative positions or urban schools that are already relatively well staffed.

18. In addition, teachers are not held accountable for educational outcomes and often not even for their own attendance, especially in rural areas. The supervisors are union representatives. Because of the volume of resources going to the sector, the EdoMex Secretary of Finance has effectively managed its budget, reallocating some of the federal education transfers to the state part of the sector and, at times, even outside the education sector. The EdoMex Secretary of Education lacks real responsibility for outcomes in the sector because so many of the critical decisions are taken by others—the state and federal teachers' unions, the federal Secretary of Education, and the state Secretary of Finance.

19. HEALTH. Health indicators for EdoMex are relatively good by national and international (developing country) standards, reflecting the long tradition of public health provision and the extensive participation of the private sector. The public part of EdoMex's health sector has five health-care provider networks. Federal social security covers most workers in the formal private sector, and federal workers in the state are covered by the Federal Workers Social Security Institute. The EdoMex social security system (ISSEMyM, under the state Secretary of Administration) covers state and municipal workers. The EdoMex Institute of Health (under the Secretary of Health) covers most of the uninsured (open population), which are about half of total population, and the Family Integrated Services of EdoMex (under co–administration by

municipalities) provides an outreach program for poor families, which includes health care. The per capita resources and the average quality and effective accessibility of services vary widely among the networks. The hospitals and clinics of the Institute of Health are often overcrowded, while ISSEMyM's health system has considerable under-used capacity and outspends its income, using money from the pension fund to make up the difference. To summarize the key problems: (a) the state's spending in health is fragmented among agencies that do not coordinate with each other, (b) is inefficiently and inequitably allocated, and (c) particularly in the social security part, lacks a hard budget constraint.

20. PENSIONS. The pension part of the state's social security (ISSEMyM) is effectively an off-budget component of the compensation to state workers. Currently, employees of EdoMex and its municipalities contribute to ISSEMyM, which provides them pensions, health services, and other social services, with the contribution based only on the base salary, roughly 43 percent of total remuneration. Financially, it is a contingent liability that would surely fall on the general budget if, or when, the pension fund runs out of money to make the expected payouts, which would occur in six years' time under current rules. The financial weakness of the system has four main causes: First, the under-funded health-care part of social security has been siphoning money from the retirement fund, as noted above. Second, the retirement age of 50 for all workers who began employment before 1984 means that a large contingent will soon retire, creating a growing imbalance between retirees and contributors. Third, the contribution rate of 11 percent of salary is too low relative to the benefits, which are equal to 100 percent of the reference salary. And, fourth, the reference period for defining benefits is only the last six months before retirement, which gives managers an incentive to give out last–minute raises, the main cost of which comes not out of their own budget, but out of the pension fund. Moreover, for all of the system's financial vulnerability, state pensions remain inadequate to meet the retirees' needs because both the contributions and benefits relate only to the employees' base salary, which is less than half of the total compensation package. The EdoMex pension system, like the others in Mexico, offers no portability of benefits, thus making employees increasingly captive in their jobs after they have been there several years and see retirement approaching.

21. WATER. The national water sector in Mexico is financially unbalanced and subject to inefficient incentives. While states are part of the sector, they have limited control over its local performance. EdoMex's State Water Commission (CAEM) is a financial and physical intermediary between the Federal Water Commission (CNA), which owns all water rights and sells bulk water, and the multitude of municipal operators, which deliver the water to customers and collect the revenue from them. In a number of small municipalities that do not have their own operator organization, CAEM also is the real retail provider. The prices between each level do not usually reflect economic costs and are not consistent for water from the same source or going to the same area of users. More critically, payment is rarely enforced, either by CNA over CAEM (or other state-level bulk purchasers), by CAEM over municipal operators, or by these operators over final consumers. This creates myriad distortions and large nominal liabilities without a clear prospect of repayment. Laws and administrative decisions demanding adequate water charges have not provided sufficient incentives to overcome a long-standing tradition of non-enforcement, which is nurtured by the federal level and emulated by many Mexican states and municipal operators. Beyond the technical difficulty of supplying water to 20 million people (including the D.F.) in an often arid environment at almost 3,000 meters altitude, EdoMex's physical water system suffers from leakage of over 50 percent in some places, and many

municipalities lack water meters and charge at most only an annual hook-up fee. Although the water sector is largely off-budget, CAEM gets sizable cash subsidies from the state treasury and has large liabilities toward CNA. Although CNA itself appears reluctant to collect from its debtors, CAEM's debts are in principle contingent liabilities of the state and will affect its credit rating, which is now important in the new environment.

22. TRANSPORT–ROADS. Roads and urban rail transit are the most important infrastructure areas for which the state government has responsibility. A series of Mexico City metropolitan-area agreements between the state, the D.F., and the Federal Government has taken care of the urban transit issues relatively well. But with the largest network of roads among Mexican states, EdoMex roads remain problematic. Deficiencies start with the absence of a medium-term plan for maintenance, rehabilitation, and new construction. There is no highway inventory that is usable for planning. The neglect of routine and relatively low-cost maintenance—which has no line item in the budget—is allowing the roads to deteriorate to the point of an impending crisis, which would require massive and costly rehabilitation and reconstruction. Toll road concessions have been poorly managed and remain financially troubled, making it all but impossible to arrange new deals that are needed to meet growing traffic demands.

23. FINANCIAL ADMINISTRATION AND BUDGETING. Current budgeting and financial management practices in EdoMex have many shortcomings. The income side of the budget regularly includes extraordinary transfers from the Federal Government, even when they have not been approved by the Federal Government and, in contrast to the decades before 1997, are unlikely to materialize. This makes the budgets under-funded from the start. On the other hand, the expenditure side is organized by agency rather than by function and program, which makes it difficult to assess whether resources are allocated in accord with democratic priorities and to monitor whether the spending achieves the expected results. Although budget equilibrium is technically required, growing overdue debt with suppliers and contractors (which comprise most of the so-called ADEFAS) is rolled over in such a way that the budget appears to be formally balanced when in fact it is not. The administration and execution of the budget focuses on filling funding gaps in order to meet wage and debt-service obligations, which discourages transparency and further reduces accountability for public service results. Finally, the state does not have a medium-term plan for financing and debt management.

III. THE ECONOMIC REFORM PROGRAM OF THE EDOMEX GOVERNMENT

24. The EdoMex Government is well aware of the weaknesses in the state's fiscal position, the shortcomings in its sectoral and financial management, and their negative effects on long-term growth and poverty reduction. The authorities therefore seek to design and implement, with support from the Federal Government and the World Bank, a comprehensive structural reform agenda that would put the state's fiscal accounts on a sustainable path while enhancing and protecting its provision of social services. This section summarizes the rationale behind the various policies in that agenda and compares the projected evolution of EdoMex's fiscal accounts under the reform and no-reform scenarios.

25. At the outset, one should remember that the state authorities operate under three critical policy constraints which are likely to remain in the short- and medium-term, and which are

embedded in the constitutional and legal framework for federal-state relationships in Mexico. First, while states now have incentives to seek the reform of the tax and transfer system in order to recover tax powers, reaching the necessary national political agreement will take time because the new arrangement will implicitly define the kind of federal country Mexico wants to be. Second, the sectoral policies at the federal level in water (for example, CNA's subsidization of bulk water), education (for example, unionized wage–setting for federal-system teachers), and pensions (for example, delegation of liabilities to the states) are unlikely to change in the immediate future, and may continue to impose distortions and/or costs on the corresponding sectoral policies at the state level. In response, the EdoMex authorities have rightly taken a conservative position: their adjustment program is calibrated to bring sustainability to the state's fiscal accounts, without assuming any relaxation of the federally based constraints. Third, the policy distortions that have led to EdoMex's current fiscal problems are many and entrenched. Removing them all will require time and substantial enhancement of the state's institutional capacity. Thus, the reform program described below focuses on the initial structural policy actions needed to achieve fiscal and financial stability. A forthcoming technical assistance project would support the requisite institutional development, and in some cases sectoral projects would follow on, such as in water, transport, and the social sectors.

(A) The Program's Policies

26. The policy initiatives that make up EdoMex's reform program are described in the Letter of Development Policy and attached matrix of the EdoMex Government, addressed to the federal Secretary of Finance and attached to his Letter to the Bank (Annex D). While the Bank will support all of these reforms, e.g. with technical advice, certain key commitments will be explicitly required for the disbursement of tranches to Banobras, as elaborated below. At the center of EdoMex's program is the virtual elimination, within two years, of the state's fiscal deficit—from a projected 2.2 percent of ordinary revenue in 2000,[10] it is to fall to 0.5 in 2001 and to become a surplus in 2002 and thereafter. That will prevent and reverse an otherwise unsustainable debt and debt-service accumulation and will be achieved in a manner that protects social sector expenditures and objectives. To deliver that outcome, a combination of policies will enhance revenues and rationalize spending—moving it toward higher and more efficient social expenditures and shifting it away from unwarranted subsidies for infrastructure. The initial reforms also include key measures to strengthen financial management, especially of the budget and debt. These will strengthen the oversight and control by the state Congress, measures that will set precedents and that the opposition-controlled Congress is likely to endorse and maintain.

27. REVENUES. First, state taxes and fees will be increased, and their administration strengthened. The base of the payroll tax will be expanded to include all remuneration, all firms, and all employees, and its rate will be raised by 0.5 percentage points, to 2.5 percent. Registration fees for older cars will be set at the same level as in the neighboring D.F. The government will publish and implement a plan for improving tax administration, by shifting resources from collection to enforcement and by using data from federal administration of taxes

10. "Ordinary" income is defined as current plus capital income minus "extraordinary transfers" from the federation. Ordinary transfers are those that the federal Congress allocates state by state or according to formulas. All other transfers are considered "extraordinary".

and the social security system. Over four years, these changes are projected to bring EdoMex's own revenue collections up to a similar share of state GDP as in Hidalgo and Morelos, the Mexican states with the highest efficiency of collection after the D.F. In two years the state will have more than doubled its own tax collection as a share of programmable expenditures. This and the administrative reforms will help lay the foundation of attitudes and institutions needed for an eventual reform of the federal fiscal pact.

28. Second, capital revenues will be enhanced through better asset management. The Mexican states do not own major firms—power companies, phone companies, or banks, as in Argentina and Brazil. Still, EdoMex has ranches, hotels, and other properties that could be commercialized to improve growth opportunities for the private sector and to obtain badly needed revenue, either by sales, leases, or concessions. A five-year plan for disposing of the properties susceptible to commercialization will be launched. The plan will have a published target of commercializing, each year, a fifth of the total initial estimated market value of the assets, and annual progress reports will be sent to Congress to ensure adequate accountability. This practice, in itself, will represent a major break-through relative to past practice among Mexican states.

29. EDUCATION. Reform of this large and complex sector will start with measures to control its overall dimensions—real outlays and teacher recruitment—and will take initial steps to rationalize its organization and increase accountability for performance and efficiency. First, to protect this critical sector during the adjustment process, the education budget, in real per-student terms, will not be reduced from its 2000 level. Second, to end the traditional practice of letting the supply of normal-school graduates drive the personnel process, the state will set specific teacher recruitment targets (and limits) based on the number of students (demand for education) and will achieve a more even distribution of student/teacher ratios across rural and urban schools and across educational levels. These policies will follow the national standards, which are already in place in most states, but not EdoMex. They will provide a systematic basis to assure that schools in high poverty areas get at least the standard allocation of teachers per student. The new practice of publishing the territorial allocation of education spending, by municipality, will generate complementary pressures for equal treatment. The Inter-Secretarial Finance Committee will also issue a formal instruction to put the state and (formerly) federal schools under a single, unified personnel management system, which will address another area where EdoMex lags behind most other states Third, the 2001 budget law will specify performance and impact indicators for the public education system, and will grant the *Secretaria de Educación* authority in the management of its budget, so that the agency can be held accountable to achieve the expected results. The Government will propose a law to make these innovations permanent. While more detailed education reforms will need to follow in EdoMex and across the nation, with direct involvement from the Federal Government, it will have been critical to accelerate reforms in the nation's largest state, which as of now lags well behind best practice in the country.

30. HEALTH. The structural adjustment phase of EdoMex's reforms for the health sector will enforce hard budget constraints more equally in the different parts of the state system and will set up institutions for increased coordination between them. First, for the State Institute of Health (ISEM) the budget allocation will be increased by at least 2 percent in real terms in each of 2001 and 2002. This part of the system covers the uninsured population (where the concentration of

poverty is highest) has been the most budget-constrained in the past, and therefore needs protection during the adjustment process. Second, the ISSEMyM, which covers state and municipal civil servants, will be prevented from using pension reserves to fund health services and will, instead, need to raise contribution rates to recover its operational costs. This part of the health sector has been the least budget-constrained until now. Thus, part of the adjustment process is to give it a harder budget constraint and to make its spending subject to the budget process (the state budget will have to pay the increased contributions) and not to allow it to continue expanding with the hidden cost of increasing the implicit pension debt. Third, both health-care networks will implement their plans for cost recovery and higher use. While these measures may have a small initial budget impact, they should help improve incentives and accountability. Fourth, the two networks will carry out a program to optimize the use of their combined capacity (for example, by selling services to each other and to the private sector). In addition the health part of the Integrated Family Development Program (DIF) will be brought under the purview of the ISEM, to realize economies of scale and to prevent marginalization of the DIF, whose program target the poor.

31. PENSIONS. The pension reform strategy has four components, three for the traditional pension system and one to bring in a totally new element that creates a bridge to the recently reformed national system for the private sector. First, to move the regular state employee system toward long-term sustainability, the Government will implement a combination of reducing benefits, increasing the retirement age, and ending transfers to health—measures calculated to bring down the implicit pension debt by at least 20 percent. Second, the Government will issue new regulations that establish transparent supervision and investment of the ISSEMyM pension reserves. Third, new regulations will make contributions into ISSEMyM portable, in the sense that workers leaving the public sector before retirement would have a guarantee of a prorated pension when they reach retirement age, which will enhance flexibility in the state's labor market. Fourth, the Government will make its employees' remuneration in excess of the base salary (not covered at all now) subject to contribution rates that will be paid into a system like the new one for the private sector.

32. In 1996, the Federal Government of Mexico enacted a far-reaching reform of the public pension system for private sector workers, which transferred all workers immediately to a fully funded defined contribution system (AFORE), from the previous bankrupt pay-as-you-go (PAYG) system. Important components of Mexican society, however, including federal civil servants and state and municipal civil servants, were not included in this reform and have retained their separate PAYG systems, all actuarially unbalanced, but to varying degrees. The long-term goal of any pension strategy in Mexico would be to move these excluded groups into the national system, the AFORE system, with the twin objectives of improving long term actuarial balance and promoting an integrated labor market. While no pension strategy is perfect, the current AFORE system is considered best practice internationally.

33. The fourth component of EdoMex's pension strategy makes substantial movement toward this goal, while working within the bounds of what is politically and financially feasible. A complete shift toward the AFORE system, which implies the elimination of ISSEMyM, is not a politically viable option at this juncture, and may not be optimal in any case. Instead, the reform program would institute mandatory contributions on the non-salary part of the remuneration, over half of the total, with these funds going to the AFORE system, and would

downsize the traditional ISSEMyM over the medium term, in order not to violate legally acquired rights. Although the proposed downsizing of ISSEMyM would not achieve full actuarial balance, introduction of the mandatory AFORE component will provide an additional source for pension income, which will allow further downsizing of the existing ISSEMyM benefits and, perhaps more important, break the monopoly of ISSEMyM in providing benefits to public sector employees. This latter impact is critical to make further private sector involvement in either pensions or health provision to the public sector employees politically viable. Finally, the mandatory AFORE system also creates some portability of pensions to the private sector, where workers also have the AFORE accounts.

34. Adding the AFORE accounts would not require the massive transition costs involved with converting a PAYG system to a funded system. The only costs are the mandatory employer contributions to the AFORE system, but ISSEMyM was planning anyway on raising pension contributions (paid by the government), so this expected increase is now being diverted to the AFOREs, partially offsetting the new costs. In the future, a fuller conversion could still take place, but this would be done in the context of a downsized ISSEMyM, which would lower these future transition costs. In the long run, it may be desirable to envisage a system where the public sector employees are fully integrated within the AFORE system, but where an ISSEMyM continues to provide a smaller occupational supplemental pension. Backloading part of the remuneration for public sector employees through pensions is sometimes considered a way of reducing corruption, since a corrupt official would face larger losses if discovered and dismissed without pension.

35. WATER. In water, reforms are needed from the Federal level on down, but the State of Mexico, where the water problem is biggest, needs to put some internal reforms in place, to protect the regular budget from problems in the water sector and to prepare the state to respond appropriately to federal reforms when they come. The strategy thus has three prongs. First, the state budget will end operating subsidies to CAEM. Second, the budget bill will moderately increase the rates that CAEM charges to municipalities. While further increases will be necessary when federal policy enforces the collection of water extraction charges, increases now of CAEM rates will let it cover operating costs. Third, new regulations will establish incentives to ensure that municipal operators pay CAEM for their water purchases. When municipalities renew their agreements with CAEM, as they must do beginning next year, they will have to delegate to the state the right to deduct any overdue payments to CAEM from one of the federal transfers that goes to municipalities. In addition, CAEM will begin charging the state or the municipal water utilities for the services it provides. This will allow for the immediate elimination of transfers from the state Treasury to cover CAEM's operating cost, and allow a major reduction in support for CAEM's investment and technical assistance activities. These reforms will be complemented by the establishment of a State Water Supply and Sanitation Agency to regulate the market and enforce rules for transparency and private sector participation.

36. ROADS. To prevent unmaintained highways from becoming a deteriorating asset whose rapid decline in use-value would lead to significant future outlays, the state will allocate at least 70 percent of road-related expenditures to maintenance. Given the overall budget constraints, this will mean reducing capital outlays for new road building. In parallel, an inventory of existing highway concessions will be published, as well as a plan to expand the participation of private operators in both maintenance and concessions, especially on a road-network basis.

While the reform program has not yet defined the details of road planning, maintenance, and private participation, the importance of these measures for the structural adjustment process is to establish procedures of transparency and accountability, whose rationality and success can be judged by Congress and the voters.

37. MANAGEMENT OF BUDGETING AND DEBT. EdoMex's Government will overhaul its budgeting and financial administration tools. First, the state will also impose a hard budget constraint on its own accounts. The budgets it will submit to its Congress will no longer assume extraordinary transfers from the Federal Government. Financing by arrears will no longer be allowed, as described below. Second, a package of measures will increase accountability of the executive to Congress. The budget will have a high and increasing share presented according to programs, with allocations specified in the budget law. That law will also require the quarterly publication of detailed reports on the execution of the budget (comparing it with the approved budget); amendments to the Organic Budget Law will make more permanent the practice of program-based and, eventually, performance-based, budgeting. The State will publish the quarterly reports within 90 days of the end of each quarter, not only submitting them to Congress but also posting them on the internet, which will be important for increasing public awareness and government accountability. Third, the state will eliminate the capacity of the executive to make discretionary (that is, not explicitly identified in the budget) transfers to municipalities. This will change the nature of the relationship between the states and the municipalities, and will impose a hard budget constraint on the latter. As a counterpart to that constraint, the state will begin to publish the distribution of its sectoral expenditures (education, transport, and so forth) municipality by municipality and will offer technical assistance for institutional upgrading at the municipal level.

38. Revenue, expenditure, and budgeting reforms will be complemented by a stronger framework for debt management. The state Executive's borrowing powers will be put more tightly under the control of the state Congress by setting specific net borrowing ceilings in the yearly budget (rather than limiting new debt accumulation only in relation to realized revenues, as now). The program will control and reduce floating debt, which is the most expensive kind of debt and the fastest growing, especially in the last year since the Federal Government tightened the rules for regular borrowing from banks. The Executive will give Congress quarterly reports on the floating debt, as well as other debt. During 2001 and 2002, the State will be reducing its floating debt by 40 percent per year from the end-2000 level. The quarterly reports to Congress, also to be posted on the internet, will tell the value of accounts overdue in various time categories, such as 30–90 days, 90–180 days, and over 180 days. This will involve upgrading the State's information system on accounts payable and lay the foundation of technical capacity and political interest for systematically improving the promptness of payments. It will close a serious loophole for unsupervised indebtedness and will reduce the state's effective financing costs, because these supplier credits carry high hidden charges, like inflated procurement prices.[11]

11. International experience shows that when the government has a reliable and timely payment system, it eliminates bureaucratic discretion and possible corruption in deciding which supplier to pay first and opens opportunities for a wider array of suppliers, including small firms that could not give credit with long and uncertain terms in exchange for a higher price.

(B) The Program's Outcomes

39. The reform program described above brings socially sustainable balance to the state's fiscal accounts. Each of the proposed measures carries important fiscal implications. These are singled out in the projections, through 2005, shown in Table 1.[12] Their main message is that a combination of current and capital revenue efforts, rationalization of teacher recruitment, and the elimination of water-related subsidies, can bring about both a substantial increase in social expenditures (notably in health) and the disappearance of overall deficits. Alternatively, if no reform were to be implemented, the state's finances would continuously sink into deeper, and probably explosive, deficits. (See Figures 1 and 2.)

40. As a result of the reform package, the state's relative debt position will turn around—instead of entering into a rapidly deteriorating, unsustainable spiral, EdoMex's debt-to-ordinary-income ratio improves continually and stabilizes at about 60 percent (Figure 2).

IV. THE PROPOSED EDOMEX STRUCTURAL ADJUSTMENT LOAN (EMSAL)

(A) Objectives

41. The proposed EMSAL will be the instrument through which the World Bank will support the Government of Mexico's effort to deliver technical and financial support to the EdoMex Government's structural adjustment. The proceeds of the loan will enable BANOBRAS to reduce the state's borrowing costs and lengthen its debt maturity during the reform transition.

42. The objectives of the loan go beyond EdoMex. For the Federal Government's new decentralization policy to work in the long term, a critical mass of states needs to be fully solvent and striving successfully to improve their creditworthiness within the more rigorous regulatory framework established in December 1999. If the largest state with the largest fiscal problems (EdoMex) were to lose hope under the weight of a debt overhang and sought to subvert that framework, it could seriously weaken the system and perhaps render it politically unsustainable. This is one of the key lessons from the longer history of successes and failures with sub-national fiscal reform efforts in Argentina and Brazil. So this loan carries a nation-wide externality—to make EdoMex a positive example to show the rest of the Mexican states that structural adjustment is feasible and rewarding.

12. The projections have been discussed extensively with the experts in the state Secretary of Finance, and in relevant spending Secretariats.

Table 1. Mexico—Estado de México
Fiscal Balance, 1999–2005 (current million pesos, unless otherwise indicated) Scenario with Reforms

	1999	2000	2001	2002	2003	2004	2005
CURRENT REVENUE	**31,524.1**	**40,705.0**	**47,155.8**	**52,164.0**	**55,612.0**	**59,855.9**	**64,368.6**
STATE REVENUE	2,770.3	3,467.1	4,745.2	5,554.2	6,336.2	7,011.1	7,698.7
State Taxes	1,139.4	1,442.7	2,240.5	2,806.5	3,245.9	3,617.4	4,022.4
Due to reform to payroll tax [1]			492.3	791.3	984.3	1,099.0	1,224.0
Due to reform to state *tenencia* [2]			48.4	82.5	102.6	112.5	123.5
Due to reform to lottery tax [3]			9.8	10.3	10.8	11.3	11.9
Fees	646.7	792.6	935.3	950.5	1,012.8	1,079.9	1,152.1
Revenue administration federal taxes	984.1	1,231.8	1,569.3	1,797.2	2,077.5	2,313.9	2,524.2
Due to improvements in federal *tenencia* collection [4]			42.4	156.9	241.1	264.5	290.2
Due to enforcement (*fiscalización*) [5]			10.4	82.2	133.2	187.4	198.3
TRANSFERS	28,753.8	37,237.9	42,410.6	46,609.8	49,275.8	52,844.7	56,669.9
Participaciones Federales	14,675.4	19,050.4	22,003.2	24,455.4	25,850.0	27,947.5	30,215.2
Aportaciones Federales (*Ramo* 33)	14,078.5	18,187.5	20,407.4	22,154.4	23,425.8	24,897.2	26,454.7
CURRENT EXPENDITURES	**31,068.8**	**38,332.9**	**43,579.8**	**47,358.9**	**50,741.7**	**53,777.0**	**58,037.4**
PROGRAMMABLE EXPENDITURES	23,347.3	28,296.6	32,559.9	35,303.8	38,145.4	40,296.2	43,655.2
O/w Education	15,311.5	18,984.9	21,656.4	23,380.4	24,762.8	26,215.3	27,739.3
Due to better management of education expenditure [6]	0.0	0.0	(212.9)	(926.8)	(1,720.6)	(2,610.8)	(2,814.3)
Due to lower transfers to CAEM [7]			(392.5)	(432.9)	(468.1)	(505.7)	(546.0)
Increase in wages quota due to ISSEMyM reform [8]			440.2	536.0	643.8	775.4	935.6
NONPROGRAMMABLE EXPENDITURES	7,721.6	10,036.3	11,019.9	12,055.1	12,596.3	13,480.8	14,382.2
Participaciones and municipalities funds	6,132.5	7,657.3	8,686.3	9,700.6	10,253.8	11,085.8	11,985.3
Interest	1,589.1	2,379.1	2,333.6	2,354.6	2,342.6	2,395.0	2,396.9
Saving from lower interest rates of comm. banks [9]			(17.1)	(19.2)	(20.9)	(30.3)	(36.0)
CURRENT BALANCE	**455.3**	**2,372.1**	**3,575.9**	**4,805.1**	**4,870.2**	**6,078.9**	**6,331.2**
CAPITAL REVENUE	**687.6**	**205.5**	**406.7**	**444.4**	**458.0**	**472.0**	**486.5**
Due to better asset management [10]			200.0	209.1	213.2	217.3	221.6
CAPITAL EXPENDITURES	**1,926.1**	**2,967.6**	**4,133.0**	**4,784.4**	**5,236.1**	**5,628.9**	**6,068.7**
Due to water sanitation transfers [11]	0.0	0.0	151.5	169.5	185.9	204.0	223.8
Due to higher maintenance of highways [12]			502.9	522.7	532.9	543.4	554.0
CAPITAL BALANCE	**(1,238.5)**	**(2,762.1)**	**(3,726.3)**	**(4,339.9)**	**(4,778.1)**	**(5,156.9)**	**(5,582.2)**
OVERALL BALANCE	**(783.2)**	**(390.1)**	**(150.4)**	**465.2**	**92.1**	**922.0**	**749.0**
FINANCIAL REQUIREMENTS							
GROSS BORROWING	1,582.9	2,123.1	3,612.5	3,229.6	2,144.0	1,775.2	2,827.7
Proceeds from World Bank loan			3,017.6	2,298.9			
REPAYMENTS	799.6	1,733.0	3,462.2	3,694.8	2,236.1	2,697.2	3,576.7
Due to ADEFAS reduction [13]			1,789.2	1,789.2	0.0	0.0	0.0
Memo Items							
Estado de México total debt stock (including ADEFAS) [14]	24,923.7	27,065.8	28,926.9	30,110.2	31,583.8	31,805.5	32,215.5
Total debt/ordinary income (percent)	77.4	66.2	60.8	57.2	56.3	52.7	49.7
Overall balance/ordinary income (percent)	-2.4	-1.0	-0.3	0.9	0.2	1.5	1.2
Total saving on interest due to reforms	0.0	0.0	289.2	540.3	651.3	1,144.5	1,772.0

Notes:

1. Reforms to payroll tax consist of increasing the tax rate from 2 to 2.5 percent in 2001, eliminating exemptions, and reducing past-due payments over the next four years, which are projected to increase payroll tax revenues by approximately 20 percent. Broadening the fiscal base will increase collection by 50 percent for the same period.

Notes continue on the next page

Notes: (continued)

2. Reforms to State Tenencia consist of increasing the rate on old vehicles to MxP 300 in 2002, enforcement of past-due payments (estimated to increase collection by 20 percent for the next four years), and increasing coverage (estimated to increase revenues by 32 percent from 2001 to 2004).
3. Reforms to lottery tax include the elimination of exemptions to schools, political parties, and religious organizations over the next four years.
4. The enhancements to federal Tenencia collection include a reduction in past-due tax payments through better administrative operation and a broader tax base.
5. Tax collection will be increased through administrative changes that reallocate presonnel to enforcement and allow EdoMex to participate in the fiscal review and audit of larger firms by the Federal Government, starting in 2002.
6. Reforms in the education sector will improve budget planning and determine teacher recruitment according to the number of students, not the number of normal-school graduates.
7. To promote payment of overdue balances from municipalities to CAEM, the State will automatically withhold from the municipalities federally allocated transfers (Ramo 33) in case they have past-due balances with CAEM. In 2001 transfers from the State to CAEM will be cut by half, and then there will be no transfers.
8. Pension system reforms consist of an increase in the health services contribution to eliminate the existing ISSEMyM deficit in health, which immediately requires higher payments from the State.
9. A 50-basis-point reduction in the commercial banks intermediation margin on newly contracted debt is expected due to the improvements in the State's fiscal position generated by the proposed reforms.
10. Commercialization of public assets, and their better management, is estimated to increase capital revenues by US$20 million per year.
11. Transfers from EdoMex to pay concessionaires for water and sanitation services.
12. Increased highway maintenance expenditures are estimated at US$50 million per year.
13. This reform includes the regularization of the State's floating debt (ADEFAS plus *Cuentas por pagar*).
14. Debt stock increases due to both overall deficits and revaulation of inflation-indexed UDI debt.

Figure 1. Mexico—Estado de México: Overall Balance to Ordinary Revenue Ratio—Alternative Reform Scenarios

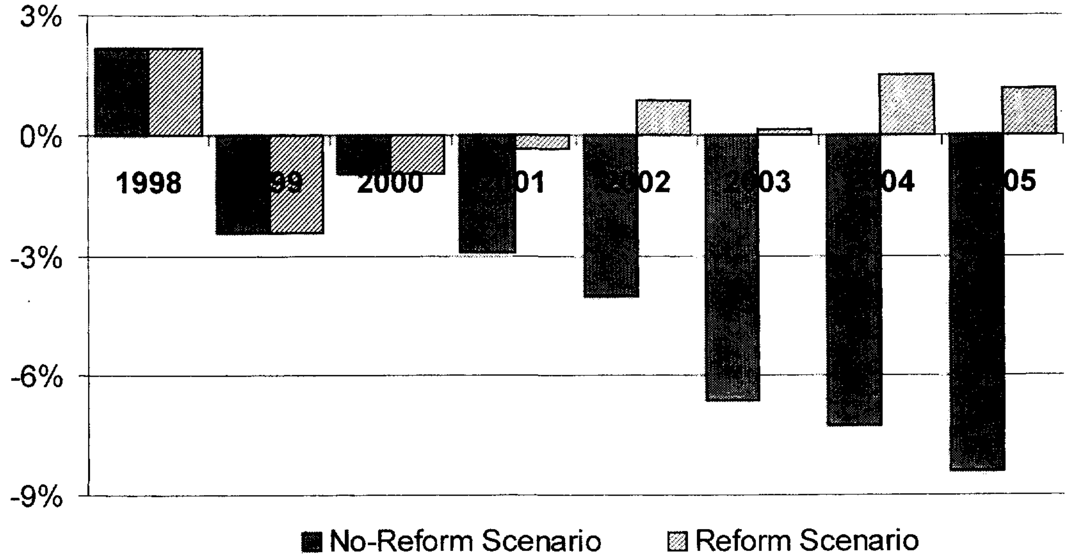
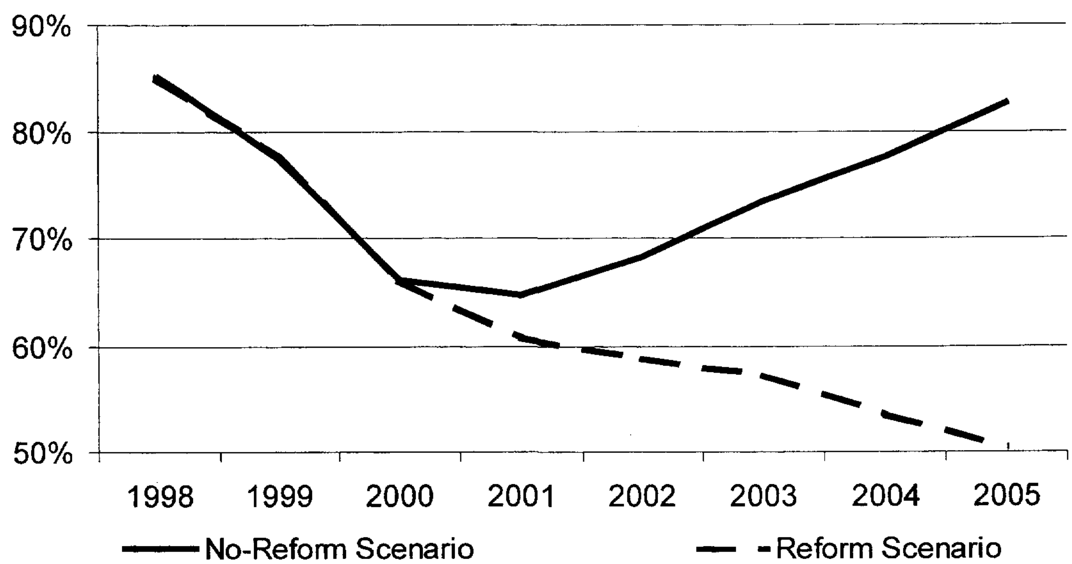


Figure 2. Mexico—Estado de México: Total Debt to Ordinary Revenue Ratio—Alternative Reform Scenarios



(B) Content

43. The overall decentralization reform program of the Federal Government is laid out in the Federal Letter of Development Policy, including the place of the EdoMex operation in that overall strategy. The success of the operation clearly depends on the implementation of the EdoMex authorities' own program of economic reforms, in coordination with the Federal Government and as summarized in the table attached to the letter of development policy in Annex D. From that program, a core subset of policy actions, listed in Table 2, has been selected as the legally agreed actions that would trigger the disbursement of each of the three planned tranches. The release of those tranches will be tentatively targeted for January 2001, July 2001 and January 2002, in order to capture one full budget execution and two state budget preparations.

44. These tranche-release commitments were selected for their centrality to the fiscal adjustment of the state, and hence to the overall decentralization reform and macroeconomic stability in Mexico. Other measures are undeniably important for improving the efficiency and quality of public service and poverty reduction in EdoMex, but none of them can be sustained unless the overall fiscal stance is brought into line. In addition, the Mexico-wide externalities of adjustment in the largest state, and previously one of the most fiscally unbalanced, depend on the success of the fiscal aspect of the structural adjustment.

(C) Risks

45. This will be the Bank's first adjustment loan in Mexico based on the policy actions of a state. Several risks are present. First, like any first adjustment loan to a country with a past record of weak fiscal policy, there is a risk that the client will revert to the undisciplined ways of the past. This is unlikely in EdoMex's case for two reasons. First, the new state government is committed to change from past ways and the state is now under a "hard budget" constraint for the first time—its commercial bank lenders face tougher lending regulations, and bail-outs by the Federal Government, which as of December 2000 will be in the hands of a competing political party, are no longer available. Second, since the Bank's loan will require a federal guarantee (the loan itself is contracted with the federation's financial agent; see below), it is possible that the central government could withdraw support from EdoMex. This is also unlikely because it is in the federation's interest to promote fiscal discipline among states and avoid the potential negative impact that a state-level fiscal crisis could have on the nation's macroeconomic framework (for example, Minas Gerais in Brazil). Both the outgoing and incoming federal administrations have emphatically endorsed the preparation of this project, and senior officials of SHCP have participated in all important meetings of the Bank with the EdoMex authorities.

Table 2. Matrix of Policy Actions by the State of Mexico for Tranche Releases of EMSAL

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
1. The 2001 budget submitted to Congress will have a deficit in the overall balance of no more than 0.5 percent of ordinary income.[1]	1. The accumulated overall deficit in the 2001 budget as executed through the end of the most recent quarter[2] will be no more than 0.5 percent of the ordinary income of the state.	1. The accumulated overall deficit in the 2001 budget as executed through the end of the most recent quarter will be no more than 0.5 percent of the ordinary income of the state.
2. The Government will have submitted the necessary legal amendments to Congress to (a) expand the base of the payroll tax to include all remuneration, all firms, and all employees, based on location of employment, except for exemptions already granted for 2000-2001 to new firms located in the state, which will expire at the end of calendar year 2001, and (b) increase the rate of the payroll tax to 2.5 percent.	2. The Government will have submitted to Congress a draft bill that will: (a) reduce the implicit pension debt of the state by at least 20 percent over its value at the end of 2000 through, among other things, reduced benefits and increased retirement ages; (b) collect contributions on the non-salary portion of the remuneration (on a mandatory basis for new entrant workers and on a voluntary basis for other workers), with these contributions to be deposited into individual accounts in the AFORE system; and (c) grant workers who leave the ISSEMyM pension system the right to receive a prorated pension upon reaching retirement age.	2. The 2002 budget submitted to Congress will have a surplus in the overall balance of at least 0.9 percent of ordinary income.
3. The 2001 budget submitted to Congress will include: (a) real, per-student expenditure in education not less than the comparable expenditure in the approved budget for 2000; (b) teacher recruitment targets based upon pre-defined efficiency and quality standards;[3] and (c) provisions to guarantee that the monthly savings accrued in the execution of the education budget by the state *Secretaria de Educación* will be retained by that *Secretaria.*	3. Regulations for the Water Law will have been issued and published in the State's Official Gazette not later than February 28, 2001, in accordance with the policies in the State's LDP concerning CAEM's water supply agreements, payment collection, cost coverage, fiscal reporting, and ways for the private sector to participate in water provision, including *Contratos Integrales de Administración* and concessions.	3. The 2002 budget submitted to Congress will include: (a) real, per-student expenditure in education not less than the comparable expenditure in the approved budget for 2001; and (b) teacher recruitment targets based on pre-defined efficiency and quality standards.
4. The Government will have directed ISSEMyM to employ pension-related funds only for pension-related expenditures.	4. All water supply agreements among CAEM, municipal water organizations, the State (Secretariat of Finance and Planning), and the municipal governments signed since November 16, 2000, will have complied with the relevant inter-agency Administrative Agreement and the subsequent regulation.	4. Contribution rates for ISSEMyM health services will have been raised by at least 4 percentage points from the rate in December 31, 2000 (2 percentage points each from employers and employees) .
5. The 2001 budget submitted to Congress will increase the budget of the Secretariat of Health of the State of Mexico (SSEM) by at least 2 percent in real terms compared to 2000 and will provide funding for ISSEMyM health so that no funds for health need to be taken from the pension fund.	5. The Government will have reduced the stock of floating debt by at least 20 percent relative to the stock	5. The 2002 budget submitted to Congress will increase the allocation for SSEM by at least 4 percent in real terms compared to the 2000 budget.
6. An Administrative Agreement between the State's Secretaries of Finance and Planning and of Urban Development and Public Works and the CAEM (*Comisión de Agua el Estado de México*) concerning		6. The 2001 budget as executed will have included no transfers to CAEM other than transfers for investments specifically included in the public investment program of the state.
		7. The budget for 2002 submitted to Congress will include: (a) no transfers to CAEM other than transfers for investments that will be specifically included in the public investment program of the state; and (b) an increase of at least 6 percent in real water rates charged by CAEM relative to the rates in effect in October 31, 2000.
		8. The Government will have reduced the stock of

CAEM's payment collection will have been signed and become effective with the content specified in the State's LDP. 7. The 2001 budget submitted to Congress will include: (a) no transfers to CAEM other than transfers for investments that will be specifically included in the public investment program of the state; and (b) an increase of at least 3 percent in real terms in the water rates charged by CAEM, relative to the rates in effect in October 2000. 8. The 2001 budget submitted to Congress will have an explicit nominal net borrowing[4] ceiling equivalent to no more than 5 percent of ordinary income (to finance the overall deficit and to settle the floating debt[5]) and a requirement for the government to report quarterly to Congress the amount and terms of all debt outstanding, including floating debt. 9. The 2001 budget submitted to Congress will provide for reduction of the stock of floating debt, relative to that existing on December 31, 2000, by at least 40 percent by December 31, 2001.	existing on December 31, 2000. 6. The Government will have submitted to Congress (a) a draft bill (*Proyecto de Ley de Planeación*) to establish, *inter alia,* the procedures governing integrated financial management and sector performance indicators applicable to the State Budget and (b) a draft bill to amend the Fiscal Law (*Código Financiero del Estado de México y Municipios*) requiring, *inter alia*, that any intra-year reforms to the State Budget must preserve the same Overall Balance as in the budget initially approved by the state legislature for the corresponding year and that future State Budgets be prepared, presented, and executed according to program budgeting procedures. 7. The Government will have presented to Congress and posted on the internet quarterly reports, through the end of the most recent quarter, detailing (a) the execution budget (compared with the budget approved) and (b) the amount and terms of all outstanding debt (including the floating debt, categorized by the time outstanding for accounts payable).	floating debt by at least 40 percent relative to the stock existing on December 31, 2000. 9. The budget for 2002 submitted to Congress will have an explicit nominal net borrowing ceiling not higher than 80 percent of the stock of floating debt on December 31, 2000, minus the reduction of floating debt that took place in the execution of the 2001 budget.

Notes:

Unless otherwise specified, in this table "the state" and "the government" refer to the executive branch of the State of Mexico, "Congress" refers to that of the State of Mexico, and "the budget" refers to the budget of the state.

1. "Ordinary" income is defined as current plus capital income minus "extraordinary transfers" from the federation (ordinary transfers are those that the Federal Congress allocates by state or by formulas; all other transfers are considered "extraordinary"). The overall balance is the difference between ordinary income and all expenditures (including loans and transfers to other public or private entities).
2. "Quarter" refers to calendar quarters: January-March, April-June, July-September, and October-December.
3. The standards will include, among other things, (a) teacher recruitment rates that do not reduce the average student-to-teacher ratio at each level of schooling (basic, secondary, technical, higher education) below present ratio; (b) no teacher recruitment (of either new or transferring teachers) in schools whose student-to-teacher ratio is already higher than the federal standard; and (c) adoption by the Secretary of Education of a teacher certification test for all newly recruited teachers
4. Net borrowing refers any new issuance of debt and obligations minus amortization of principal.
5. Floating debt is defined as the sum of ADEFAS and Accounts Payable (*Cuentas por pagar*), as defined by the Treasury Department.

46. Third, the state Congress, currently controlled by a party in opposition, could block one or several of the policy initiatives embedded in the adjustment program. This risk is real, but is substantially mitigated because the bulk of the reforms will put more discipline and accountability on the Executive (for example, by eliminating its powers to effect discretionary transfers to municipalities; and by subjecting the Executive to various, previously absent reporting requirements), something that serves well the Congressional interests. Fourth, the federal context in which many of the proposed sectoral reforms are cast (for example, taxes, education, pensions, water) could change during the life span of the EMSAL, rendering agreed policy commitments inapplicable. Such changes would probably improve, rather than debilitate, the reform-scenario fiscal outlook in EdoMex, so would not present obstacles to completion of the loan commitments. Finally, there is a substantial risk that the reform program could prove too formidable a task for the implementation capacity of EdoMex's Government. To mitigate this risk, Bank staff are preparing a proposed *Decentralization Technical Assistance Project,* which will be sent to the Board later this fiscal year.

47. In spite of the above-mentioned mitigating factors, the EMSAL remains a high–risk, high–return operation. It will thus be essential to maintain a close working relationship with the client, and to provide ample and on-going assistance during implementation. A schedule of monthly project supervisions will be maintained, greatly facilitated by the resident presence in Mexico City of the Bank's Mexico Country Team.

(D) Poverty Impact

48. The proposed EMSAL will contribute to poverty reduction at both the national and state levels. It helps protect the macroeconomic framework of the country as a whole by reducing the likelihood of any fiscal crisis at the sub-national level. (World Bank analysis shows that negative macro shocks are the single most important determinant of poverty increases in Mexico.) Second, the various sectoral reforms that underpin the state's fiscal adjustment will generate direct benefits to the poor. The most important poverty-related activities under the responsibility of the Mexican states, including EdoMex, are in the education and health sectors. (The Federal Government handles the main direct poverty alleviation programs, some of which are considered best practice.) In both sectors, the proposed adjustment agenda will protect real expenditures and will seek to increase their efficiency and the equality of distribution of state resources in different parts of the system. Some reforms aim particularly at services for the poor, such as strengthening the Integrated Family Development program and bringing balance and transparency to municipal finances (EdoMex's poor live disproportionately in underserved municipalities and lack information on how their service compares with other communities). More generally, by avoiding a major fiscal crisis in the state, the EMSAL ensures that essential public services continue to be available to those that could not otherwise procure them by their own means. (In contrast with the Federal Government, EdoMex's authorities have no access to a lender of last resort—like a central bank—and a fiscal crisis would paralyze their operations).

(E) Loan Amounts, Conditions, and Arrangements

49. The proposed (US$500 million) EMSAL in the form of a fixed spread, U.S. dollar-denominated loan would be made to Banobras S.N.C. with a guarantee from the United Mexican

States. Disbursements under the proposed loan would be made to an account ("Deposit Account") of Banobras, S.N.C. established at the *Banco de México* for this purpose. Under orders from the Federal Government, Banobras would actually make the loan to EdoMex in pesos through FOAEM, with a charge for the currency conversion, to avoid any conflict with the constitutional prohibition against states borrowing in foreign exchange or from foreign lenders.

50. The proposed loan would have three tranches, in order to enhance monitoring and provide ample implementation support, as the state and Federal governments have requested. Those tranches would tentatively be of US$200 million in early 2001, US$100 million expected in mid 2001, and US$200 million expected in early 2002. A single loan with three tranches and an integrated set of conditions is more appropriate in this instance than three separate loans, because it would give the wrong signals economically and politically within Mexico if a single state were to be the beneficiary of three successive World Bank loans.

V. THE MACROECONOMIC FRAMEWORK FOR THE PROPOSED EMSAL

51. Sound macroeconomic management consisting of (a) a conservative fiscal stance, (b) tight and independent monetary policy, and (c) a flexible foreign exchange regime, continue to provide the basis for a respectable rate of growth, single-digit inflation and a viable external balance. See Annex B for a fuller discussion of the macroeconomic situation and prospects. Economic growth for 2000 is now expected at 6.5 to 7.0 percent, still considerably above the country's annual growth trend of 5 percent observed over the past four years. Inflation continues its downward trend and, at an expected year-end rate of 8.8 percent for 2000, will stay well within the annual objective set by the monetary authorities (below 10 percent). The overall external deficit, i.e. the balance of payments current account deficit, is projected at 3.2 percent of GDP—slightly up from 2.9 percent in 1999 and within manageable proportions. Favorable external developments, in particular, stronger than expected growth of the U.S. economy and the sharp increase of international oil prices since mid-1999, contributed to the growth of aggregate demand. The real effective exchange rate, based on relative consumer prices, continued to appreciate gradually during 2000, while unit labor costs rose more slowly, because of labor and productivity gains and lagging real wages.

52. The economic program of the incoming administration includes tightening of monetary and especially fiscal policy in order to reduce aggregate demand pressures and inflation, while minimizing external vulnerability of the economy. The fiscal tightening and an expected slowdown of U.S. economic activity. (to 3 percent annual real growth) led to program targets of 4.0 to 4.5 percent real growth in 2001, with 6.5 percent inflation. Fiscal tightening would come from a reduction of expenditures rather than an increase of non-oil revenues. The administration has also managed external public debt in order to reduce short-term repayment and refinancing needs, particularly during the political transition, and to keep large amounts of contingency resources available. All the net external financing needs in the near term are expected to come from the Mexican private sector.

VI. BANK STRATEGY

(A) The CAS and the Proposed EMSAL

53. The EMSAL will be instrumental for the World Bank in its effort to achieve the three objectives of the current CAS: effective public governance, growth and macroeconomic stability, and social sustainability. An operation like the EMSAL with a sub-national government was envisaged in the CAS. The identity of the borrowing state and the exact nature of the loan could not be known, however, at the time of the CAS discussion by the Board of Executive Directors on June 8, 1999, because the new federal incentive framework which would trigger state adjustments was still at the design stage. Thus, the EMSAL was not mentioned by name in the CAS. Instead, the CAS listed a State Decentralization Adaptive Program Loan and a State-level Public Administration Learning and Innovation Loan; the EMSAL encompasses many of the objectives foreseen for these projects. The Bank's strategy for assistance to Mexico in the decentralization area has four parts: (a) helping the Federal Government to make the decentralization process macroeconomically sustainable through the imposition of hard-budget constraints on sub-national entities (an effort already implemented and supported by the Bank's US$600 Decentralization Adjustment Loan of 1999) and the reform of the federal-state fiscal pact on taxes and transfers; (b) supporting the Federal Government in its efforts to help states undertake structural adjustment in order to adapt to the new fiscal discipline, rather than resist it; (c) supporting further reforms at the federal level in sectors where the federal and subnational governments share responsibilities; and (d) enhancing institutional capacity within subnational governments through technical advice, WBI-sponsored training programs, and lending to support federal efforts. The proposed EMSAL contributes to part b). There are strong synergies between supporting state-level adjustment and advancing sectoral agendas at the federal level. The reason is that states which undergo adjustment find strong incentives to see those agendas implemented, and become powerful advocates for federal-level reforms.

54. The EMSAL also fits within the lending and exposure limits of the CAS,[13] which included an overall lending program for fiscal 1999–2001 of US$5.2 billion, of which US$1.9 billion would take the form of adjustment lending. So far only US$2.1 billion has been committed, of which US$1.1 billion are in two adjustment loans (DAL and Bank Restructuring). Within the remaining lending space, the program for fiscal 2001 of the CMU and the Latin American and Caribbean Region foresees a total amount of new lending for Mexico of US$1.9 billion, of which US$0.9 billion will be in investment loans and US$1 billion will be in adjustment operations (i.e., EMSAL and Bank Restructuring II). Therefore, if the fiscal 2001 program is completely delivered as planned, total new lending over the fiscal 1999–2001 would amount to US$4 billion, of which US$2.1 billion is in adjustment operations. This would fall far short of the CAS-envisaged US$5.2 billion for fiscal 1999–2001 (by over US$1.1 billion) and would only slightly surpass the targeted three-year adjustment lending (by US$200 million).

55. Bank exposure to Mexico (including guarantees) diminished substantially from US$15 billion at the end of fiscal 1995 to US$11.4 billion by the end of fiscal 1998, and stabilized over

13. Report No. R99-92 (IFC\R99-82), discussed on June 8, 1999

fiscal 1999–2001 at US$11.5 billion to $11.8 billion. It will increase slightly to US$12 billion by the end of fiscal 2002, and will stabilize at that level thereafter. This remains well within the Bank's exposure limits for a single country, currently set at a nominal level of US$13.5 billion.

(B) Complementarity with Other World Bank Operations

56. The World Bank has been active for some time on decentralization issues in Mexico at both the macro and the sectoral levels. The strategy of the government and the Bank has been first to reform the regulatory and incentive environments that federal policy set for the sub-nationals (the DAL-supported reforms made major advances in this direction), and then to proceed with adjustment and investment operations in individual states.

57. At the macro level, the design of the proposed EMSAL builds directly on, and furthers the objectives of, the DAL, as noted earlier. At the sectoral level, the Bank has helped finance municipal infrastructure funds since 1990 through SEDESOL. For instance, to promote access to basic services, especially in the poorest areas, the Government has mobilized the Bank's support through two loans for municipal social infrastructure and capacity building (Decentralization and Rural Development I and II—DRD—of US$350 million and US$500 million, respectively). "Just-in-time" technical assistance as required by the authorities has also been part of the Bank's support (notably, through the production of the Policy Agenda for Decentralization delivered in April 1999 and through upon-request technical advice to state governments on, among others, water issues, education, health, and public administration). New channels for investment lending to states are under consideration.

58. In partnership with the Monterrey Institute of Technology, the World Bank Institute has developed a very successful distance learning program for municipal officials. Since it started operating in 1999 the program has been offered three times and has helped train over 3,000 municipal officials in 65 remote-learning centers in Mexico (plus eight in other countries of Latin America). This complements well the EMSAL's (and the DAL's) objectives, because it makes municipalities better able to manage their finances and programs in the new, market-disciplined framework for sub-national borrowing.

(C) Complementarity With Operations by Other Institutions

59. At the national level, the proposed EMSAL would come shortly after the completion of a SDR 3.1 billion (US$4.2 billion), 17-month, IMF Stand-By operation which was approved in July 1999 and succeeded in providing a solid macroeconomic underpinning for the implementation of the new decentralization framework. Continuous coordination between the IMF and the Bank takes place in the review of economic policy and the preparation of respective operations.

60. The EMSAL will also exploit strong synergies with decentralization-related operations by the Inter-American Development Bank (IDB). The bulk of IDB's sub-national involvement in Mexico was channeled through a hybrid loan—US$400 million in fast-disbursing funding and US$400 million in a line of credit through Banobras. For the fast-disbursing part, the commitments of the first tranche (released in December 1999) corresponded to reforms of intergovernmental fiscal relations contained in the budget laws of 1998–2000 (particularly

adherence to the approved schedule of *Ramo* 33 transfers to states and municipalities). The second tranche commitments (expected in Fall 2000) are primarily associated with the reform of Banobras, especially its internal management capacity, and with the Federal Government rationalizing the rules under which states use *participaciones* as collateral for their borrowing. The regulatory framework for sub-national borrowing supported by the DAL provided such rationalization by eliminating *mandatos* for SHCP implicit guarantees and replacing them with private *fideicomisos* or equivalent arrangements where SHCP plays no role. The EMSAL will further that cross-institutional synergy by making EdoMex, potentially the largest sub-national client in Mexico, better able to profit from the IDB's facility.

VII. RECOMMENDATION

61. I am satisfied that the proposed loan complies with the Articles of Agreement of the Bank, and I recommend that the Executive Directors approve it.

James D. Wolfensohn
President

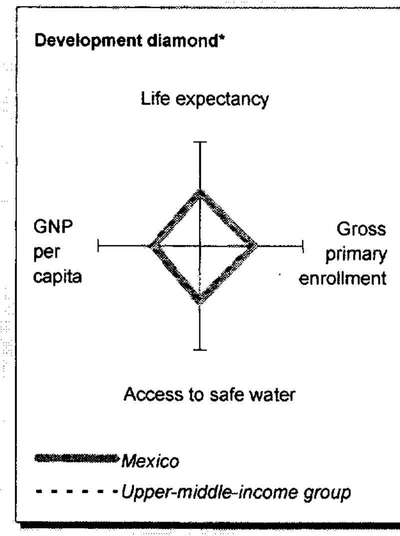
Washington, D. C.
November 16, 2000

Mexico at a glance

11/9/00

POVERTY and SOCIAL

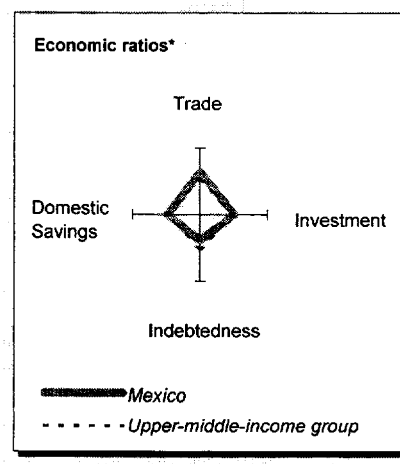
	Mexico	Latin America & Carib.	Upper-middle-income
1999			
Population, mid-year *(millions)*	97.4	509	573
GNP per capita *(Atlas method, US$)*	4,400	3,840	4,900
GNP *(Atlas method, US$ billions)*	428.9	1,955	2,811
Average annual growth, 1993-99			
Population *(%)*	1.7	1.6	1.4
Labor force *(%)*	3.0	2.5	2.1
Most recent estimate (latest year available, 1993-99)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	74	75	76
Life expectancy at birth *(years)*	72	70	70
Infant mortality *(per 1,000 live births)*	30	31	27
Child malnutrition *(% of children under 5)*	..	8	7
Access to improved water source *(% of population)*	83	75	78
Illiteracy *(% of population age 15+)*	9	12	10
Gross primary enrollment *(% of school-age population*	114	113	109
Male	116	..	..
Female	113	..	..



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

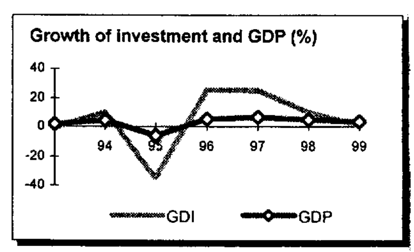
	1979	1989	1998	1999
GDP *(US$ billions)*	134.5	223.0	416.1	483.7
Gross domestic investment/GDP	26.0	22.9	24.3	23.2
Exports of goods and services/GDP	11.2	19.0	30.8	30.8
Gross domestic savings/GDP	24.7	22.9	22.2	21.9
Gross national savings/GDP	21.7	20.3	20.5	20.5
Current account balance/GDP	-4.1	-2.6	-3.9	-2.9
Interest payments/GDP	2.5	3.5	2.2	2.1
Total debt/GDP	31.8	42.1	38.4	34.5
Total debt service/exports	72.4	32.9	20.0	25.3
Present value of debt/GDP	..	..	37.3	33.5
Present value of debt/exports	..	..	111.1	101.9

	1979-89	1989-99	1998	1999	1999-03
(average annual growth)					
GDP	1.3	2.9	4.9	3.5	5.2
GNP per capita	-0.9	1.1	3.3	2.3	3.6
Exports of goods and services	8.4	13.6	12.1	13.9	9.5

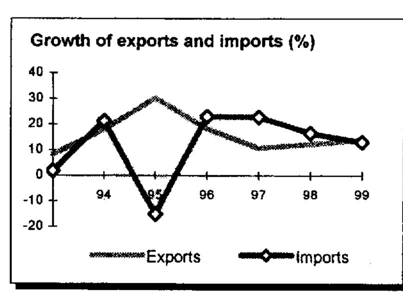


STRUCTURE of the ECONOMY

	1979	1989	1998	1999
(% of GDP)				
Agriculture	9.8	7.8	5.2	5.0
Industry	33.4	29.4	28.5	28.2
Manufacturing	22.7	21.9	21.3	21.1
Services	56.7	62.9	66.3	66.8
Private consumption	64.4	68.9	67.3	68.0
General government consumption	10.9	8.3	10.4	10.0
Imports of goods and services	12.5	19.1	32.8	32.0



	1979-89	1989-99	1998	1999
(average annual growth)				
Agriculture	1.2	1.8	3.0	0.8
Industry	0.9	3.5	6.3	3.8
Manufacturing	1.1	4.0	7.3	4.1
Services	1.8	2.7	4.5	3.6
Private consumption	1.4	2.2	5.4	4.3
General government consumption	3.1	1.7	2.2	1.0
Gross domestic investment	-4.3	4.3	10.2	0.9
Imports of goods and services	-1.1	11.9	16.5	12.8
Gross national product	1.2	2.9	5.0	4.0



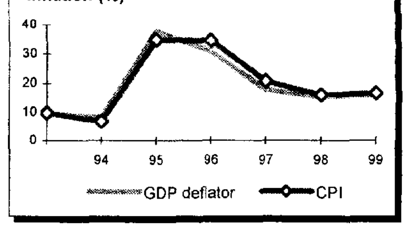
Note: 1999 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Mexico

PRICES and GOVERNMENT FINANCE

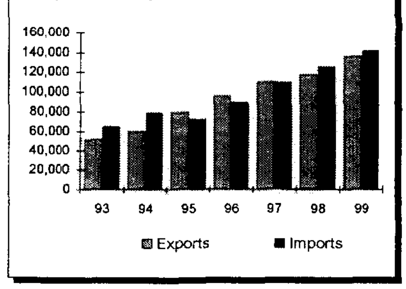
	1979	1989	1998	1999
Domestic prices				
(% change)				
Consumer prices	..	20.0	15.9	16.7
Implicit GDP deflator	19.6	26.5	15.4	16.2
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	25.8	20.4	20.7
Current budget balance	..	-1.8	2.1	1.7
Overall surplus/deficit	..	-4.6	-1.2	-1.1



Inflation (%)

TRADE

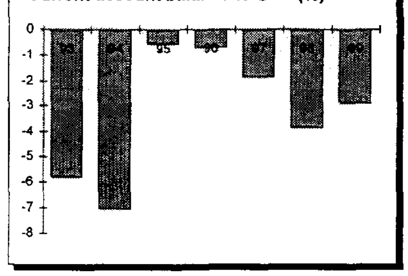
	1979	1989	1998	1999
(US$ millions)				
Total exports (fob)	..	35,171	117,460	136,391
Oil	..	7,876	7,134	9,928
Agriculture	..	1,754	3,797	3,926
Manufactures	..	24,936	106,062	122,085
Total imports (cif)	..	34,766	125,373	141,975
Consumer goods	..	3,499	11,109	12,175
Intermediate goods	..	26,499	96,935	109,270
Capital goods	..	4,769	17,329	20,530
Export price index *(1995=100)*	..	96	95	98
Import price index *(1995=100)*	..	89	100	99
Terms of trade *(1995=100)*	..	108	94	99



Export and import levels (US$ mill.)

BALANCE of PAYMENTS

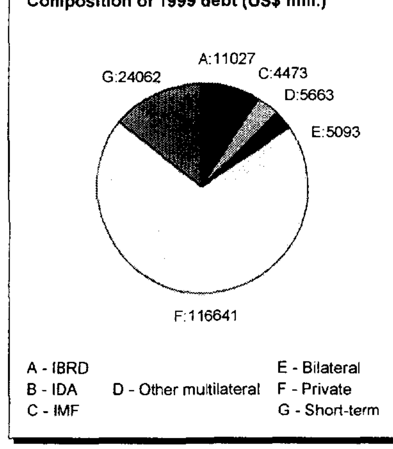
	1979	1989	1998	1999
(US$ millions)				
Exports of goods and services	15,131	42,362	128,982	148,083
Imports of goods and services	16,704	42,426	137,801	155,465
Resource balance	-1,573	-63	-8,818	-7,382
Net income	-4,111	-8,302	-13,284	-13,099
Net current transfers	131	2,544	6,012	6,313
Current account balance	-5,553	-5,821	-16,090	-14,168
Financing items (net)	5,868	6,093	18,227	14,762
Changes in net reserves	-315	-272	-2,137	-594
Memo:				
Reserves including gold *(US$ millions)*	..	6,376	29,032	31,829
Conversion rate *(DEC, local/US$)*	2.28E-2	2.5	9.2	9.6



Current account balance to GDP (%)

EXTERNAL DEBT and RESOURCE FLOWS

	1979	1989	1998	1999
(US$ millions)				
Total debt outstanding and disbursed	42,765	93,826	159,962	166,959
IBRD	1,731	7,821	11,514	11,027
IDA	0	0	0	0
Total debt service	11,591	15,559	27,990	40,194
IBRD	221	1,245	2,024	2,155
IDA	0	0	0	0
Composition of net resource flows				
Official grants	26	37	..	..
Official creditors	284	936	-805	-1,702
Private creditors	3,798	-2,397	13,225	13,867
Foreign direct investment	1,332	3,037	11,311	11,568
Portfolio equity	0	0	-666	3,769
World Bank program				
Commitments	527	2,325	2,212	1,616
Disbursements	326	1,297	1,283	844
Principal repayments	76	677	1,257	1,323
Net flows	250	620	26	-479
Interest payments	145	567	767	832
Net transfers	105	52	-741	-1,311



Composition of 1999 debt (US$ mill.)

Mexico Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1993-99	Latin America & Carib.	Upper-middle-income
POPULATION					
Total population, mid-year *(millions)*	59.1	75.5	97.4	509.2	573.1
Growth rate *(% annual average)*	3.1	2.2	1.7	1.6	1.4
Urban population *(% of population)*	62.8	69.6	74.2	74.9	75.6
Total fertility rate *(births per woman)*	6.5	4.2	2.8	2.7	2.4
POVERTY					
(% of population)					
National headcount index	..	..	..	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNP per capita *(US$)*	1,480	2,180	4,400	3,840	4,900
Consumer price index *(1995=100)*	0	3	219	147	132
Food price index *(1995=100)*	..	..	..	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	..	..	..	..
Lowest quintile *(% of income or consumption)*	3.3	..	3.6	..	..
Highest quintile *(% of income or consumption)*	60.7	..	58.2	..	..
SOCIAL INDICATORS					
Public expenditure					
Health *(% of GDP)*	..	..	2.8	3.3	3.3
Education *(% of GNP)*	3.5	3.9	4.9	3.6	5.0
Social security and welfare *(% of GDP)*	3.4	2.2	3.0	7.4	7.9
Net primary school enrollment rate					
(% of age group)					
Total	..	100	101	95	96
Male	..	..	..	96	97
Female	..	..	..	94	95
Access to improved water source					
(% of population)					
Total	62	82	83	75	78
Urban	70	95	91	84	87
Rural	49	50	62	45	54
Immunization rate					
(% under 12 months)					
Measles	..	64	97	93	94
DPT	..	40	83	82	83
Child malnutrition *(% under 5 years)*	..	..	14	8	7
Life expectancy at birth					
(years)					
Total	63	68	72	70	70
Male	60	64	69	67	67
Female	65	71	75	73	74
Mortality					
Infant *(per thousand live births)*	69	47	30	31	27
Under 5 *(per thousand live births)*	110	74	38	38	35
Adult (15-59)					
Male *(per 1,000 population)*	246	205	166	216	218
Female *(per 1,000 population)*	188	121	83	116	115
Maternal *(per 100,000 live births)*	..	..	..	..	..
Births attended by skilled health staff *(%)*	..	..	..	78	87

11/1/00

Mexico
Estado de Mexico Structural Adjustment Loan
Key Economic Indicators

Indicator	Actual					Projected			
	1995	1996	1997	1998	1999	2000	2001	2002	2003
National accounts (as % GDP at current market prices)									
Gross Domestic Product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture[a]	5.5	6.1	5.5	5.2	5.0	4.5	4.4	4.4	4.3
Industry[a]	27.9	28.4	28.6	28.5	28.2	27.6	27.9	28.4	28.6
Services[a]	66.6	65.5	65.9	66.3	66.8	67.8	67.6	67.2	67.1
Total Consumption	77.5	74.8	74.2	77.8	78.1	77.8	77.8	77.5	77.2
Gross Domestic Investment	19.8	23.1	25.9	24.3	23.2	23.8	23.9	24.4	24.7
Government Investment	3.7	3.0	3.1	2.6	2.1	1.6	1.7	2.0	2.0
Private Investment	12.4	14.9	16.4	18.3	18.9	19.7	19.7	20.0	20.2
Increase in Stocks	3.7	5.2	6.3	3.3	2.2	2.5	2.5	2.5	2.5
Exports (GNFS)[b]	30.4	32.2	30.4	30.8	30.8	31.6	32.5	32.8	33.8
Imports (GNFS)[b]	27.8	30.1	30.4	32.8	32.0	33.2	34.3	34.7	35.6
Gross Domestic Savings	22.5	25.2	25.8	22.2	21.9	22.2	22.2	22.5	22.8
Gross National Savings[c]	19.2	22.4	23.9	20.5	20.5	20.5	20.3	20.4	20.7
Memorandum items									
Gross Domestic Product (US$ million at current prices)	286,167	332,339	401,091	416,117	483,737	567,876	607,673	653,370	701,131
Gross National Product per Capita (US$, Atlas method)	3,800	3,640	3,680	3,960	4,410	5,060	5,640	6,080	6,420
Real Annual Growth Rates (%, calculated from 1993 prices)									
GDP at market prices	-6.2	5.2	6.8	4.9	3.5	7.0	4.5	5.0	5.0
Gross Domestic Income	-7.9	5.3	7.7	4.2	3.8	7.8	4.0	4.4	4.8
Real Annual per Capita Growth Rates (%, calculated from 1993 prices)									
GDP at market prices	-7.8	3.4	5.0	3.2	1.8	5.3	2.8	3.3	3.3
Total Consumption	-10.0	0.1	4.2	3.2	2.2	5.8	2.3	2.2	2.6
Private Consumption	-11.1	0.5	4.7	3.7	2.6	5.9	2.2	2.0	2.3

(Continued)

Mexico
Estado de Mexico Structural Adjustment Loan
Key Economic Indicators *(Continued)*

Indicator	Actual					Projected			
	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public finance (as % of GDP at current market prices)[d]									
Current revenues	22.8	23.0	23.1	20.4	20.7	21.6	22.0	22.3	22.3
Current expenditures	19.6	19.2	19.9	18.3	18.9	18.6	18.8	18.8	18.8
Current account surplus (+) or deficit (-)	3.2	3.8	3.1	2.1	1.7	2.1	2.5	2.7	2.8
Capital expenditure	3.2	3.9	3.7	3.3	2.9	3.1	3.4	3.4	3.5
Overall Balance	0.0	0.0	-0.7	-1.2	-1.1	-0.8	-0.4	-0.3	-0.1
Monetary Indicators									
M2/GDP (at current market prices)	29.1	26.5	28.3	27.9	26.0	...	...	...	...
Growth of M2 (%)	31.7	25.3	33.9	19.7	11.8	...	...	...	...
Private sector credit growth/ total credit growth (%)	-1.5	0.9	0.4	1.8	-0.8	...	...	...	...
Price indices (1993=100)									
Merchandise export price index	108.7	110.5	109.4	102.9	106.8	113.1	114.3	115.2	117.2
Merchandise import price index	107.9	108.3	109.0	108.3	107.3	109.7	112.4	115.0	117.6
Merchandise terms of trade index	100.8	102.0	100.4	95.1	99.6	103.1	101.7	100.1	99.7
Real exchange rate (LCU/US$)[e]	99.1	95.3	101.6	97.9	100.2	93.3	93.3	93.3	93.3
Consumer price index (% growth rate, period average)	35.0	34.4	20.6	15.9	16.7	7.8	7.5	5.7	4.2
Consumer price index (% growth rate, end of period)	52.0	27.7	15.7	18.6	12.3	8.0	6.0	4.5	3.5
GDP deflator (% growth of rate)	37.9	30.7	17.7	15.4	16.2	9.0	7.0	5.0	4.0

a. GDP components estimated at factor cost, as a % of GDP at factor cost.
b. "GNFS" denotes "goods and nonfactor services".
c. Includes net unrequited transfers excluding official capital.
d. Consolidated non-financial public sector
e. "LCU" denotes "local currency units". An decrease in LCU/US$ denotes appreciation.

Mexico
Estado de Mexico Structural Adjustment Loan
Balance of Payments

Indicator	Actual 1995	1996	1997	1998	1999	Projected 2000	2001	2002	2003
Balance of Payments (US$ m)									
Exports (GNFS)[a]	89,207	106,779	121,701	128,982	148,083	179,217	197,339	214,137	236,683
Merchandise FOB	79,542	96,000	110,431	117,460	136,391	166,060	183,192	198,927	220,361
Imports (GNFS)[a]	81,454	99,700	121,608	137,801	155,465	188,287	208,181	226,758	249,510
Merchandise FOB	72,453	89,469	109,808	125,373	141,975	173,327	192,172	209,546	231,040
Resource balance	7,753	7,079	94	-8,818	-7,382	-9,071	-10,842	-12,621	-12,827
Net current transfers (including official current transfers)	3,960	4,531	5,247	6,012	6,313	6,326	6,644	6,977	7,327
Current account balance (after official capital grants)	-1,577	-2,330	-7,448	-16,090	-14,168	-18,295	-22,305	-26,059	-27,809
Net private foreign direct investment	9,526	9,186	12,830	11,311	11,786	13,800	13,900	14,595	15,325
Portfolio investment	-9,715	3,708	3,800	-451	3,901	3,500	3,400	3,900	4,173
Long-term loans (net)	16,344	4,442	1,440	12,420	12,165	7,797	5,776	7,390	9,097
Official	10,352	-7,681	-4,563	-805	-1,702	-76	371	247	-167
Private	5,992	12,123	6,003	13,225	13,867	7,872	5,405	7,142	9,264
Other capital (net, including errors and omissions)	-17,130	-11,184	3,312	-3,990	-9,408	-133	-39	-14	141
Net use of IMF resources	12,144	-2,052	-3,439	-1,063	-3,682	-4,310	0	0	0
Change in gross reserves	-9,593	-1,768	-10,494	-2,137	-594	-2,360	-732	188	-927
Memorandum items									
Resource balance (% of GDP at current market prices)	2.7	2.1	0.0	-2.1	-1.5	-1.6	-1.8	-1.9	-1.8
Current account balance (% of GDP at current market prices)	-0.6	-0.7	-1.9	-3.9	-2.9	-3.2	-3.7	-4.0	-4.0
Real annual growth rates (%) (1993 prices)									
Merchandise exports	30.6	20.7	15.0	6.4	16.1	21.8	10.3	8.6	10.8
Merchandise imports	-8.7	23.5	22.7	14.2	13.2	22.1	10.9	9.0	10.3

a. "GNFS" denotes "goods and nonfactor services".

Mexico
Estado de Mexico Structural Adjustment Loan
Key External Debt Indicators

Indicator	Actual					Projected			
	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total debt outstanding and disbursed (TDO) (US$m)[a]	166,780	157,848	149,690	159,962	166,959	170,120	175,853	183,228	192,466
Net disbursements (US$m)[a]	26,466	-4,843	-3,560	11,357	8,483	3,787	5,836	7,462	9,183
Total debt service (TDS) (US$m)[a]	26,886	40,792	42,452	27,990	40,194	41,867	37,659	49,827	53,253
Debt and debt service indicators (%)									
TDO/XGS[b]	179.6	142.2	118.3	118.8	108.4	91.7	86.2	82.9	78.9
TDO/GDP	58.3	47.5	37.3	38.4	34.5	30.0	28.9	28.0	27.5
TDS/XGS[b]	28.9	36.7	33.5	20.8	26.1	22.6	18.5	22.5	21.8
IBRD exposure indicators (%)									
IBRD DS/public DS	13.8	8.1	6.6	10.6	10.1	10.8	14.8	12.0	13.0
Preferred creditor/ public DS (%)[c]	27.4	19.5	20.9	22.2	38.7	42.0	21.1	17.4	19.1
IBRD DS/XGS[b]	2.6	2.1	1.7	1.5	1.4	1.2	1.1	1.0	0.9
IBRD TDO (US$m)[d]	14,295	13,078	11,906	12,109	11,456	11,431	11,691	11,873	11,756
Present value of guarantees (US$m)	472	510	550	595	429	116	0	0	0
Share of IBRD portfolio (%)	12.0	11.5	10.5	9.3	8.7	8.3	8.2	8.1	7.9
IFC (US$m)									
Loans	550	528	495	338	402	...	...	...	...
Equity and quasi-equity[e]	57	65	76	78	57	...	...	...	...

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.
b. "XGS" denotes exports of goods and services, including workers' remittances.
c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank of International Settlements.
d. Includes present value of guarantees.
e. Includes equity and quasi-equity types of both loan and equity instruments.

Mexico
External Financing Requirement and Projected Sources of Financing
(in millions of U.S. dollars)

Category	2000	2001	2002
Financing requirements:			
1. Current Account Deficit	18,295	22,305	26,059
2. External Debt Amortization[a]	51,809	46,228	57,362
a. Public and Publicly Guaranteed	13,849	7,514	11,157
of which IMF	5,526	0	0
of which IBRD	1,359	1,289	1,337
b. Private	37,960	38,714	46,205
of which short term	24,062	24,362	24,422
3. Change in gross reserves (-decline)	2,360	732	-188
4. Gross Financing Requirements (1 + 2 + 3)	72,464	69,265	83,233
Sources of Financing:			
5. Private Investment Flows (Net)	17,300	17,300	18,495
6. External Debt Contracted[a]	55,164	51,965	64,738
Public and Publicly Guaranteed	11,234	7,643	11,329
Multilateral and Bilateral Gross Disbursements	3,532	2,512	2,340
of which IMF	1,216	0	0
of which IBRD	1,647	1,664	1,520
Private Creditors	6,370	4,168	8,188
Private Non-Guaranteed[a]	43,930	44,322	53,409
of which short term	24,362	24,422	24,494
7. Total Sources of Financing (5 + 6)	72,464	69,265	83,233

Source: Bank staff estimates, SHCP.

Estado de Mexico Structural Adjustment Loan
Total Debt Flows and Stock with IBRD
(US$ million)

	Actual					Projected		
	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03
Debt Outstanding	13,322	12,251	11,363	11,540	11,540	11,960	12,098	12,020
of which guarantees	499	539	572	424	429	116	0	0
Share of IBRD portfolio (%)	11.9	11.3	9.8	9.8	9.8	10.0	9.9	9.6
Commitments	527	485	1,767	950	1,169	1,926	1,500	1,500
Disbursements	1,473	943	1,024	1,309	1,339	2,072	1,551	1,276
Repayments	1,461	1,363	1,268	1,285	1,341	1,339	1,297	1,355
Net Disbursements	12	-421	-244	24	-2	732	254	-78
Interest	937	892	750	816	882	861	898	904
Net Transfer	-925	-1,313	-994	-793	-885	-128	-643	-983

As per information available as of September 30, 2000.
Source: Bank staff estimates

Mexico
Estado de Mexico Structural Adjustment Loan
Status of Bank Group Operations in Mexico
Operations Portfolio
As of October 31, 2000

Project ID	Fiscal Year	Borrower	Purpose	Original Amount in US$ Millions				Diference between expected and actual disbursements a/		Last PSR Supervision Rating b/	
				IBRD	IDA	Cancel.	Undisb.	Orig	Frm Rev'd	Dev Obj	Imp Prog
Number of Closed Projects: 15											
Active Projects											
MX-PE-7667	1992	NAFIN	IRRIG SCTR	400.00	0.00	50.00	0.00	0.00	0.00	S	S
MX-PE-7667	1993	BANOBRAS	HWY RHB & SAFETY	480.00	0.00	0.00	0.05	0.05	0.00	S	HS
MX-PE-7723	1993	BANOBRAS	MEDIUM CITIES TRANSP	200.00	0.00	23.00	106.86	130.50	98.90	S	S
MX-PE-7725	1994	NAFIN	PRIMARY EDUC.II	412.00	0.00	40.00	63.50	106.70	66.70	HS	S
MX-PE-7710	1994	BANOBRAS	N. BORDER I ENVIRONM	368.00	0.00	301.00	36.22	322.20	47.60	S	S
MX-PE-7712	1994	NAFIN	ON-FARM & MINOR IRRI	200.00	0.00	30.00	49.46	81.22	49.46	S	S
MX-PE-7612	1994	BANOBRAS	SOLID WASTE II	200.00	0.00	193.06	1.48	-4.50	1.48	S	S
MX-PE-7707	1994	BANOBRAS	WATER/SANIT II	350.00	0.00	84.30	51.79	173.50	0.00	U	U
MX-PE-34490	1995	NAFIN	TECHNICAL EDUC/TRAINING	265.00	0.00	30.00	120.54	157.66	13.96	S	S
MX-PE-34161	1995	NAFIN	FINANCIAL SEC T.A. SUPPLM	37.40	0.00	8.75	0.00	0.00	0.00	S	S
MX-PE-7702	1995	SEDESOL	SECOND DECENTRALZTN	500.00	0.00	29.34	0.00	0.00	0.00	S	S
MX-PE-7689	1996	NAFIN	BASIC HEALTH II	310.00	0.00	0.00	90.70	78.90	44.60	HS	HS
MX-PE-7713	1996	NAFIN	WATER RESOURCES MANA	186.50	0.00	0.00	132.59	66.51	11.91	S	S
MX-PE-7726	1997	BANCOMEXT	AQUACULTURE	40.00	0.00	38.91	0.00	0.00	0.00	U	U
MX-PE-7700	1997	NAFIN	COMMUNITY FORESTRY	15.00	0.00	0.00	7.81	2.70	0.00	S	S
MX-PE-43163	1997	BANOBRAS	FEDERAL ROADS MODZTN	0.00	0.00	0.00	0.00	0.00	0.00	HU	U
MX-PE-7732	1997	NAFIN	RURAL FIN. MKTS T.A	30.00	0.00	28.71	0.00	0.00	0.00	U	U
MX-PE-44531	1998	NAFIN	KNOWLEDGE & INNOV	300.00	0.00	0.00	251.23	26.20	0.00	S	S
MX-PE-7720	1998	BANOBRAS	HEALTH SYSTEM REFORM - SAL	700.00	0.00	0.00	350.00	350.00	0.00	S	S
MX-PE-40199	1998	NAFIN	BASIC EDUC.DEVELOPMENT PHASE I	115.00	0.00	0.00	68.09	29.10	0.00	S	S
MX-PE-43670	1998	BANOBRAS	HEALTH SYSTEM REFORM TA	25.00	0.00	0.00	14.80	10.20	0.00	S	S
MX-PE-49895	1998	BANOBRAS	HIGHER ED. FINANCING	180.20	0.00	0.00	164.65	33.70	0.00	S	S
MX-PE-7711	1998	NAFIN	RURAL DEV. MARG.AREA	47.00	0.00	0.00	33.24	16.90	0.00	S	S
MX-PE-48505	1999	NAFIN	AGRICULTURAL PRODUCT	444.45	0.00	0.00	266.35	11.30	0.00	S	S
MX-PE-7610	1999	BANOBRAS	FOVI RESTRUCTURING	505.05	0.00	0.00	462.00	282.00	0.00	U	U
MX-PE-67491	2000	NAFIN	BANK RESTRUCTURING FACILITY	505.06	0.00	0.00	150.00	144.90	0.00	HS	HS
MX-PE-66867	2000	BANOBRAS	DECENTRALIZATION SAL	606.07	0.00	0.00	0.00	0.00	0.00	S	S
MX-PE-66938	2000	NAFIN	GENDER (LIL)	3.07	0.00	0.00	3.07	0.00	0.00	#	#
MX-PE-57530	2000	NAFIN	RURAL DEV.MARG.AR II	55.00	0.00	0.00	51.45	-0.50	0.00	S	S
Total				7,479.80	0.00	857.07	2,475.88	2,019.24	334.61		

	Active Projects	Closed Projects	Total
Total Disbursed (IBRD and IDA)	3,645.16	21,895.95	25,541.11
of which has been repaid	218.94	13,974.60	14,193.54
Total now held by IBRD and IDA	5,902.10	7,921.35	13,823.45
Amount sold	0.00	92.34	92.34
of which has been repaid	0.00	92.34	92.34
Total Undisbursed	2,475.88	0.00	2,475.88

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.

b. Following the FY94 Annual Review of Portfolio performance (ARPP), a letter based system was introduced (HS = highly Satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

Mexico

Estado de Mexico Structural Adjustment Loan
Statement of IFC's Held and Disbursed Portfolio
As of August 31, 2000
(In US Dollars Millions)

		Held				Disbursed			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1988/91/92/93/9:	Apascc	12.60	0.00	0.00	50.40	12.60	0.00	0.00	50.40
1998	Ayvi	10.00	0.00	0.00	0.00	10.00	0.00	0.00	0.00
1990/92/96	BANAMEX	96.21	0.00	0.00	45.18	96.21	0.00	0.00	45.18
1997	Banco Bilbao MXC	70.59	0.00	30.00	0.00	70.59	0.00	30.00	0.00
1992	Banorte-SABROZA	3.00	0.00	0.00	0.00	3.00	0.00	0.00	0.00
1995/96	Baring Mex. FMC	0.00	0.02	0.00	0.00	0.00	0.02	0.00	0.00
1995/99	Baring Venture	0.00	2.73	0.00	0.00	0.00	0.00	0.00	0.00
1998	CIMA Mexico	0.00	4.80	0.00	0.00	0.00	4.80	0.00	0.00
1998	CIMA Puebla	7.00	0.00	0.00	0.00	3.50	0.00	0.00	0.00
1994	CTAPV	3.73	0.00	2.32	0.00	3.73	0.00	2.32	0.00
0	Chiapas-Propalm:	0.00	0.80	0.00	0.00	0.00	0.31	0.00	0.00
1997	Comercializador:	3.06	0.00	2.19	6.25	3.06	0.00	2.19	6.25
1999	Corsa	13.00	3.00	0.00	0.00	13.00	3.00	0.00	0.00
1993	Derivados	2.20	0.00	0.00	0.00	2.20	0.00	0.00	0.00
1997	Fondo Chiapas	0.00	4.20	0.00	0.00	0.00	0.43	0.00	0.00
1998	Forja Monterrey	13.00	3.00	0.00	13.00	13.00	3.00	0.00	13.00
1991/96	GIBSA	21.64	0.00	10.00	72.76	21.64	0.00	10.00	72.76
1993	GIDESA	6.25	8.00	0.00	4.25	6.25	8.00	0.00	4.25
1996/00	GIRSA	45.00	0.00	0.00	60.00	22.71	0.00	0.00	30.29
1993	GOTM	0.82	0.00	0.00	0.22	0.82	0.00	0.00	0.22
1997/98	Gen. Hipotecari:	0.00	1.20	0.00	0.00	0.00	0.00	0.00	0.00
1998	Grupo Calidr:	12.00	6.00	0.00	10.00	12.00	6.00	0.00	10.00
1989	Grupo FEMSA	0.00	9.43	0.00	0.00	0.00	9.43	0.00	0.00
1997	Grupo Minsa	18.00	10.00	0.00	27.00	18.00	10.00	0.00	27.00
1992/93/95/96/9:	Grupo Posadas	25.00	0.00	10.00	10.00	25.00	0.00	10.00	10.00
1992/96/97/98	Grupo Probursa	0.00	1.32	0.00	0.00	0.00	1.32	0.00	0.00
1998	Grupo Sanfandil:	9.58	0.00	0.00	4.70	6.25	0.00	0.00	3.03
1994/96/98/0C	Heller Financial	0.00	0.32	0.00	0.00	0.00	0.32	0.00	0.00
2000	ITR	14.00	0.00	0.00	4.00	10.90	0.00	0.00	3.10
1994	Interceramic	8.00	0.00	6.00	3.50	8.00	0.00	6.00	3.50
2000	InverCap	0.00	1.00	0.00	0.00	0.00	1.00	0.00	0.00
1993	Masterpak	2.40	0.00	0.00	0.00	2.40	0.00	0.00	0.00
1998	Merida III	30.00	0.00	0.00	73.95	27.36	0.00	0.00	67.44
1995/99	Mexplus Puertos	0.00	1.41	0.00	0.00	0.00	1.41	0.00	0.00
1996/99/00	NEMAK	0.00	0.00	0.83	0.00	0.00	0.00	0.83	0.00
1998	Punta Langosta	2.63	1.00	0.00	4.55	2.63	1.00	0.00	4.55
2000	Rio Bravc	50.00	0.00	0.00	59.50	22.83	0.00	0.00	27.17
2000	Saltillo S.A.	35.00	0.00	0.00	43.00	0.00	0.00	0.00	0.00
1999	Sudamerica	0.00	15.00	0.00	0.00	0.00	15.00	0.00	0.00
1997	TMA	2.77	0.00	2.10	9.60	2.77	0.00	2.10	9.60
1992	Toluca Toll Roac	7.16	0.00	0.00	0.00	7.16	0.00	0.00	0.00
1991/92	Vitro	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1991	Vitro Flotadc	4.96	0.00	0.00	2.07	4.96	0.00	0.00	2.07
1998	ZN Mxc Eqty Func	0.00	25.30	0.00	0.00	0.00	9.81	0.00	0.00
	Total Portfolio:	529.60	98.53	63.44	503.93	432.57	74.85	63.44	389.81

Approvals Pending Commitment

	Loan	Equity	Quasi	Partic
2000 Teksid Aluminio	25.00	0.00	0.00	0.00
2000 Teksid Hierrc	15.00	0.00	0.00	30.00
1999 BANAMEX LRF II	50.00	0.00	0.00	0.00
1999 Baring BMPEF FMC	0.00	0.06	0.00	0.00
1998 Cima Hermosillc	7.00	0.00	0.00	0.00
2000 Educacion	9.70	0.00	0.00	0.00
2000 FCCM	10.50	2.00	0.00	17.70
2000 Hospital ABC	30.00	0.00	0.00	14.00
2000 Innopack	15.00	15.00	0.00	0.00
Total Pending Commitment	162.20	17.06	0.00	61.70

Annex B

MACROECONOMIC FRAMEWORK

Recent Economic Developments

62. Mexico's economic performance in 2000 has been strong, and key macroeconomic indicators generally exceed both government targets and private sector expectations. Economic growth accelerated during the first half of 2000 to 7.8 percent, in comparison with the same period of the previous year. After some initial signs of a moderate slowdown in the expansion of economic activity during the second half of the year, economic growth for 2000 is now expected at 6.5–7.0 percent, still considerably above the country's annual growth trend of 5 percent observed over the past four years. Inflation continues its downward trend and, at an expected year-end rate of 8.8 percent for 2000, will stay well within the annual objective set by the monetary authorities (below 10 percent). The overall external deficit, i.e. the balance of payments current account deficit, is projected at 3.2 percent of GDP—slightly up from 2.9 percent in1999 and within manageable proportions.

63. Sound macroeconomic management, largely consisting of (i) tight and independent monetary policy, (ii) a flexible foreign exchange regime and (iii) a conservative fiscal stance, continues to provide the basis for a respectable rate of growth, single-digit inflation and a viable external balance. Favorable external developments, in particular stronger than expected growth of the US economy and the sharp increase of international oil prices since mid-1999, enhanced the economic performance of Mexico in 2000. The rapid growth of aggregate demand, resulting from these favorable external developments and their multiplier effects on domestic demand, poses Mexican policymakers with additional challenges to (i) avoid a possible overheating of the economy and (ii) manage the vulnerability of the economy to declines in US economic activity or in international oil prices, both of which have been at unusually high levels.

64. The higher-than-anticipated oil prices generated substantial windfall revenue with a direct impact on both the external and fiscal accounts. The external oil windfall in 2000 amounted approximately to US$5.6 billion or 1 percent of GDP.[14] The windfall revenue for the overall public sector is even slightly larger at approximately US$7 billion or 1.25 percent of GDP, due to additional higher revenue generated from domestic oil sales.

65. The year-end fiscal deficit is expected to be slightly under the target of 1.0 percent. With the exception of the higher transfers to states and municipalities, no substantial increase of public expenditure took place, and overall public expenditure remained very much on target. On the revenues side, higher oil revenues were largely offset by other revenue shortfalls. The fiscal position, by not increasing public savings in an amount equal to the externally generated oil windfall, thus had a more expansionary result than originally targeted for 2000. In addition, front-loading some public expenditures further contributed to the particularly rapid expansion of domestic demand during the first half of the year.

14. On the basis of the observed average price of Mexican oil of US$25 per barrel compared to the price of US$16.5 per barrel estimated for the 2000 economic program and federal budget.

66. The real effective exchange rate, based on relative consumer prices, continued to appreciate gradually during 2000. Although it is now close to the level observed before the 1994–95 crisis, concerns about an "overvaluation" of the peso should be tempered with recognition that that the long-term equilibrium real exchange rate depends on real phenomena such as terms of trade, relative productivity and the availability of external capital. The floating-rate regime, adopted after the 1995 crisis, remains in place and continues to allow market-driven adjustments, and labor-productivity gains in Mexican manufacturing industry and a yet incomplete recovery of real wages (to the level observed before the 1995 crisis) show a more limited appreciation of the real effective exchange rate based on relative unit labor costs.

67. Tight monetary policy, together with the appreciation of the peso, contributed lower than expected inflation and led to high real interest rates, in a range of 7–9 percent. Monetary authorities repeatedly stressed the need for an appropriate mix of monetary and fiscal policy in aggregate demand management in order to avoid the negative impact on the country's external balance (and the related increase in vulnerability to external shocks) from excessive reliance on monetary policy).

Macroeconomic Prospects and Vulnerability

68. The economic program of the incoming administration includes tightening fiscal policy, in order to keep aggregate demand pressures in check, and continued reduction of inflation. The fiscal tightening and an expected slowdown of US economic activity. (to 3 percent annual real growth) lead to program targets of 4.0–4.5 percent real growth in 2001.

69. Fiscal tightening is planned in order to bring the deficit down to 0.5 percent of GDP even with a projected reduction of the oil price, from an average of US$25 per barrel during 2000 to US$18 per barrel for 2001. That oil-price assumption reduces public sector oil revenues by about 1 percent of GDP compared to 2000, part of which is automatically shared with state and municipal governments through lower *participaciones*. The additional fiscal tightening will be obtained from a reduction of expenditures rather than an increase of non-oil revenues. While the incoming government recognizes the need for comprehensive fiscal reform by broadening the tax base and increasing non-oil revenues, it will not enact the reform in 2001. Assumptions on the external environment underlying the monetary and fiscal program for 2001 are more conservative than international sources,[15] particularly for oil prices. Adopting more conservative assumptions, mainly for precautionary reasons, also provides the additional fiscal tightening needed to correct the excess domestic demand expansion that took place during 2000.

70. The monetary authorities announced a year-end inflation target of 6.5 percent for 2001, in line with the medium-term objective of 3 percent inflation by 2003. The inflation target is ambitious compared with private sector expectations of 8 percent in 2001 and will require continued tight monetary policy along with the fiscal measures.

15. IMF–WEO and the World Bank's DECPG projections of September 2000 are 3.2 percent for US economic growth and an equivalent of US$22 per barrel for the Mexican oil price, whereas the Consensus Forecast of October 2000 includes a 3.7 percent US economic growth and US$21 per barrel for Mexican oil.

71. In addition to the vulnerability of the Mexican economy to the performance of the US economy and oil prices, the macroeconomic scenario depends on the ability of the incoming administration to build the political consensus necessary to implement its program. Following the historical presidential elections last July, the markets reacted favorably to the lack of a post-electoral conflict and the perception of an important structural reform agenda by the new administration. Avoiding political stalemate on major structural reform initiatives, including a comprehensive fiscal reform to reduce dependence on oil revenue, will require strong political consensus building, since there is no partisan majority in Congress.

72. Annex Tables A provide detailed macroeconomic projections based on the government's fiscal and monetary programs and on assumptions from international sources about the country's external environment. The base scenario shows a slowdown in domestic demand, and in particular private consumption. The initial slowdown of economic activity and domestic demand will partly offset the impact on the balance of payments of lower oil prices and slower US growth, maintaining the current account deficit within manageable proportions and financed largely by foreign direct investment.

External Financing Requirements

73. One element that contributed to the severity of the 1994–95 crisis was the amount of short-term dollar-indexed public debt (*Tesobonos*) contracted immediately before the crisis. Therefore, in addition to prudent fiscal and monetary policies and a flexible exchange rate regime, the current administration has managed external public debt in order to reduce short-term repayment and refinancing needs, particularly during the political transition. Mexican authorities announced in July 2000 the renewal of a contingent external financing package totaling US$26.4 billion covering a period until December 2001, a full year into the next administration. The package consists of US$19.7 billion in credit resources that can be accessed from international organizations (IMF US$1.5, World Bank US$6.0[16], IDB US$4.2 and Eximbanks US$8.0 billion) and US$6.7 in contingent, crisis-management credit arrangements with the US and Canadian monetary authorities. On this occasion the Mexican authorities also announced that remaining resources under the IMF Stand-By Arrangement of US$1.5 billion would not be drawn but remain at the disposal of Mexico. In August 2000, Mexico prepaid all its outstanding obligations with the IMF, US$3.0 billion.

74. Detailed projections of Mexico's external financing requirements and sources of finance are presented in Annex Table A. Total public and private sector external financing requirements are estimated at US$63, 58 and 67 billion for the years 2000, 2001 and 2002, respectively. These amounts include the roll-over of short-term trade finance as well as the inter-bank credit lines. These sizeable external financing requirements are expected to be financed mainly from international private sources. All the net financing needs, i.e. the balance of payments current account deficit, are expected to come from the Mexican private sector. Over two-thirds of these net financing needs will be covered by private investment flows and the remainder with

16. Potential access to World Bank resources refers to the stock of un-disbursed World Bank loans of about US$2.9 billion and the remainder of the CAS fiscal 1999–2001 lending program presented to and discussed by the Board on June 8, 1999. Of the total fiscal 1999–2001 lending program of US$5.2 billion, US$2.1 billion has been committed during fiscal 1999–2000 leaving another US$3.1 billion to be committed.

additional debt incurred by the private sector. The public sector is not expected to increase its external indebtedness substantially, but does require refinancing of obligations coming due and will continue a strategy to refinance external public debt to improve its cost and maturity structure if international markets conditions allow. Maintaining adequate access to longer-term financing as provided by the World Bank and other international financial organizations will continue to be essential for improving the structure of Mexico's external public debt.

Annex C

AMOUNT AND STRUCTURE OF PUBLIC DEBT IN THE ESTADO DE MEXICO

75. By the end of 2000 the EdoMex Government is projected to have MxP 22.9 billion of public debt, plus accumulated arrears of MxP 4.7 billion. This estimated total public stock of MxP 27.6 billion represents 69 percent of total ordinary income of the state during fiscal 2000—above the generally accepted benchmark of a maximum of 60 percent. This ratio is substantially higher—143 percent—if earmarked resources transferred to the state for decentralized activities (Ramo 33) and *participaciones* to municipalities are deducted from the state's ordinary income.

76. The impact of this over-indebtedness is only mitigated by a favorable amortization schedule, resulting from several Federal Government-led debt-restructuring schemes. These schemes, accessible to all states and municipalities, were put in place in 1995 and 1997 to remedy the impact of the financial crisis that hit the country in 1995, which led to large interest rate increases. Under the *Programa de Apoyo Crediticio a Estados y Municipios* (PACEM) states and municipalities could restructure their debt with both commercial and development banks into inflation-indexed (UDI) debt and extend the average maturity. This greatly reduced debt-service payments in the short term, because what would have been the inflation component of the interest on regular debt was automatically capitalized in to the principle, via the indexing. Under the first phase of the PACEM in 1995, the EdoMex restructured its debt into UDI debt at a real interest rate of 9.5 percent and a final maturity of eight years with a two-year grace period. The second phase of the PACEM allowed the state to restructure the maturity and interest rate of its UDI debt to a real interest rate of 7.5 percent, with a maturity of 18 years and level debt-service payments.[17]

77. The EdoMex public debt, restructured under the second PACEM since May 1997, will require annual debt service payments over the next years of 745 million UDIs (equivalent at this moment to MxP 2.1 billion), of which amortization will make up a gradually increasing part, due to the level-payment structure of the debt. Amortization of UDI debt will make up about one third of the UDI debt service payment due in 2001. By the end of 2000 the stock public debt denominated in UDIs will amount to an equivalent of MxP 18.6 billion, which represents 81 percent of the state's public debt excluding arrears (or 67.5 percent of public debt including arrears), and a remaining average maturity of nine years.

78. New debt contracted by the EdoMex after the second phase of PACEM has been denominated almost all in pesos, i.e. at a nominal interest rate. At the moment, EdoMex has a nominal peso debt stock (excluding arrears) of MxP 4.3 billion with a remaining average maturity of slightly under three years. This peso-denominated debt has been contracted at a variable nominal interest rate, on average at the Mexican inter-bank rate (TIIE) plus 110 basis points.[18] Debt service payments on this existing debt stock are heavily front-loaded due to both the short average maturity and the absence of a level payment structure. Amortization requirements amount to approximately MxP 0.8 billion in 2001 and an annual average of MxP 0.4 billion for the next four years.

17. This structure is equivalent to an average maturity of the debt of 11.7 years.
18. TIIE is on average some 200 basis points above the comparable federal government nominal CETES rate.

79. The EdoMex accumulated a significant amount of arrears over the past two years, an estimated amount of MxP 0.7 billion and MxP 1.2 billion in 1999 and 2000 respectively, bringing the total amount of arrears to an estimated MxP 4.7 billion by the end of 2000. The inability of the EdoMex to contract debt to the amount of its annual financing requirements on the market can be attributed to both the perception by the market of an over-indebtedness issue and the freeze on sub-national government borrowing since April 2000. This is partly due to the lack of agreement thus far between banks and states in establishing an alternative guarantee mechanism after the Federal Government's reform abolished its previous practice of accepting *mandatos* to collateralize state debt with *participaciones*. In addition, the state has not yet gotten its credit rating published.

80. The fiscal adjustment program to be adopted by the EdoMex is projected to substantially diminish the state's annual financial requirements through the improvement of the overall fiscal balance, namely, posting increasing fiscal surpluses after 2002, and financing part of the financial requirements in 2001 and 2002 with the proceeds of the Bank loan that would carry a longer maturity than market finance. The Bank loan would finance approximately two thirds of the state's financial requirements during 2001–02 and represent about 17 percent of the state's total debt stock (including remaining arrears) by the end of 2002.

Annex D

LETTERS OF DEVELOPMENT POLICY

G.H.1

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

DIRECCION GENERAL DE CREDITO PUBLICO
DIRECCION GENERAL ADJUNTA DE ORGANISMOS FINANCIEROS INTERNACIONALES
Subdirección de Proyectos Especiales y del Sector Privado

Oficio No. 305 – VI.6. 282

México D.F., a 13 de noviembre de 2000.

440

14 NOV. 2000

OLIVIER LAFOURCADE
Director y Representante Residente
para México - Banco Mundial
Insurgentes Sur No. 1605
Torre Mural, Piso 24
Col. San José Insurgentes

Hago referencia al Programa de Saneamiento Financiero del Estado de México recientemente negociado con el Banco Mundial, y en específico a las condiciones de presentación al Directorio Ejecutivo, establecidas en la Minuta de Negociación de dicho préstamo.

Sobre el particular, adjunto me permito enviar a Usted la Carta de Política del Gobierno Federal, dirigida por el Secretario de Hacienda y Crédito Público, Lic. Ángel Gurría, al Señor James Wolfensohn, Presidente del Banco Mundial.

Sin otro particular por el momento, aprovecho la ocasión para reiterarle mi consideración más distinguida.

SUFRAGIO EFECTIVO. NO REELECCION
El Director General Adjunto de Organismos Financieros Internacionales,

RICARDO OCHOA

C.c.p.- Dirección General de Crédito Público.- Secretaría Particular.- SHCP.- Presente.
Ismael Díaz Aguilera.- Gerente de Organismos Financieros Internacionales.- BANOBRAS.- Presente.
Dirección General Adjunta de Organismos Financieros Internacionales.- SHCP.
Subdirección de Proyectos Especiales y del Sector Privado.- SHCP.- Presente.

TIEV - HACIENDA

G.H.1

SECRETARIA DE HACIENDA Y CREDITO PUBLICO

SECRETARIA PARTICULAR

101- 1792

México D.F., a 13 de noviembre del 2000.

Sr. James D. Wolfensohn
Presidente
Banco Mundial
1818 H Street, N.W.
Washington D.C. 20433

Estimado Señor Wolfensohn:

En relación con el préstamo en apoyo al Programa de Saneamiento Financiero del Estado de México a ser contratado por la Federación con el Banco Mundial (BM), cuyo fin es sanear las finanzas del Estado a través de reformas sectoriales que contribuyan a hacer más eficientes las erogaciones del gasto y fortalecer los ingresos públicos, me permito hacer de su conocimiento algunos aspectos de la situación y políticas macroeconómicas del país, y en particular las acciones más relevantes del Gobierno de México para impulsar el federalismo a fin de que los estados de la República fortalezcan su capacidad de gestión y respondan más directamente a las necesidades de su población. En específico, me refiero a la propuesta del Estado de México para reformar sus finanzas internas para poder participar más vigorosamente de los beneficios que este nuevo federalismo le brinda.

I. Situación Macroeconómica

La exitosa implementación de políticas económicas equilibradas permitió a la economía mexicana cumplir las metas macroeconómicas que el actual Gobierno se había propuesto a principios de año, y en algunos casos incluso sobrepasarlas. Como resultado, México mantuvo su posición como una de las economías más dinámicas de América Latina. Estos éxitos han fortalecido la capacidad de México para sobrellevar eventos desfavorables en los mercados internacionales, distinguiéndose así de otras economías emergentes. En este contexto, el crecimiento del Producto Interno Bruto para el año 2000 será de alrededor del 7%, cifra superior a la meta del 4.5% programada al principio del año, con lo cual el crecimiento promedio anual para el periodo 1996-2000 será de aproximadamente 5%. Se estima que para el año 2001 el crecimiento del producto podría ubicarse en 4%.

La expansión de la economía mexicana, que para finales del segundo semestre del 2000 habrá registrado 18 trimestres consecutivos de crecimiento, ha producido un crecimiento importante de los niveles de empleo. La tasa de desempleo abierto (TDA) promedió 2.5% en 1999, y durante el periodo enero-junio de 2000 se ubicó en 2.26 %, inferior en 0.49 puntos porcentuales a la registrada en el mismo lapso del año anterior. La TDA observada en el presente semestre es la menor que se ha registrado desde que este indicador comenzó a calcularse en 1985.

Por su parte la política fiscal ha promovido la generación de ahorro interno, liberando recursos adicionales para la inversión privada, contribuyendo a la reducción de la inflación y de las tasas de interés, así como al mantenimiento de un nivel de déficit en cuenta corriente congruente con la disponibilidad de ahorro externo de largo plazo. En 1999 el sector público registró un déficit de 1.14% del Producto Interno Bruto, monto menor al máximo permitido por el Congreso según las previsiones hechas para el año (1.25% del PIB). Cabe señalar que durante el periodo enero – junio del 2000, el balance público registró un superávit de 23 mil 124 millones de pesos, superior en 46.4 por ciento en términos reales al del mismo periodo del año anterior, y en línea con la meta anual de déficit público equivalente a 1.0 % del PIB contemplada para el año 2000.

Este aumento en la actividad económica y crecimiento en la tasa de empleo ocurrió dentro de un marco de menor inflación. La tasa de inflación registrada en 1999 fue de 12.3%, cifra menor en más de 0.5 puntos porcentuales a la cifra de inflación programada. De este mismo modo, a octubre del presente año la inflación acumulada asciende a 6.9% con lo cual al cierre del año podrá registrarse una tasa de inflación menor a la programada (10%).

En materia de deuda externa, la favorable evolución de los mercados financieros internacionales hizo posible que en abril se completara la totalidad del programa de refinanciamiento de la deuda externa programado para el año 2000 y en agosto se cancelaron, en forma anticipada, todas las obligaciones pendientes con el Fondo Monetario Internacional. Los resultados favorables del sector público en 1999 llevaron a una reducción de 2.7 puntos porcentuales sobre el total de la deuda pública neta como porcentaje del PIB. Durante los primeros seis meses del año 2000 la disminución en el saldo total de la deuda pública externa es de 0.8 puntos porcentuales respecto al observado al cierre de 1999, para ubicarse en 15.0 % del PIB.

Los resultados del sector externo también fueron favorables. Durante 1999, el déficit en cuenta corriente fue de US 14,012.8 millones (2.8% del PIB). Durante el primer trimestre de 2000, el déficit de la cuenta corriente ascendió a 4 mil 203.4 millones de dólares congruente con las entradas de inversión extranjera directa al país y en línea con la meta programada para el cierre del año (3.1% del PIB). Esto fue resultado de la política monetaria restrictiva del Banco de México, de la mayor estabilidad en los mercados financieros y del manejo disciplinado de las finanzas públicas.

Por todo lo anterior, el desempeño de la economía mexicana durante el presente año indica que la economía ha entrado al nuevo milenio con bases sólidas, con lo que se asegura una suave transición hacia la nueva administración.

II. El Federalismo como Directriz de la Política Económica

El fortalecimiento del federalismo ha sido uno de los ejes principales sobre los que la presente administración ha basado la consolidación de la economía y de las instituciones democráticas. Al comenzar esta Administración nos propusimos avanzar hacia un nuevo federalismo sobre la base de una profunda redistribución de competencias, responsabilidades y recursos del Gobierno Federal hacia las autoridades estatales y municipales. La renovación del pacto federal ha permitido vigorizar a los gobiernos de las entidades federativas y municipios.

El camino seguido por México ha consistido en (i) el incremento de los recursos a las entidades subnacionales y la ampliación de sus responsabilidades, (ii) el mejoramiento en la transparencia de las transferencias intergubernamentales y, de manera general, del gasto público federal ejercido en las entidades subnacionales, y (iii) la consolidación de un sistema regulatorio para el endeudamiento subnacional basado en mecanismos de mercado.

Además del tradicional sistema de participaciones utilizado desde 1980, el Gobierno Mexicano ha delegado a los estados las responsabilidades sobre educación y salud y les ha transferido los recursos correspondientes. Asimismo, se han aumentado las transferencias a los municipios. Todo esto ha favorecido a las entidades ya que ahora tienen la capacidad de predecir el monto de sus recursos y programar su asignación.

Los recursos federalizados que serán canalizados a estados y municipios en el año 2000 a través de aportaciones, participaciones federales y convenios de descentralización, aumentarán en 5.9 por ciento real con relación a 1999. En el presente ejercicio, el total de recursos federalizados representa 60.3 por ciento de la recaudación federal participable, mientras que en 1994 dichos recursos equivalían a 47.3 por ciento. Así, la mayor parte de la recaudación federal se reintegra a los gobiernos de las entidades federativas y a los municipios para su ejercicio soberano, con independencia de lo que recaudan los gobiernos locales como fuentes propias.

En general, los recursos otorgados a estados y municipios se distribuyen conforme a criterios claros y transparentes. La distribución de las participaciones sigue fórmulas bien establecidas. La distribución de las aportaciones federales para infraestructura social, fortalecimiento municipal y seguridad pública se ciñe también a fórmulas que consideran factores como la población objetivo y el grado de marginación. Los programas sectoriales de fondos de contrapartida y de acuerdos intergubernamentales de desempeño, ofrecidos por el Gobierno Federal, se rigen por fórmulas o criterios de acceso que constan en el Presupuesto Federal y que son publicados en detalle en el Diario Oficial de la Federación. La transparencia en la asignación de los recursos federales se fortaleció en los años 1999-2000, con la eliminación casi completa de las transferencias discrecionales a los gobiernos subnacionales y la creación de un Fondo para cubrir gastos de emergencias, con reglas claramente establecidas para disponer de los recursos sólo en caso de desastres naturales. En 1999 las transferencias discrecionales representaron menos del 0.15 por ciento del gasto federal y para el año 2000 se espera mantenerlas por debajo de esta proporción. Paralelamente, se incrementó el número de entidades federativas que reformaron o actualizaron el marco jurídico de las finanzas públicas, de manera que la mayoría de ellas cuenta hoy con Ley de Deuda Pública, Ley de Presupuesto e informes trimestrales de finanzas públicas. Todas estas medidas incentivan a los estados y municipios a observar la responsabilidad fiscal y asignar el gasto público de manera más eficiente y se mantiene la estabilidad fiscal a nivel federal.

Gracias al fortalecimiento de las transferencias fiscales y de los instrumentos contables y presupuestarios de las entidades subnacionales se consiguió disminuir el número de estados con déficit primario y financiero. Consecuentemente se logró una reducción en el saldo de la deuda pública total así como del impacto de la deuda sobre el ingreso total de los estados. La deuda estatal total disminuyó 24% in términos reales durante el periodo 1995-1999 y, salvo en el caso de tres excepciones, la deuda real disminuyó en todas las entidades. Sin embargo, se necesitaba disponer de más y de mejor información sobre la situación fiscal de estados y municipios para facilitar su

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- El esfuerzo fiscal adicional, mediante la ampliación de la base gravable y la elevación de la tasa del impuesto sobre el salario.
- La protección del gasto en salud y en educación, compatible con la utilización más eficiente de los recursos de ambos sectores. Estas reformas sientan bases para un manejo más autónomo de la educación por parte de los estados.
- La reforma al sistema de pensiones, que incluye la apertura del sistema de pensiones del Estado a los nuevos sistemas de capitalización individual, estimula la *portabilidad* y establece precedentes para reformas de las pensiones en otros estados.
- La implantación de mecanismos efectivos de cobro del servicio de agua, que habrá de posibilitar la reforma de las prácticas de cobro en los niveles federal y municipal.
- La elevación de la transparencia en la administración financiera.
- La introducción de nuevos límites al endeudamiento, especialmente al nivel de la deuda flotante, y de prácticas de diseminación de la situación y el manejo de la deuda del Estado.

Creemos que este programa de reformas fortalecerá las finanzas del Estado, mejorará la capacidad de gestión del gobierno y fomentará la reducción de pobreza. A nivel nacional, estas reformas contribuirán a la estabilidad macroeconómica, elemento clave necesario para llevar a cabo con éxito medidas dirigidas a reducir la pobreza. Asimismo, las reformas van a incrementar los recursos del Estado de México destinados a los programas sociales que dan atención de la gente pobre – por ejemplo, escuelas con menor índice de maestro por alumno que el estándar nacional y los programas de salud para gente no empleada en el sector formal.

El apoyo del la Federación a este programa está basado, entre otros aspectos, en el impacto de las finanzas del Estado en el marco macroeconómico nacional, el compromiso evidente del gobierno del estado con el programa de reforma, y en el efecto demostrativo que se puede producir en otros estados.

V. Apoyo del Banco Mundial

La consolidación del Federalismo es un proceso irreversible que complementa el programa de reformas macroeconómicas de México. Significativos son los avances logrados en materia de descentralización hasta la fecha. No obstante, México deberá continuar los esfuerzos dirigidos a fortalecer el desempeño de las finanzas subnacionales.

En este contexto, el Gobierno Federal solicita el apoyo técnico y financiero del Banco Mundial para la realización del programa de ajuste fiscal y financiero del Estado de México. Este programa del Gobierno Federal está dirigido a respaldar las políticas de saneamiento estructural y de financiamiento de la deuda del Estado de México y a mejorar su calificación de crédito y acceso a recursos. Este mismo apoyo establecerá pautas para aumentar la autonomía, la responsabilidad fiscal y la transparencia de los gobiernos subnacionales en las decisiones de asignación de recursos, mejorando el desempeño de los mercados de crédito a nivel estatal y municipal, y reforzando la capacidad de gestión financiera de los recursos públicos de los gobiernos subnacionales.

ESTADOS UNIDOS MEXICANOS

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

La asistencia del Banco Mundial contribuirá a consolidar las reformas puestas en marcha previamente con el apoyo del Banco Mundial mediante el antes mencionado Préstamo de Ajuste para la Descentralización y, de manera general, para fortalecer el proceso de descentralización en México.

Atentamente,
SUFRAGIO EFECTIVO. NO REELECCION.
El Secretario

Ángel Gurria

Toluca de Lerdo, México,
10 de noviembre de 2000.

LICENCIADO
JOSE ANGEL GURRIA TREVIÑO
SECRETARIO DE HACIENDA Y CREDITO PUBLICO
P R E S E N T E

Estimado Señor Secretario:

Deseo hacer de su conocimiento que el Gobierno del Estado de México se propone llevar a cabo un programa de reformas de sus finanzas públicas con objeto de mejorar su situación financiera, fortalecer la capacidad de gestión y mejorar la provisión de infraestructura y servicios públicos. Por lo tanto, es de interés del Gobierno del Estado, contar con el respaldo del Gobierno Federal a través de BANOBRAS, para lograr que el programa de reformas se realice con éxito. Atento a lo anterior, a continuación se describen las acciones más relevantes que se han realizado y el programa de reformas que se prevé poner en marcha.

I. Realizaciones del Estado de México en el contexto fiscal tradicional.

- El Estado de México se caracterizó por trabajar estrechamente con la Federación en el marco del Federalismo Mexicano hasta la década de los noventa. Durante ese tiempo, la interacción entre ambos niveles fue de coordinación en el diseño e implementación de políticas, co-financiando o subsidiando actividades estatales. Las políticas del Gobierno Federal contribuyeron a hacer frente a los retos fiscales y financieros en el Estado más importante del país en lo que respecta a población y Producto Interno Bruto. Las transferencias federales compensaron en alguna medida los balances fiscales estatales, y cuando se requirió de financiamiento, el acceso del Estado al crédito se facilitó por medio de la garantía de participaciones federales.

- La población estimada en el Estado de México es de más de 13 millones de personas. El gobierno estatal ha diseñado y aplicado políticas sociales y de infraestructura, orientadas a atender las necesidades generadas por la más alta tasa de crecimiento poblacional del país, a la vez que ha atraído grandes inversiones (nacionales e internacionales) que han establecido una sólida base productiva dentro del territorio del Estado.

- En respuesta a los flujos masivos de migración interna, tuvo la necesidad de desarrollar su propio sistema de educación para llegar a donde el sistema federal no alcanzó. La diversidad cultural propia de la entidad fue multiplicada por personas que llegaron de todos los estados del país. La dispersión multicultural y geográfica de la población, fue atendida a través de un sistema de educación diversificado que alcanzó cada lugar de la entidad. Debido a la asignación de montos importantes del presupuesto estatal para el pago de maestros y otro tipo de inversiones en educación, el Estado alcanzó niveles más altos de cobertura en áreas urbana y rural y tiene tasas "maestro/alumno" arriba del promedio nacional. Cuando se inició la descentralización del Sistema de Educación Básica Federal, el gasto per cápita en educación alcanzó los niveles más altos en todo México. La ampliación de la oferta educativa para la formación de personal docente, aseguró el suministro regular de maestros quienes fueron reclutados en el sistema de educación estatal a su egreso de las escuelas normales.

- Sistemas paralelos de seguridad social, proveen servicios de salud para empleados públicos y privados, el Instituto de Salud Estatal brinda servicios básicos para los trabajadores del sector informal y la población marginada, así como parte del Programa de Desarrollo Integral de la Familia. Mientras que el porcentaje de pobreza registrado en el Estado se sitúa por debajo del promedio nacional, debido al tamaño de su población, cuenta con la mayor cantidad de personas que viven por debajo de la línea de pobreza en el país.

- Se ha asignado un papel preponderante a la oferta de infraestructura. Con la participación del Gobierno Federal, se construyó la red más grande de carreteras de todos los estados. Se asegura la provisión de agua y saneamiento aún a comunidades con limitadas posibilidades de pago, y es también la primera fuente de ayuda en emergencias en caso de desastres naturales.

II. El nuevo contexto fiscal y financiero para el Estado de México.

- El Federalismo Mexicano ha evolucionado durante los últimos ocho años y en los próximos se caracterizará por una mayor autonomía estatal, reducirá la dependencia del nivel nacional y aumentará las responsabilidades de los gobiernos locales. En este nuevo contexto, los estados tienen que empezar a reforzar su autonomía fiscal y financiera de inmediato. Particularmente, el Estado de México espera que la revisión del Pacto Fiscal Federal expanda su capacidad, aumentando sus ingresos propios y que compense adecuadamente el alto gasto educativo que enfrenta el Gobierno Estatal.

Los retos fiscales y financieros inmediatos requieren la adecuación de las finanzas estatales al nuevo marco regulatorio para las operaciones crediticias y el reestablecimiento del acceso a los mercados de crédito, bajo términos y condiciones favorables. Para llegar a lo anterior, se necesita disminuir el déficit fiscal y empezar a reconstruir una capacidad de inversión sustentable propia. También necesita reprogramar su deuda y hacer que el servicio de la misma sea compatible con el balance fiscal. A fin de llevar a cabo un programa de inversión adecuado, el Estado de México debe revertir la tendencia de alta demanda de endeudamiento y creciente servicio de la deuda.

- Como consecuencia de lo anterior, el Estado de México no puede confiar más en transferencias federales extraordinarias para equilibrar el presupuesto estatal. Por lo tanto, los requerimientos de servicio de deuda deben guardar una proporción adecuada al balance primario estatal y la deuda flotante debe ser reducida a una proporción razonable al tamaño del gasto. Fortalecerá sus ingresos para asegurar el pago de las pensiones estatales y otras deudas contingentes. También, tiene que aprovechar al máximo las fuentes de generación de ingresos propios mientras se promueven reformas para una mayor autonomía fiscal. Si el Estado pretende mantener un alto nivel de inversión privada y expandir gradualmente las industrias de servicios de alta tecnología, los programas de inversión pública deben ser sostenidos, los impuestos deben permanecer neutrales y eficientes y los costos de transacción deben ser reducidos al mínimo.

- Nuestro reto es el de elevar la eficiencia en la provisión de infraestructura, así como de servicios públicos y establecer claramente la división de responsabilidades entre los distintos niveles de Gobierno. El Estado de México debe mejorar la fiscalización de sus ingresos y promover el cobro del agua en bloque a los municipios. De esta forma se estima tener mayores oportunidades para una reforma del pacto fiscal federal de acuerdo a las expectativas del Estado.

- El Estado es conciente de que se está produciendo una creciente descentralización del gasto federal y un mayor reforzamiento de la autonomía administrativa municipal. Las transferencias federales etiquetadas para los municipios, han tenido un enorme crecimiento durante los últimos tres años bajo las aportaciones del Ramo 33. La reforma en 1999 al artículo 115 de la Constitución, garantiza autonomía local en el presupuesto municipal, en la política de impuestos y en la administración.

El Estado está preparado para seguir estas políticas del Gobierno Federal por dos vías: reduciendo los subsidios propios a los municipios y haciendo sus propias transferencias para los municipios con mayor transparencia. Esto reforzará la capacidad para planear el presupuesto estatal y ayudar a generar un superávit en el balance fiscal.

III. Las políticas de ajuste y acciones del Estado de México.

Como Gobernador, deseo comunicarle de las políticas de reforma y acciones que el Estado de México ha decidido realizar como parte de su estrategia de largo plazo, para la provisión eficiente y sostenible de servicios sociales y de infraestructura. El programa de reformas consiste en una agenda amplia de reformas a nivel estatal, congruente con los cambios de política fiscal y financiera en proceso en el país, incluyendo reformas a nivel federal y local y cambios en las relaciones dentro de los tres niveles de Gobierno.

- El Estado de México promueve y adopta políticas que:

  - Lo adapten al nuevo entorno financiero para las operaciones de la entidad.
  - Desarrollen una mejor coordinación fiscal federal y sectorial con los municipios.
  - Lo condicionen anticipada y adecuadamente al proceso continuo de federalización dirigido a reforzar la autonomía estatal.

  El Estado está interesado en que algunas de las políticas enunciadas, sean pioneras y útiles para su posible adopción en otros estados.

- La reforma económica y de ajuste del Estado está resumida en la matriz que se anexa a la presente. Sus objetivos son mejorar el balance fiscal del Estado a través de acciones en siete sectores: de los ingresos (activos físicos e impuestos) y de gastos (en educación, salud, pensiones, agua y carreteras), además, varias reformas sistemáticas de administración de finanzas y deuda.

- El Gobierno Estatal considera que ningún programa de ajuste fiscal puede ser sustentable en el mediano plazo sin reformar los sectores sociales y de infraestructura. Las reformas institucionales y presupuestarias son indispensables para eliminar subsidios indiscriminados y prevenir gastos no sustentables en educación, agua y salud. Por ello, continuaremos revisando el crecimiento del personal del sector educativo y otros gastos corrientes. Además, para permitir la realización de un programa de inversión adecuado, es necesario establecer montos de deuda que mejoren la calificación crediticia y reduzcan los precios pagados a contratistas y proveedores.

- Con estas medidas, el programa de reformas del Estado de México reducirá el déficit fiscal a no más de 0.5% de los ingresos ordinarios para el año 2001 y alcanzará un superávit fiscal en el año 2002 y por lo menos hasta el 2005.

- A continuación describo con mayor detalle las medidas incorporadas en el programa:

  - **Impuestos:**

  a) Expansión de la base de impuesto al salario por eliminación de excepciones.
  b) Incremento de la tasa de impuesto al salario al 2.5% (superior al promedio nacional).
  c) Incremento de la tenencia estatal de autos dentro de los límites compatibles con otras entidades.
  d) Mejoramiento de las administración impositiva para facilitar a los contribuyentes el pago de impuestos.
  e) Fortalecimiento del proceso de fiscalización.

  - **Comercialización de Activos Físicos.** Para reducir el costo de mantenimiento y generar ingresos de capital, la comercialización de bienes físicos podrá realizarse a través de la renta, concesión o venta, dependiendo del tipo de bien. Nuestro objetivo es comercializar todos los activos incluidos en el plan de comercialización dentro de los próximos cinco años.

  - **Educación.** Se debe sostener nuestra provisión de servicios sociales, especialmente para los ciudadanos más marginados de nuestro Estado. En educación, mantendremos el nivel de gasto per cápita y la relación alumno-maestro y se incentivará la eficiencia en el gasto a través de una mejor coordinación Federación-Estado y la aplicación de indicadores de desempeño. Con gastos en educación por más de 60% del programa de gasto estatal, estabilizando la relación maestro-alumno, producirá una reducción de gastos significativa con respecto a la proyección de gastos en educación, de acuerdo a la pasada práctica de reclutamiento de maestros. En el futuro, el reclutamiento de nuevos maestros, se realizará principalmente para incrementar la relación maestro/estudiante en escuelas que se encuentren por debajo de la media nacional. En la práctica esto significará que la mayoría de los nuevos maestros se destinará a escuelas en zonas rurales. Con una mayor eficiencia en el gasto del sector educativo se sientan las bases para incentivar la administración escolar por las propias escuelas y comunidades. Con estos incentivos se busca que el Gobierno Federal transfiera a los Estados mayor autoridad en la administración de los recursos humanos en el sector educación.

- **Salud.** Incrementaremos el presupuesto para el Instituto de Salud, el cual sirve a la gente más necesitada; incrementaremos las contribuciones para nuestros servicios de seguridad social asegurando que las reservas de las pensiones no se empleen para el otorgamiento de otro tipo de subsidios; haremos mejor uso de la infraestructura, equipo y personal del sector mediante la coordinación para el uso de instalaciones del sector entre todas las instituciones públicas de salud y estableciendo un sistema consolidado para la compra de medicinas.

- **Pensiones.** Se protegerán las reservas y se expandirá la sustentabilidad financiera del sistema de pensiones del Estado, mientras se introducen parcialmente sistemas de pensiones de capitalización individual. La reforma del sistema de pensiones se alcanzará por una combinación de:

a) Limitar el uso de los fondos de pensión exclusivamente a los gastos de pensión, previniendo la desviación de fondos de pensión a otros usos.
b) Incrementando la tasa de contribución y la edad de retiro gradualmente para reducir la deuda implícita del sistema en por lo menos 20%.
c) Requiriendo pagar contribuciones por las remuneraciones no incluidas en el salario base, asignando estos ingresos adicionales a la acumulación en cuentas individuales.

- **Agua.** Se adoptarán nuevas regulaciones sobre tarifas y mecanismos para el cobro efectivo de agua para municipios y organismos operadores. El Estado invitará a los municipios para que voluntariamente cobren el pago por el suministro de agua en bloque con las participaciones federales. Se establecerá la eliminación de subsidios en el presupuesto estatal para los municipios y organismos operadores, por lo cual se eliminarán las transferencias del presupuesto del gobierno estatal a la Comisión del Agua del Estado de México, contribuyendo así a la reducción del déficit fiscal.

- **Transporte.** El incremento de los recursos del presupuesto para el mantenimiento de las carreteras, disminuirá el deterioro y reforzará la planeación del transporte, incluyendo la planeación y concesión de nuevas carreteras.

Administración financiera estatal. Esta reforma incluye, entre otras acciones, aquéllas destinadas a aumentar la transparencia en materia de deuda y de gastos, establecer indicadores de desempeño presupuestal para mejorar la eficiencia y rendición de cuentas, y a mejorar la planeación del presupuesto para asegurar la correspondencia entre el presupuesto aprobado y el ejercido. El nuevo tope de endeudamiento aprobado por el Congreso, así como el requerimiento de informes periódicos fortalecerán los equilibrios constitucionales entre las diferentes ramas del gobierno y facilitará el trabajo del Congreso para el cumplimiento de sus atribuciones. Destinaremos recursos para el mejoramiento de la administración financiera y particularmente en lo referente a la mejoria en el cumplimiento de compromisos de pago a proveedores. Asimismo, explotaremos mecanismos para mejorar la adquisición de bienes y servicios por parte del Gobierno Estatal, incluyendo la posibilidad de usar sistemas computarizados de licitaciones públicas como el "Compranet" desarrollado por el Gobierno Federal.

IV. Compromiso y capacidad del Estado para realizar las reformas propuestas.

- La administración actual del Estado ha estado poco más de un año en funciones. Le quedan aún cinco años para implementar totalmente las reformas propuestas y demostrar los beneficios del programa de ajuste. Conforme a sus atribuciones, el Congreso del Estado de México estará al corriente del desarrollo del programa de reformas.

- Finalmente, sabemos que nuestros ciudadanos, otros Estados y el público en general están observando el desempeño del Estado de México. Estamos determinados a mostrarles el desarrollo exitoso del programa de reformas.

V. Necesidades de apoyo del Estado de México para mantener un crecimiento sustentable.

- El Estado de México requiere el apoyo federal para realizar las reformas propuestas. Esta petición incluye un préstamo de BANOBRAS para financiar las reformas y un crédito complementario para la asistencia técnica (en preparación) necesaria para llevar a cabo este programa, el cual sentará las bases para fortalecer las acciones que se realizan para aliviar la pobreza y brindar sustentabilidad fiscal.

- El apoyo del Gobierno Federal hará posible la implementación del programa de reformas del Gobierno del Estado. Esto permitirá mejorar la calidad crediticia del Estado para acceder en mejores condiciones a recursos financieros requeridos para atender las necesidades de la población más desfavorecida.

Sin otro particular, reitero a usted la seguridades de mi más alta y distinguida consideración.

SUFRAGIO EFECTIVO. NO REELECCION
EL GOBERNADOR CONSTITUCIONAL DEL
ESTADO DE MEXICO

ARTURO MONTIEL ROJAS

C.c.p. Dr. Héctor Luna de la Vega, Secretario de Finanzas y Planeación.

Table 1. State of Mexico—Structural Adjustment Loan (EMSAL)—Matrix of Policy Actions for Tranche Release

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
FISCAL POLICY		
The budget of the state for 2001 submitted to the state Congress will have a deficit in the overall balance of no more than 0.5 percent of ordinary income.[1]	The accumulated overall deficit in the 2001 budget as executed through the end of the most recent quarter[2] will be no more than 0.5 percent of the ordinary income of the state.	The accumulated overall deficit in the 2001 budget as executed through the end of the most recent quarter will be no more than 0.5 percent of the ordinary income of the state. The budget of the state for 2002 submitted to the state Congress will have a surplus in the overall balance of at least 0.9 percent of ordinary income.
TAX POLICY AND TAX ADMINISTRATION		
The Government will have submitted the necessary legal amendments to the state Congress to: i) expand the base of the payroll tax to include all remuneration, all firms, and all employees, based on location of employment, except for exemptions already granted for years 2000-2001 to new firms located in the state –which will expire at the end of calendar year 2001 ii) increase the rate of the payroll tax to 2.5 percent. iii) introduce a new, simplified rate structure for the annual state fee for cars (*Tenencia*) that increases the average fee to $300 per vehicle, and an automatic mechanism for inflation indexation. The budget of the state (*Inciativa de Ley de Ingresos*) for 2001 submitted to the state Congress will have incorporated the above-mentioned reforms in its revenue projections. The Secretary of Finance has issued an *Acuerdo Programático* adopting a plan for shifting tax administration resources from collection (*recaudación*) to enforcement (*fiscalización*), including the closure of additional state tax collection offices, reallocating and retraining personnel for enforcement work, sharing information with the federal social security system, and streamlining payment of car fees.	The implementation of tax administration reforms, including the sharing of information with the federal social security administration and Secretaría de Hacienda y Crédito Público, is on schedule according to the *Acuerdo Programático*.	The tax administration reforms, including the sharing of information with the federal social security administration, will be on schedule according to the plan. A report on the impact of the tax administration reforms through the most recent quarter, including changes in collection performance, will be published.

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
ASSET MANAGEMENT AND CAPITAL REVENUE		
The budget of the state (*Iniciativa de Ley de Ingresos*) for 2001 submitted to the state Congress will have incorporated a revenue projection of at least MXP 200 million from the commercialization (that is, sale, lease, or concession to private management) of state assets.	The Government will have completed an inventory of its physical assets subject to commercialization, including their book value and legal status, and will have published a five-year plan for their commercialization. The Government will have completed an appraisal process to determine the estimated market value of all the assets subject to commercialization. The Government will have amended the internal regulations of the Secretary of Public Administration (*Secretaria de Administración*) as necessary to establish a new unit responsible for integral asset management and for implementation of the five year plan for commercialization. At least 35 percent of the revenue from asset commercialization projected in the approved State budget for 2001 will have been realized.	The Government will have reported to Congress the progress in commercialization of assets. At least 100 percent of the revenue from asset commercialization projected in the approved State budget for 2001 will have been realized. The budget of the state (*Iniciativa de Ley de Ingresos*) for 2002 submitted to the state Congress will have incorporated a revenue projection of at least MxP 200 million from the commercialization of state assets.

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
EDUCATION The 2001 budget (*Iniciativa de Presupuesto de Egresos*) submitted to Congress will include: i) a real, per-student expenditure in education that will be not less than the comparable expenditure in the approved budget for the year 2000. ii) specific teacher recruitment targets based upon pre-determined efficiency and quality standards.[3] iii) specific performance indicators for the education sector as defined in the System for Public Expenditure Evaluation.[4] iv) provisions to guarantee that the monthly savings accrued in the execution of education budget by the state *Secretaria de Educación* will be retained by that *Secretaria.* v) provisions requiring that the execution of the education sector budget follows a published and unified Annual Operational Plan (*Programa Operativo Anual*) that includes both the state and federal (*educación federalizada*) education sub-sectors within the state.	The Government has submitted to the state Congress a draft bill (*Proyecto de Ley de Planeación)* requiring, *inter alia*, that the annual state budget includes: i) specific performance and impact indicators for the education sector *(sistema de evaluación de gasto publico*). ii) the timing for the publication of semi-annual reports on actual outcomes in the education sector as per the above-mentioned performance and impact indicators. iii) provisions to set a schedule for automatic transfer of the education sector's budget allocation to the *Secretaría de Educación* and to guarantee that the monthly savings accrued in the execution of education budget by the state *Secretaria de Educación* will be retained by that *Secretaria.* *Instrucción del Grupo Intersecretarial de Financiamiento* has been issued requiring that the *Secretaria de Educacion* adopts and implements under its own responsibility, one and the same integrated personnel management system (*Sistema Integral de Administración de Personal*) for both state and federal (*federalizados*) teachers.	The 2002 budget submitted to Congress will include: i) a real, per-student expenditure in education that will not be less than the comparable expenditure in the approved budget for the year 2001. ii) teacher recruitment targets based upon pre-defined efficiency and quality standards.[3] The *Secretaria de Educación* has launched the implementation of a pilot program for the introduction of modern teaching methods in science classes in selected urban and rural primary, secondary and preparatory (*preparatorias*) schools.

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
HEALTH The 2001 budget submitted to Congress will increase the budget of the Secretariat of Health of the State of Mexico (SSEM) by at least two percent in real terms compared to 2000 and will provide funding for ISSEMyM health so that no funds for health operations need to be taken from the pension fund.	The government has issued regulations by which funding for health services (hospitals) offered by the State Program for Integrated Family Development (DIFEM) will be separated from the rest of DIFEM's expenditures and will be transferred directly to SSEM. The Government will have published and initiated implementation of a plan for cost recovery and efficient utilization of existing capacity for health care by SSEM and ISSEMyM, including sale of services to each other and to the private sector.	Contribution rates for ISSEMyM health services will have been raised by at least 4 percentage points (2 percentage point from employer and 2 percentage point from employee) from levels as of October 2000. The 2002 budget submitted to Congress will increase the allocation for SSEM by at least four percent in real terms compared to the 2000 budget (including the health related funds formerly allocated to DIFEM). The SSEM and ISSEMyM will have consolidated their purchases of basic medicines. Implementation of the cost recovery and higher utilization plan in SSEM and ISSEMYM will have proceeded on schedule according to plan.

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
PENSIONS		
The state Government will have issued regulations that: i) direct ISSEMyM to maintain, and publish semi-annually, separate accounts for pensions, health and contributions and expenditures as designated in the Social Security Law; ii) direct ISSEMyM to employ pension-related funds only for pension-related expenditures, with any shortfall in the health and other categories to be covered by the general Government budget on a transitional basis until 2003. iii) direct ISSEMyM to review and identify amendments, if needed, to the regulation governing the Supervisory Board and investment limits for ISSEMYM'S reserves in order to prevent their use in support of the state budget. iv) require the Government to pay all ISSEMyM contributions within 5 days of their due date v) establish procedures for semi-annual public disclosure of investment performance of the pension reserve fund.	ISSEMyM will demonstrate compliance with the new regulations. The state Government will have submitted to Congress a law proposal that will: i) reduce the implicit pension debt of the state by at least 20 percent over its value at the end of 2000 through, *inter alia,* reduced benefits and increased retirement ages. ii) require contributions to be paid on the non-salary portion of the remuneration (on a mandatory basis for new entrant workers and on a voluntary basis for other workers) with these contributions designated for accumulation on individual accounts in the AFORE system. State and municipal employers will be required to pay half of those contributions for employees participating in the new system. iii) allow workers who leave the ISSEMyM pension system the right to receive a prorated pension upon reaching retirement age The state Government will have approached the Federal Government and neighboring states to negotiate agreements of reciprocal recognition and transferability of pension rights for workers moving across those government entities. The first semi-annual reports on the accounts of the pension system and on the investment performance of the pension reserve fund will have been published.	ISSEMyM will demonstrate compliance with the new regulations. The second semi-annual reports on the accounts of the pension system and on the investment performance of the pension reserve fund will have been published.

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
WATER An Administrative Agreement between the State's Secretaries of Finance and Planning and of Urban Development and Public Works and the CAEM (*Comisión de Agua del Estado de México*) will have been signed and become effective and would include: i) a provision forbidding CAEM (*Comisión de Agua del Estado de México*) from entering or renegotiating water supply agreements (*Convenios de Suministro de Agua)* with municipal water companies (*Organismos Operadores)* if those agreements do not include the authorization by the municipality(ies) in question for the state to employ as a source of payment the municipality's(ies') federally-allocated transfers (*Participaciones*) in order to pay any overdue balance that its(their) water company may owe to CAEM for water delivered after January 1, 2001 ii) a provision obliging the state to a) whenever the water supply agreement so authorizes, use the relevant muncipality's(ies') federally-allocated transfers *(Participaciones)* to settle any overdue balance that its water company may owe to CAEM; b) to immediately transfer those amounts to CAEM; and c) to publish semi-annual reports detailing the status of all municipal water companies' accounts with CAEM, as well as the amounts, per municipality, of federally-allocated municipal transfers used by the State to settle overdue balances of those companies with CAEM for water delivered after January 1, 2001 The budget of the state for 2001 submitted to the state Congress will include: i) no transfers to CAEM other than transfers for investments that will be specifically included in the public investment program of the state. ii) an increase of at least 3 percent in real terms in water rates currently charged by CAEM	All water supply agreements between the municipal water companies and the CAEM signed after November 16, 2000 will have included the provisions agreed as conditions of Board presentation and will have been implemented satisfactorily. The Regulations for the Water Law will have been issued before February 28, 2001 and include: i) a provision forbidding CAEM (*Comisión de Agua del Estado de México*) from entering or renegotiating water supply agreements (*Convenios de Suministro de Agua)* with municipal water companies (*Organismos Operadores)* if those agreements do not include the authorization by the municipality(ies) in question for the state to employ as a source of payment the municipality'(sies') federally-allocated transfers (*Participaciones*) in order to pay any overdue balance that its(their) water company may owe to CAEM for water delivered after January 1, 2001 ii) a provision obliging the state to a) whenever the water supply agreement so authorizes, use the relevant muncipality's(ies') federally-allocated transfers *(Participaciones)* to settle any overdue balance that its water company may owe to CAEM; b) to immediately transfer those amounts to CAEM; and c) to publish semi-annual reports detailing the status of all municipal water companies' accounts with CAEM, as well as the amounts, per municipality, of federally-allocated municipal transfers used by the State to settle overdue balances of those companies with CAEM for water delivered after January 1, 2001	CAEM will be applying the pricing guidelines issued in the Regulations of the Water Law. The budget of the state for 2001 as executed will have included no transfers to CAEM other than transfers for investments that will be specifically included in the public investment program of the state. The budget of the state for 2002 submitted to the state Congress will include: i) no transfers to CAEM other than transfers for investments that will be specifically included in the public investment program of the state ii) an increase of at least 6 percent in real water rates charged by CAEM relative to the rates in effect in October 2,000. The State will have published a report detailing the status of all municipal water companies' accounts with CAEM, as well as the amounts, per municipality, of federally-allocated municipal transfers employed as a source of payments by the State to settle overdue balances of those companies with CAEM. CAEM will have published its audited financial accounts for at least the first half of 2001 (including a break-down of its costs into own operational expenses, investment and technical assistance) and its operational and financial plans for 2002, including measures necessary to comply with the federal government's effective policy regarding charges by CNA (*Comisión Nacional de Agua*).

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
WATER (continued)	iii) pricing guidelines for CAEM and for the municipal water companies that foster financial sustainability, water preservation, metered consumption, and rationalization of consumer subsidies iv) provisions whereby CAEM is required to cover costs for all services provided to the state, municipalities, *organismos operadores* or third parties. v) general guidelines for operational and financial reporting standards (including cost accounting) to be followed by CAEM. The State will have launched an on-demand Technical Assistance Program to help water municipal companies i) apply the pricing guidelines issued in the Regulations of the Water Law, and ii) improve the quality and sustainability of their services. The state has issued regulations for the Water Law identifying ways for the private sector to participate in water provision including *Contratos Integrales de Administración* and concessions. The State published a report detailing the status of all municipal water companies' accounts with CAEM, as well as the amounts, per municipality, of federally-allocated municipal transfers withheld by the State to settle overdue balances of those companies with CAEM. The State completed a plan to establish an independent State Water Supply and Sanitation Agency with powers to regulate and supervise water provision. CAEM has elaborated and presented to the Secretaries of Finance and Planning and of Urban Development and Public Works a plan for debt recovery to be implemented over the next three years.	The Government will have submitted to the state Congress a draft law establishing an independent State Water Supply and Sanitation Agency in charge of regulating and supervising water provision. The debt recovery plan has been implemented as per schedule.

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
ROAD TRANSPORT At least 70 percent of road-related expenditures included in the budget submitted to Congress for 2001 will be earmarked for maintenance.[5]	The *Secretaría de Transporte* will have published: i) an inventory of highways, including their planned and actual use and the condition of their maintenance. ii) a report on the financial situation of highway concessions. iii) a plan for institutional strengthening of the state *Secretaría de Transporte*.	At least 70 percent of road-related expenditures included in the budget submitted to Congress for 2002 will be earmarked for maintenance. The government will have published a five year plan for improved highway maintenance and concessions.
FINANCIAL ADMINISTRATION AND RELATIONS WITH MUNICIPALITIES The budget of the state for 2001 submitted to the state Congress will include: i) a minimum of 85 percent of total expenditures specified as projects in the program budgeting structure. Allocations not specified as projects will be distributed according to specific allocation rules previously established by Congress; ii) no funds that can be used for discretionary transfers to municipalities;[6] iii) provisions for monitoring and publishing detailed quarterly reports on budget execution (revenue, expenditure and debt) and on the distribution, municipality by municipality, of fund allocations for education, transport, and emergency relief for natural disasters;[7] iv) authorization for the Government to automatically adopt an emergency expenditure rationalization plan were total revenues to fall below 5 per cent of estimated revenues in the approved budget.	The state Government has submitted to the state Congress a draft bill for the new *Ley de Planeación* requiring: i) the monitoring and publishing detailed quarterly reports on budget execution (revenue, expenditure and debt) and on the distribution, municipality by municipality, of fund allocations for education, transport, and emergency relief for natural disasters ii) all intra-year reforms to the approved budget preserve the same overall balance as in the budget initially approved by Congress for the year; ii) future budgets be prepared, presented and executed as program budgeting; iii) the state implement a system of integrated financial management that includes accounting, budgeting and monitoring of physical execution of investments The Government will submit a draft bill to Congress to amend the *Ley Orgánica de la Administración Pública* so that the management of state personnel is assumed by the corresponding sector of the administration.	The execution of the state budget in 2001 contained no discretionary transfers to municipalities. The budget of the state for 2002 submitted to the state Congress will include: i) a minimum of 90 percent of total expenditures specified as projects in the program budgeting structure. Allocations not specified as projects will be distributed according to specific allocation rules previously established by Congress; ii) no funds that can be used for discretional transfers to municipalities. Quarterly reports on budget execution, debt, and municipal expenditure distribution through the end of the most recent quarter have been submitted to Congress.

BOARD PRESENTATION (expected December 2000)	SECOND TRANCHE (expected by July 2001)	THIRD TRANCHE (expected by January 2002)
FINANCIAL ADMINISTRATION AND RELATIONS WITH MUNICIPALITIES (continued)	The execution of the state budget through the end of the most recent quarter of 2001 will contain no discretionary transfers to municipalities. The Government will have posted on the internet quarterly reports, through the end of the most recent quarter, detailing i) the budget as executed (compared with the budget approved) and ii) the amount and terms of all outstanding debt (including the floating debt, categorized by the time outstanding for accounts payable, namely over 30 days, over 60 days, and over 90 days), and it will continue such quarterly reporting. Quarterly reports will have been published on the distribution according to municipality of budget expenditures on education, transport, and relief from natural disasters.	
PUBLIC DEBT The budget of the state for 2001 submitted to the state Congress will have an explicit nominal net borrowing[8] ceiling equivalent to no more than 5 percent of ordinary income (to finance the overall deficit and to settle floating debt),[9] and a requirement for the government to report quarterly to congress the amount and terms of all debt outstanding. The proposed budget for 2001 will provide for a reduction of the stock of floating debt of at least 40 percent by December 31, 2001.	The Government will have reduced the stock of floating debt by at least 20 percent relative to the stock existing on December 31, 2000.	The budget of the state for 2002 submitted to the state Congress will have an explicit nominal net borrowing ceiling not higher than the reduction of floating debt. The Government will have reduced the stock of floating debt by at least 40 percent relative to the stock existing on December 31, 2000. The proposed budget for 2002 will provide for a reduction of the stock of floating debt by at least 80 percent relative to the stock existing on December 31, 2000.

Table Notes:
Unless otherwise specified, "the state" and "the government" refers to the executive branch of the State of Mexico, and "Congress" refers to that of the State of Mexico. TBD means To Be Determined.

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1. Ordinary income is defined as current plus capital income minus "extraordinary transfers" from the federation (ordinary transfers are those that the federal Congress allocates by state or by formulae; all other transfers are considered "extraordinary". The overall balance is the difference between ordinary income and all expenditures (including loans and transfers to other public or private entities).
2. "Quarter" refers to calendar quarters: January-March, April-June, July-September, and October-December.
3. The standards will include, *inter alia*, (i) teacher recruitment rates that do not reduce the average student-to-teacher ratio at each level of schooling (basic, secondary, technical, higher education) below present ratio; (ii) no teacher recruitment (of either new or transferring teachers) in schools whose student-to-teacher ratio is already higher than the federal standard; and (iii) adoption by the Secretary of Education of a teacher certification test for all newly recruited teachers.
4. Education performance indicators will include, *inter alia*, (i) percentage of students that complete school year within regular school calendar, per level of education; (ii) student repetition rate, per level of education; (iii) student desertion rate, per level of education; (iv) average number of weekly hours effectively taught by teacher, per level of education.
5. Maintenance expenditures are restricted to: (i) routine conservation to keep roads in operating conditions during each calendar year, (ii) corrective conservation scheduled every 2 to 3 years to improve road surface, (iii) road rehabilitation, including actions to repair major damage in road surface but excluding damage to lower layers of road structure, (iv) road reconstruction, including total or partial repair of major structural damage and reconstruction of lower layers of road structure, (v) road modernization, including geometrical features of road structure, signaling, drainage, terraces and bases, (vi) reconstruction and rehabilitation of pedestrian and vehicle bridges.
6. A discretionary transfer is one in which the executive allocates funding without the specific guidance of a congressionally approved formula.
7. Disaster relief funds would be allocated as matching grants in a pre-specified ratio with federal disaster relief funds, which are now specified within an insurance scheme.
8. Net borrowing refers any new issuance of debt and obligations minus amortization of principal.
9. Floating debt is defined as the sum of ADEFAS and Accounts Payable (*Cuentas por pagar*), as defined by the Treasury Department.

SECRETARIAT OF THE TREASURY AND PUBLIC CREDIT
PRIVATE SECRETARIAT

101- November 13, 2000

Mexico D.F.

Mr. James D. Wolfensohn
President
World Bank
1818 H Street, N.W.
Washington D.C. 20433

Dear Mr. Wolfensohn:

With regard to the loan to support the Financial Rehabilitation Program of the State of Mexico that the Federation is to contract with the World Bank (WB)—the aim of which is to rehabilitate the State's finances through sectoral reforms designed to streamline expenditure and boost public revenue—I should like to draw your attention to certain aspects of the economy and of the macroeconomic policies that the country is pursuing. In particular, I wish to point out the major steps being taken by the Government of Mexico to foster federalism, in the sense of encouraging the states to strengthen their management capacity and respond more directly to the needs of their populations. Further, I refer to the proposal of the State of Mexico to reform its internal finances in order to participate more intensively in the benefits that the new federalism affords.

I. The Macroeconomic Situation

Successful application of balanced economic policies enabled the Mexican economy to meet the macroeconomic targets that the present Government had set itself at the beginning of the year and in some cases even to surpass them. As a result, Mexico retained its position as one of the most dynamic economies in Latin America. Success in these areas strengthened Mexico's capacity to withstand downturns in international markets, a feature that distinguished it from other emerging economies. Thus, gross domestic product is expected to grow by approximately 7 percent in 2000, surpassing the 4.5 percent target set at the beginning of the year. This will take the annual average rate of growth of GDP for 1996-2000 to approximately 5 percent. For 2001, the GDP growth projection is approximately 4 percent.

By end-2000, the Mexican economy will have grown for 18 consecutive semesters, an expansion that has led to substantial increases in employment. The open unemployment rate (OUR) averaged 2.5 percent in 1999, and in January-June 2000 it was 2.26 percent, 0.49 of a percentage point below the figure for the same period the year before. The present semester's OUR is the lowest since this indicator began to be recorded in 1985.

Fiscal policy has encouraged growth in domestic saving, freeing up additional resources for private investment and contributing to a reduction in inflation and interest rates, as well as maintaining a current account deficit compatible with the availability of long-term external savings. In 1999, the public sector deficit was equivalent to 1.14 percent of gross domestic product, which was lower than the (1.25 percent of GDP) ceiling authorized by Congress on the basis of projections for the year. In January-June 2000, the public sector accounts showed a surplus of 23,124 million pesos, a 46.4 percent increase in real terms over the figure for the same period last year and an amount in line with this year's public sector deficit target of 1.0 percent of GDP.

This surge in economic activity and growth of employment took place in a context of reduced inflation. The rate of inflation in 1999 was 12.3 percent, over 0.5 of a percentage point below the projected rate. Likewise, through October of this year, accumulated inflation totaled 6.9 percent, which suggests that the year could end with inflation lower than the projected 10 percent.

With respect to the external debt, favorable trends on international financial markets meant that by April Mexico was able to complete the whole of its external debt refinancing program for 2000, and in August 2000 it prepaid all its pending financial obligations to the International Monetary Fund. The improvement in public sector finances in 1999 led to a 2.7 percentage points drop in total net public debt as a percentage of GDP. In the first six months of 2000, total external public debt fell by 0.8 of a percentage point compared to the figure for end-1999 and was equivalent to 24.0 percent of GDP.

External sector outcomes were also satisfactory. In 1999, the current account deficit in the balance of payments amounted to US$14,012.8 million (2.8 percent of GDP). In first quarter 2000, the current account deficit was US$4,203.4 million, a level compatible with inflows from foreign direct investment in the country and in line with the end-of-year target (3.1 percent of GDP). This was the result of Banco de México's tight monetary policy, greater stability in financial markets, and fiscal discipline.

In light of these results, the performance of the Mexican economy this year suggests that it has entered the new millennium on a solid footing, thereby ensuring a smooth transition to the new administration.

II. Federalism as the Guideline for Economic Policy

The strengthening of federalism has been one of the pillars on which the present administration has sought to consolidate the economy and democratic institutions. Our goal, when this Administration started, was to progress to a new kind of federalism based on a thoroughgoing redistribution of jurisdictions, responsibilities, and Federal Government funds to state and municipal authorities. Renewal of the federal covenant has revitalized the governments of the federative entities and municipalities.

The path pursued by Mexico has consisted of: (i) endowing subnational authorities with more funds and wider responsibilities; (ii) increasing the transparency of intergovernmental transfers and, in general, of federal public expenditure in subnational entities; and (iii) consolidating a regulatory system, based on market mechanisms, to oversee borrowing by states and municipalities.

In addition to the traditional revenue sharing system (*participaciones*) that has been in force since 1980, the Mexican Government has delegated responsibility for education and health to the states and has transferred the corresponding funds to them (*aportaciones*). Transfers to the municipalities have also been increased. All this has benefited the subnational entities, since they can now predict their revenue and plan allocations.

The federalized funds to be channeled to states and municipalities in 2000 through aportaciones, participaciones, and decentralization agreements will increase by 5.9 percent in real terms, compared to 1999. This year total federalized funds amount to 60.3 percent of the federal revenues available for sharing, compared to 47.3 percent in 1994. Thus, well over half federal revenues are reimbursed to the governments of the federative entities and to the municipalities to be used as they choose, independently of the funds that local governments raise on their own.

Generally, the funds provided to states and municipalities are distributed according to clear and transparent criteria. The traditional sharing system follows well-established procedures. Distribution of federal contributions for social infrastructure, strengthening of municipalities, and public safety is also tied to formulas that take into account such factors as the target population and the extent to which it is underprivileged. Sectoral programs offered by the Federal Government based on counterpart funds and intergovernmental performance agreements are governed by formulas or eligibility criteria written into the Federal Budget and published in detail in the Federation gazette, the *Diario Oficial*. Transparency in the allocation of federal funds was boosted in 1999-2000, by almost completely eliminating discretional transfers to subnational governments and by the creation of a Fund to cover emergencies, with clearly established rules to ensure that the funds may be tapped only in the event of natural disasters. In 1999, discretional transfers amounted to less than 0.15 percent of federal expenditure and it is expected that they can be kept to less than that percentage in 2000. At the same time, there was an increase in the number of federative entities reforming or updating the legal framework for public finance, so that most of them now have a Public Debt Law, a Budget Law, and quarterly public finance reports. All these measures provide an incentive to states and municipalities to respect fiscal accountability and allocate public expenditure more efficiently, while fiscal stability is maintained at the federal level.

Thanks to this strengthening of fiscal transfers and of the accounting and budgetary instruments of the subnational entities, fewer states showed primary and financial deficits. Consequently, there was a reduction in the stock of total public debt as well as in the debt burden, measured as a percentage of the states' total revenue. Total state debt fell 24 percent in real terms in 1995-1999, and the debt in real terms fell for all except three of the entities. Nevertheless, more and better data were needed regarding the fiscal positions of the states and municipalities in order to enhance their access to fresh funding. The new standards for recording subnational debt adopted in 1999-2000 have helped to improve the data and disseminate information on the federative entities' debt position.

The reforms of 1999 and 2000 successfully implemented an innovative system based on market mechanisms to regulate subnational borrowing and encourage prudence by both the financial institutions granting the loans and the subnational governments contracting them. The

WB provided Mexico with technical and financial assistance in developing these policies through a Decentralization Adjustment Loan (DAL, 1999) for US$600 million.

III. Decentralization Policy: the road ahead

The current Administration has continued working on the decentralization agenda with a medium- and long-term strategy. It has implemented the rules and incentives needed to ensure that subnational entities practice fiscal discipline. Now it is a question of supporting their adaptation to the new borrowing framework and to intergovernmental fiscal relations. The Federal Government is continuing to work closely with the state governments in order to identify more precisely the problems they face and, where appropriate, to find possible solutions. The immediate challenge is to show states how they can effectively adjust their income, expenditure, and borrowing policies in ways that will increase the efficiency and guarantee the sustainability of the services they provide. States and municipalities are thus becoming the focal point of the institution building required for decentralization. Once this institutional strengthening has been demonstrated and consolidated, and is gradually extended to more and more federative entities and municipalities, further-reaching sectoral decentralization reforms can be implemented, at the federal, state, and municipal levels.

The immediate focus of the programs to support the states' efforts to adjust to the new borrowing and intergovernmental transfers framework is on: (i) boosting the revenue-raising capacity of states and municipalities; (ii) regularization and financing of their floating and contingent liabilities; (iii) reinforcing their ability to set clear expenditure priorities; (iv) creating a set of incentives designed to increase efficiency through management emphasis on performance and results; and (v) increasing the level of transparency in the financial administration of each state.

IV. Federation Support for Mexico State's Reform Program

The Mexico State reform program to be backed by the Federal Government is described in detail in the attached policy letter of the Governor of Mexico State, Mr. Arturo Montiel Rojas. In particular, the Federal Government would like to underscore the following reforms that are expected to enhance fiscal sustainability in ways that are also applicable to other states:

- The effort to raise fiscal revenue by broadening the tax base and increasing the wage tax.
- The safeguarding of expenditure on health and education in a way that is compatible with more efficient use of resources in both sectors. These reforms pave the way for greater state autonomy in the education sector.
- Reform of the pension system, including opening up the state pension system to new individual capitalization systems, encouraging portability of pensions and establishing precedents for pension reforms in other states.
- The introduction of effective mechanisms for collecting water rates. This will facilitate reform of collection practices at the federal and municipal levels.
- Increased transparency in financial management.
- The establishment of new ceilings on borrowing, especially with respect to the floating debt, and of new practices in management of the state debt and the dissemination of information about it.

We believe that this reform program will strengthen the State's finances, enhance the government's management capacity, and foster poverty reduction. At the national level, these reforms will contribute to macroeconomic stability, a key factor for successful implementation of poverty reduction measures. In addition, the reforms will increase revenues that the State of Mexico will earmark for social programs for the poor: for instance, for schools with fewer teachers per pupil than the national average and for health programs for people who are not employed in the formal sector.

Federation support for this program is based, among other considerations, on the impact of the State's finances on the national macroeconomic framework; the evident commitment of the government of the State of Mexico to the reform program, and the potential demonstration effect on other states.

V. World Bank Support

The consolidation of federalism is an irreversible process complementing Mexico's macroeconomic reform program. So far significant progress has been made with decentralization. Nevertheless, Mexico has to continue its efforts to improve public finance in the regions.

It is against this backdrop that the Federal Government requests the World Bank's technical and financial assistance for the fiscal and financial adjustment program of the State of Mexico. This Federal Government program aims to support the structural adjustment and debt restructuring policies of the State of Mexico and to improve its credit rating and access to funds. This same support effort will establish guidelines for increasing the autonomy, fiscal responsibility, and transparency of subnational governments in their resource allocation decisions, improving the performance of state and municipal credit markets, and strengthening the financial management capacity of subnational governments in administering public funds.

World Bank support will help to consolidate the reforms that the World Bank already supported with the above-mentioned Decentralization Adjustment Loan and, in general, to reinforce the decentralization process in Mexico.

Sincerely,
[EFFECTIVE VOTING. NO RE-ELECTION]
The Secretary

Ángel Gurría

Toluca de Lerdo, Mexico
November 10, 2000

Lic. José Angel Gurría Treviño
Secretary of the Treasury and Public Credit
By hand

Dear Mr. Gurría,

It is my pleasure to inform you that, as one of its objectives under the 1999-2005 State Development Plan, the Government of State of Mexico intends to carry out a public finance reform program aimed at improving its financial position, strengthening its management capacity, and streamlining its provision of infrastructure and public services. The Government of the State wishes to count on the support of the Federal Government, through Banobras, in order to ensure that the reform program is successfully implemented. To that end, I enclose a description of the main steps undertaken so far and of the reform program we wish to embark upon.

I. Achievements of the State of Mexico in the traditional fiscal context

The State of Mexico operated successfully within the Federation-State framework that characterized Mexican federalism until the 1990s. In those days the State and the Federation were closely involved with one another, sharing in policy design and execution, with the Federation cofinancing or subsidizing state and municipal activities. Federal Government policies were partly designed to address the fiscal and financial challenges posed by the country's most important state in terms of population and gross domestic product. Federal transfers to some extent helped balance the State's fiscal accounts and when financing was required the State's access to credit was facilitated by guarantees based on the federal participaciones system.

The population of the State of Mexico is estimated to be over 13 million. It grows by approximately 1,000 people a day, or 350,000 per year (the average population of a medium-sized city in Latin America). State of Mexico has devised and implemented social and infrastructure policies to cater to the needs of the fastest growing population of any state in the country, while simultaneously attracting large (national and international) investments, which have created a solid productive base in the State.

In response to massive domestic migration inflows, the State of Mexico had to develop its own educational system to cover areas that the federal system failed to reach. The State's own cultural diversity was multiplied by the arrival of people from every state in the land. The cultural and geographical dispersion of the population was addressed by a diversified education system, which reached out to every corner of the State. By allocating a substantial portion of budget funds to payment of teachers and other investments in education, the state achieved high enrollment levels in urban and rural areas, and higher teacher/pupil ratios than the national average. When decentralization of the Federal Basic Education System began, the State's per capita expenditure on education was, and remains to this day, among the highest in the whole of Mexico. The expansion of teacher training courses ensured a regular supply of teachers, who were recruited into the state education system when they graduated from teachers' college.

Parallel social security systems provide health care for public and private sector employees, and the State Health Institute delivers basic health care for workers in the informal sector and for the underprivileged, as well as those in the Integral Development of the Family Program. Although, in percentage terms, the poverty registered in the State is below the national average, due to the size of its population the State of Mexico has more people living below the poverty line than any other state in the country.

The State has accorded priority to provision of infrastructure. With Federal Government participation, the State of Mexico has built the largest highway network of any state in the country. The State guarantees water and sanitation facilities even to communities unlikely to be able to pay for them, and it is also the first source of aid in the event of natural disasters.

II. The State of Mexico's new fiscal and financial environment

The State Government is aware that the situation described above has changed radically in the past seven years and will continue to change in the years to come. Hallmarks of the new environment will be greater autonomy for the State, less dependence on national authorities, and increased responsibilities for subnational governments. Under these circumstances, the State must immediately begin strengthening its fiscal and financial autonomy. In particular, the State of Mexico expects revision of the Federal Fiscal Pact to lead to an expansion of the State's capacity through an increase in its own funds and to adequate compensation for the high educational outlays of the State Government.

Immediate fiscal and financial challenges require that state finances adapt to the new regulatory framework governing credit operations, as well as restoration of access to credit markets on favorable terms and conditions. For that to be possible, the State needs to trim the fiscal deficit and to begin to rebuild its own sustainable investment capacity. It also needs to reschedule its debt and to ensure that debt servicing is compatible with fiscal equilibrium. In order to implement an appropriate investment program, the State of Mexico has to reverse the trend toward high indebtedness and increasing debt servicing.

The State of Mexico can no longer rely on special federal transfers to balance the state budget, as it did in the past. Consequently, debt-servicing requirements have to be kept to an appropriate proportion of the State's primary balance, and the floating debt has to be pared down to a reasonable proportion of total expenditure. The State of Mexico will raise revenues to ensure payment of state pensions and other contingent liabilities. The State must also take full advantage of its sources of own funds, while efforts to promote greater fiscal autonomy are under way. If the state wishes to maintain a high level of private investment and gradually to expand high tech services industries, public investment programs have to be sustained, taxes must be kept neutral and efficient, and transaction costs have to be kept to the minimum.

The challenge we face is to expand infrastructure and the provision of public services for development and to establish a clear division of responsibilities among the different levels of government. The State of Mexico has to improve its systems for monitoring revenue and charge municipalities bulk water rates. This should increase the possibilities of reforming the federal fiscal pact in a way that meets the state's expectations.

The State is aware that efforts are being made to decentralize federal expenditure and strengthen the administrative autonomy of the municipalities. Federal transfers earmarked for the municipalities have grown significantly in the past three years under Ramo 33 aportaciones. The 1999 amendment of Article 115 of the Constitution guarantees local autonomy in the municipal budget, tax policy, and administration. The State is ready to pursue these Federal Government policies in two ways: reducing its own subsidies to the municipalities and raising the effectiveness of its own transfers to municipalities. This will strengthen the ability to plan the state budget and help to generate a fiscal surplus.

III. Adjustments policies and actions undertaken by the State of Mexico

As Governor, I should like to inform you of the reform policies and actions that State of Mexico has decided to pursue as part of its short and long-term strategy for efficient and sustainable delivery of social services in infrastructure. The reform program consists of an ample spectrum of reforms at state level that are compatible with the changes in fiscal and financial policy currently being introduced, including reforms at the federal and local levels and changes in the relations between the three levels of government.

The State of Mexico is fostering and adopting policies that: (i) adapt it to the new financial environment for the State's operations; (ii) develop better federal and sectoral fiscal coordination with the municipalities; and (iii) prepare it in advance and sufficiently for the ongoing process of federalization aimed at strengthening state autonomy. The State recognizes the value of the above-mentioned policies, such as those in the water sector, being novel and useful for possible adoption by other states.

The State's economic and adjustment reform is summarized in the matrix attached to this letter. Its aims are to improve state finances through actions in seven sectors: two on the income side (tangible assets, and taxes) and five on the expenditure side (education, health, pensions, water and roads), in addition to several systemic reforms in financial administration.

The State government considers that no fiscal adjustment program can be sustainable over the medium term without social sector and infrastructure reforms. Institutional and budgetary reforms are indispensable for eliminating indiscriminate subsidies and preventing unsustainable expenditures in education, water, and health. For that reason we will continue to check the growth of education sector personnel and other current expenditure. Furthermore, to facilitate an appropriate investment program, it is necessary to establish levels of debt that improve our credit rating and the terms on which public works are executed.

Through these measures, the State of Mexico's reform program will lower the fiscal deficit to no more than 0.5 percent of ordinary revenue for 2001 and will achieve a fiscal surplus in 2002 (of 0.9 percent of ordinary revenue) and at least through 2005.

I shall now proceed to describe in greater detail the main measures included in the program (the complete program can be found in the matrix attached to this letter):

- Taxes. (i) expansion of the wage base by eliminating exceptions; (ii) increase of the wage tax rate to 2.5 percent (which is above the national average); (iii) increase in the state vehicle allocation within limits compatible with other entities; (iv) improvement of tax administration to make it easier for tax payers to pay their taxes and (v) strengthening of tax enforcement.
- Sale of tangible assets. To reduce maintenance costs and generate capital revenue, tangible assets could be leased, licensed, or sold, depending on the type of asset. Our goal is to market all the assets included in the marketing plan within the next five years.
- Education. It is important to sustain delivery of social services especially for the least privileged citizens in our state. In education, we will maintain the level of expenditure per capita, achieve a more appropriate teacher-pupil ratio, and encourage efficiency in expenditure through improved coordination between the Federation and the state and the application of performance indicators. With expenditure in education accounting for over 60 percent of the state's expenditure budget, stabilizing the teacher-pupil ratio will lead to a significant reduction of expenditure compared to projected expenditure on education based on past teacher recruitment practices. In the future, new teachers will be recruited mainly in order to increase the teacher-pupil ratio in schools where it is below the national average. In practice this means that most new teachers will be deployed to schools in rural areas. Increasing the efficiency of expenditure in the educational sector will pave the way for incentives designed to encourage schools and local communities to run their own education establishments. The idea of these incentives is to persuade the Federal Government to give the states greater powers to administer human resources in the education sector.
- Health. We will increase the Secretariat of Health budget, which reaches the people most in need; we will increase contributions for our social security services, while making sure that pension reserves are not used to grant other kinds of subsidies; we shall make better use of the infrastructure, equipment, and personnel in the health sector by coordinating with all public health institutions in the utilization of the sector's installations and by establishing a consolidated medicine purchasing system.
- Pensions. Reserves will be protected and the financial sustainability of the State pension system will be reinforced, while individual capitalization pension schemes are gradually introduced. Reform of the pension system will come about through a combination of the following approaches: (i) restricting the use of pension funds exclusively to pension-related expenditure, and preventing the siphoning off of pension funds for other uses; (ii) gradually increasing the contribution rate and raising the retirement age in order to cut the system's implicit debt by at least 20 percent; and (iii) requiring payment of contributions for the portions of remuneration that are not included in basic wages and allocating this additional revenue to accumulation in individual accounts.
- Water. New water rate rules will be introduced, along with mechanisms for effective collection of water rates for municipalities and operating agencies. The state will ask the municipalities voluntarily to support payment for bulk supplies of water using the federal

sharing funds. Subsidies in the state budget for municipalities and operating agencies will be eliminated. This will eliminate state government budget transfers to the CAEM, and help to lower the fiscal deficit.

- Transport. The increase in budget funding for highway maintenance will reduce deterioration and make it easier to plan for the transportation sector, including highway construction and concessions.
- Financial administration. This reform includes, *inter alia*, actions to improve debt and expenditure management, establishing budgetary performance indicators to enhance efficiency and accountability, and to refine budgetary planning so that there is a better match between the budget approved and that actually executed. The new indebtedness ceiling approved by Congress, as well as the requirement to produce periodical reports will strengthen the constitutional balances between the different branches of government and make it easier for Congress to exercise its powers. We shall earmark funds to improve financial management and the office of the comptroller, focusing especially on improvements in honoring payment commitments to suppliers and contractors. We will also explore ways to improve state government procurement of goods and services, including possibly the use of computerized public bidding systems such as the "Compranet" system developed by the Federal Government.

IV. Commitment and capacity of the State to carry out the proposed reforms

The current administration has been in power for little more than a year. It still has five years left in which to implement all the proposed reforms and to demonstrate the benefits of the adjustment program. In the exercise of its powers, the Congress of the State of Mexico will keep a close watch on progress made with the reforms.

Finally, we are aware that our citizens, our states, and the general public are observing the State of Mexico's performance. We are determined to show them the success of the reform program.

V. The support that the State of Mexico needs in order to maintain sustainable growth

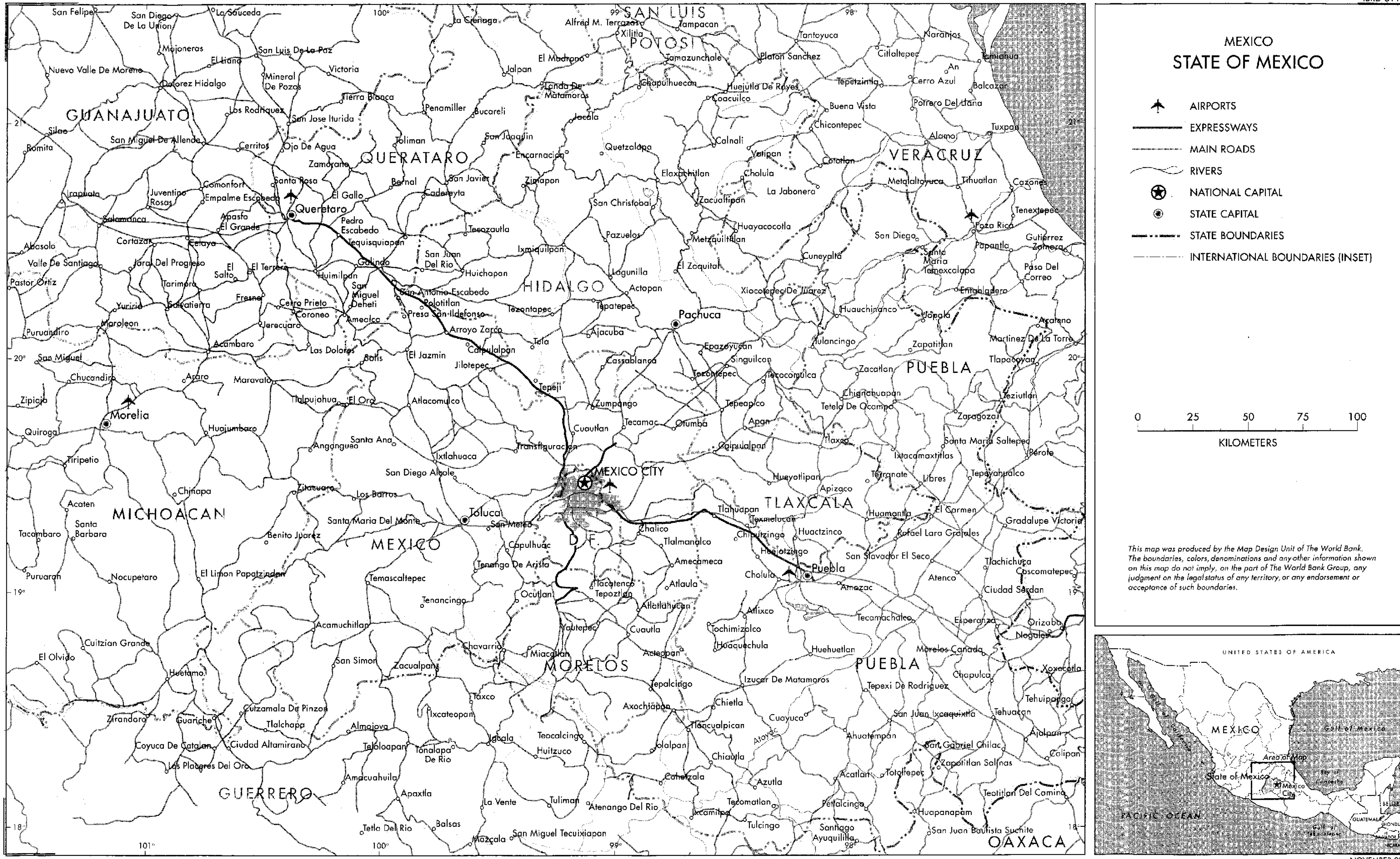
1. The State of Mexico needs federal support in order to carry out the proposed reforms. This petition includes a BANOBRAS loan to finance those reforms and a supplementary credit for technical assistance (forthcoming) needed to deliver this program completely and to lay the foundations for strengthening actions that alleviate poverty and support fiscal sustainability.

2. Assistance from the Federal Government will make it possible to implement the State Government's reform program. It will improve the State's credit rating and chances of tapping, on improved terms, the financial resources it requires to attend to the needs of the least privileged segments of the population.

Effective voting, No Re-election
The Constitutional Governor of the State of Mexico
Arturo Montiel Rojas

MAP SECTION

MAP SECTION


IBRD 31157
MEXICO
STATE OF MEXICO
AIRPORTS
EXPRESSWAYS
MAIN ROADS
RIVERS
NATIONAL CAPITAL
STATE CAPITAL
STATE BOUNDARIES
INTERNATIONAL BOUNDARIES (INSET)
0 25 50 75 100
KILOMETERS
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UNITED STATES OF AMERICA
MEXICO
Gulf of Mexico
Area of Map
State of Mexico
Mexico City
PACIFIC OCEAN
NOVEMBER 2000
SAN LUIS POTOSI
GUANAJUATO
QUERETARO
HIDALGO
VERACRUZ
PUEBLA
TLAXCALA
MICHOACAN
MEXICO
D.F.
MORELOS
GUERRERO
OAXACA
MEXICO CITY
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Amecameca
Ixtlahuaca
Atlacomulco
Tenancingo
Temascaltepec
Valle de Bravo
Tulancingo
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Actopan
Apan
Calpulalpan
Otumba