

Mexico: Ensuring Subnational Fiscal Sustainability

I. Introduction

1. **Mexico's subnational governments (SNGs) play a critical role in public spending.** Throughout the 1990s and 2000s, the federal government transferred substantial responsibility for providing essential public goods and services—including education, health, public security, and basic infrastructure—to SNGs. The large share of SNG transfers in total central-government spending underscores the extent of the decentralization process undertaken over the past few decades. In the 1990s, SNGs were responsible for just 20 percent of all public spending, but by 2017 this share had risen to over 50 percent.

2. **Consequently, ensuring sustainable SNG debt dynamics is critical to maintain consistent service provision, improve the quality of public spending, and enable SNGs to effectively support economic growth in their jurisdictions.** While subnational debt levels are still low and do not yet pose a macro-systemic risk, several Mexican SNGs have experienced episodes of fiscal distress, which have threatened their ability to provide essential services, invest in public goods, foster economic growth, and promote the welfare of their populations.

3. **In 2000, a series of market-oriented reforms to Mexico's debt framework for SNGs facilitated the rapid growth of the market for subnational borrowing.** The establishment of Master Trust Funds (MTFs) enabled SNGs to borrow against future income from federal revenue-sharing transfers (*participaciones*). Meanwhile, the introduction of subnational credit ratings into the capital-risk weighting formulas for bank loans, along with the obligation to register subnational loans in the public-debt records system of the Ministry of Finance (*Secretaría de Hacienda y Crédito Público*, SHCP), improved transparency, reduced risks, and lowered borrowing costs. As a result, SNG debt levels rose from MXN 190 billion (1.6 percent of GDP) in 2007 to MXN 580 billion (2.9 percent of GDP) in 2017. Private commercial banks hold about 60 percent of SNG debt, national development banks hold 22 percent, state bondholders hold 15 percent, and other creditors hold 3 percent.

4. **The adoption of the landmark Fiscal Responsibility Law for Subnational Governments (*Ley de Disciplina Financiera de las Entidades Federativas y los Municipios*, LDFEFM) in 2016 transformed the regulatory framework for SNG debt by establishing hierarchical controls on subnational indebtedness, which complemented the market mechanisms developed in the 2000s.** In the wake of the 2008 global financial crisis, poor revenue performance and intensifying recurrent-expenditure pressures resulted in declining fiscal balances and mounting debt levels, and rising debt-service obligations narrowed the fiscal space for investment. Between 2008 and 2016, the number of state governments with debt levels exceeding 50 percent of non-earmarked revenue (NER) rose from seven to 18, and the number with debt levels exceeding 100 percent of NER rose from zero to seven. To prevent excessive SNGs indebtedness, the federal authorities approved the LDFEFM and its ancillary regulations, which provide an institutional framework for managing SNG debt dynamics.

5. **The following note reviews the LDFEFM, assesses its initial impacts, identifies key implementation challenges, and recommends additional measures to strengthen its contribution to the fiscal sustainability of SNGs.** The note is organized into four sections. Following this introduction, Section 2, describes the evolution of SNG finances between 2008 and 2017. Section 3 analyses the LDFEFM and

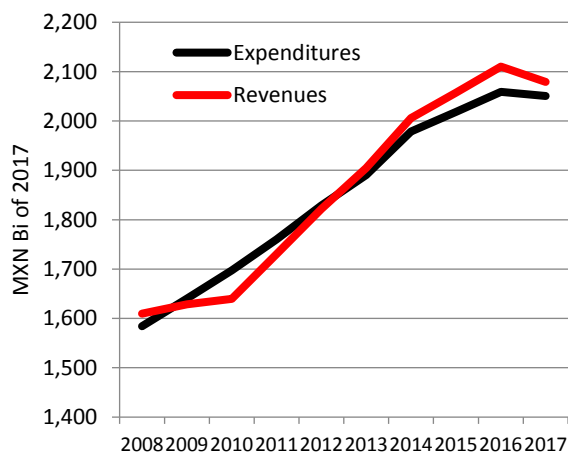
the overall framework for controlling SNGs indebtedness. Finally, Section 4 highlights challenges to the successful implementation of the LDFEFM and offers recommendations for enhancing its effectiveness.

II. Subnational Government Finances in Mexico, 2008-2017

6. **The recent evolution of SNG finances in Mexico can be divided into a period of deteriorating fiscal balances and increasing indebtedness from 2008 to 2014, followed by a period of positive fiscal balances and debt stabilization from 2014 onward.** Subnational revenue performance drove both trends. From 2008 to 2013, real SNG revenue grew by less than 3 percent per year, but since 2014 the annual revenue growth rate has averaged 3.8 percent. Meanwhile, expenditure growth slowed from an average annual rate of 3.5 percent in 2008-2013 to just 3 percent in 2012-16. Revenues and expenditures both fell in 2016, but the decline in expenditures was steeper, further contributing to the improvement in SNG fiscal balances observed since 2014 (Figure 1).

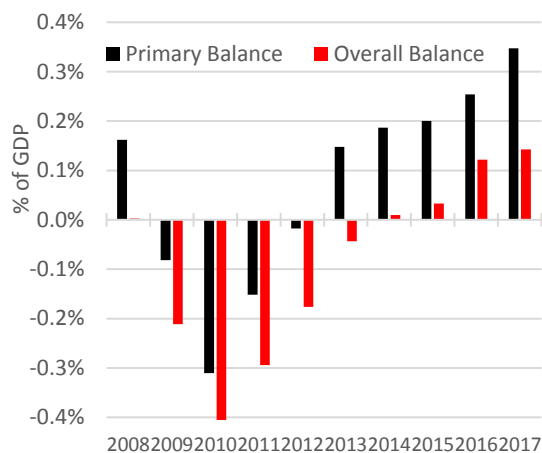
7. **In the aftermath of the global financial crisis, the Mexican economy suffered a sharp contraction that negatively affected subnational fiscal and debt dynamics.** Between 2008 and 2013, faced with rising expenditure obligations and relatively modest revenue inflows, the primary and overall balances of SNGs turned negative (Figure 2). The aggregate primary balance for all states dropped from a surplus of 0.16 percent of GDP in 2008 to a deficit of 0.3 percent in 2010 as revenue levels plateaued. The overall balance fell from equilibrium in 2008 to a deficit of 0.4 percent of GDP in 2010, and while revenues have recovered since 2011, continuous expenditure growth kept the fiscal balances negative until 2013.

Figure 1: Total SNG Revenues and Expenditures, 2008-2017 (billions of 2017 MXN)



Source: SHCP

Figure 2: Primary and Overall SNG Balances, 2008-2017 (% of GDP)



8. **These trends caused the aggregate SNG debt stock to rise from 1.7 percent of GDP in 2008 to 3.1 percent in 2013, where it remained for several years before declining in 2017.** Large fiscal deficits combined with easier access to credit more than doubled the subnational debt stock from MXN 203 billion (1.7 percent of GDP) in 2008 to MXN 482 billion (3.1 percent of GDP) in 2013. However, positive fiscal

balances since 2014 and tighter restrictions on credit access have since stabilized debt levels at 3.1 percent of GDP, and a sharp reduction in expenditures in 2017 lowered SNG debt ratios (Figure 3 and Figure 4).

Figure 3: The Subnational Debt Stock, 2005-2017 (billions of 2017 MXN)

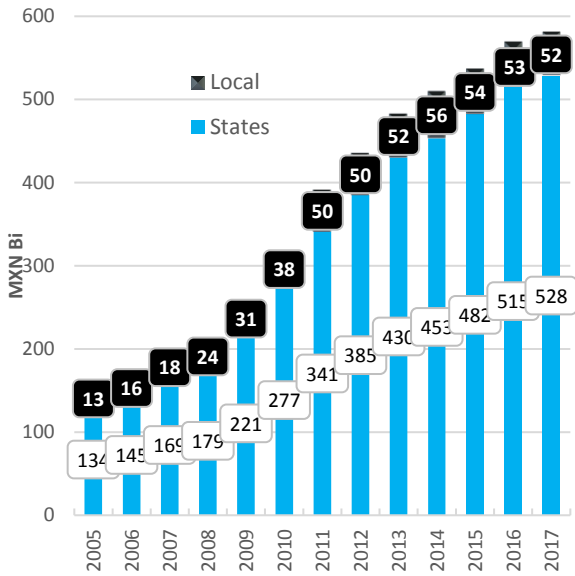
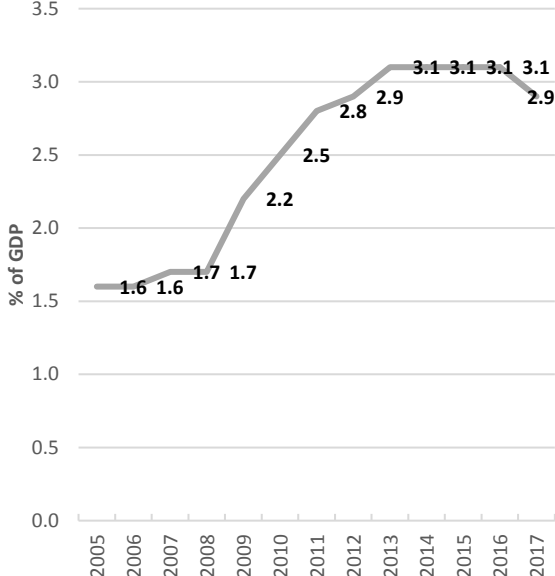


Figure 4: The Subnational Debt Stock, 2005-2017 (% of GDP)



Source: SHCP

9. **Rising revenues and slowing expenditure growth have continuously improved the primary and overall fiscal balances of SNGs since 2013.** Total SNG revenues have grown at an average rate of 3.8 percent per year since 2013. States’ own-source revenues have increased faster than federal transfers, but the latter are far larger than the former, and the share of federal transfers in total SNG revenue declined only marginally from 89 percent in 2008-2013 to 87 percent in 2014-17 (Table 1). While Mexico’s aggregate SNG debt-to-GDP ratio is low by international standards, the statutory division of tax bases between the federal and subnational levels limits the capacity of Mexican SNGs to generate own-source revenues, which impacts their ability to repay loans.¹ Total SNG debt increased from 40 percent of NER in 2008 to 75 percent in 2013. From a policy perspective, their dependence on intergovernmental transfers makes SNGs highly vulnerable to shocks that affect federal revenue, and their narrow own-source revenue base limits their capacity for fiscal adjustment.

10. **While SNG expenditure growth has slowed over time, and even contracted in 2017, a steady increase in current spending has intensified budgetary rigidity and crowded out public investment.** Current spending (including spending on personnel costs, goods and services, transfers, subsidies and allowances, interest payments, and transfer to municipalities) grew from 89 percent of total spending in 2008 to 92 percent in 2014 and reached 94 percent in 2017. Meanwhile, investment fell from 10 percent of total spending in 2008 to 8 percent over 2008-2013 and reached just 6 percent in 2017, indicating that the investment budget has borne the brunt of expenditure containment in recent years (Table 1). Given

¹ Total own-source SNG revenues amount to less than 1 percent of GDP.

their negative impact on Mexico's medium-term economic growth prospects, falling investment levels could jeopardize the sustainability of the current fiscal-consolidation effort.

Table 1: Fiscal Trends, 2008-17 (% of GDP)					
	2008	Avg. 2009/13	Avg. 2014/17	Change 2008-Avg 09/13	Change 2009/13-2014/17
	A	B	C	B - A	C - B
Total Revenues	9.5%	10.1%	10.3%	0.5%	0.3%
Federal Transfers	8.5%	8.9%	9.0%	0.4%	0.0%
Revenue-sharing transfers (participaciones)	3.5%	3.4%	3.7%	-0.1%	0.3%
Earmarked transfers (aportaciones and others)	5.0%	5.6%	5.3%	0.5%	-0.2%
Own-Source Revenues	1.0%	1.1%	1.4%	0.1%	0.2%
Taxes	0.4%	0.5%	0.7%	0.1%	0.2%
Permits	0.3%	0.3%	0.4%	0.0%	0.0%
Other	0.3%	0.3%	0.3%	0.0%	0.0%
Total Expenditures	9.5%	10.3%	10.4%	0.8%	0.1%
Non-Interest Current Expenditures	6.7%	7.5%	7.9%	0.8%	0.3%
Personnel costs	2.1%	2.3%	2.4%	0.2%	0.1%
Goods and services	0.4%	0.5%	0.6%	0.1%	0.1%
Transfers, allowances and other forms of support	4.1%	4.6%	4.8%	0.5%	0.2%
Other non-interest current expenditures	0.1%	0.2%	0.1%	0.0%	-0.1%
Transfers to municipalities	1.7%	1.8%	1.8%	0.0%	0.0%
Interest payments	0.1%	0.1%	0.2%	0.0%	0.0%
Total Current Expenditures	8.5%	9.4%	9.8%	0.9%	0.4%
Public Investment	0.9%	0.8%	0.6%	-0.1%	-0.3%
Primary Balance	0.3%	0.0%	0.4%	-0.3%	0.3%
Overall Balance	0.2%	-0.1%	0.2%	-0.3%	0.3%

Source: SHCP

11. **The national trends described above were broadly consistent those observed at the state level.** Between 2008 and 2014, 24 of Mexico’s 32 federative entities² experienced declining overall balances and rising debt levels. In most cases, slowing economic activity in the wake of the global financial crisis halted revenue growth while spending continued to rise, accelerating the accumulation of debt. This pattern was most acute in Chihuahua, Coahuila, Nuevo León, and Quintana Roo, where average overall deficits exceeding 20 percent of NER (Figure 5) boosted debt levels to 150 percent of NER (Figure 6). Meanwhile, the debt levels of Baja California, Chiapas, Michoacán, Nayarit, Veracruz, and Zacatecas approached 100 percent of NER. The few exceptions to this trend included Aguascalientes, Guanajuato, and Querétaro.

Figure 5: The Overall Balance as a Share of Non-Earmarked Revenue, 2008-2014

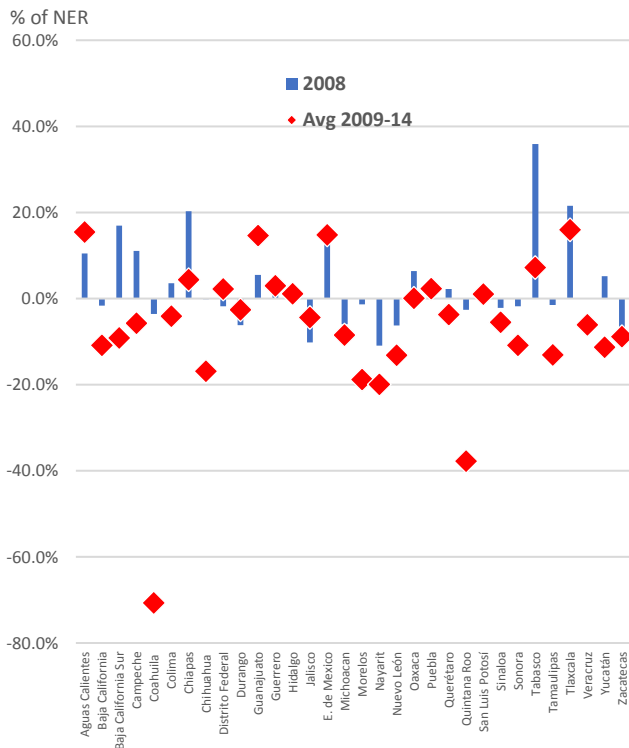
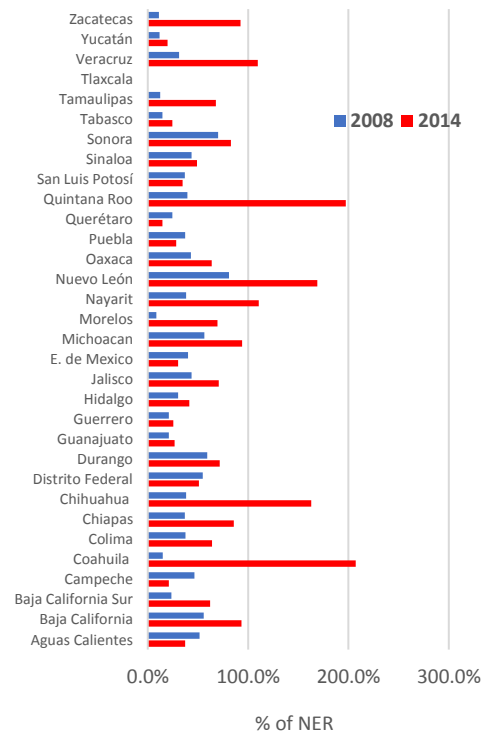


Figure 6: Debt as a Share of Non-Earmarked Revenue, 2008-2014



Source: SHCP

12. **Most individual federative entities also experienced the general improvement in debt dynamics observed in recent years.** Since 2014, fiscal balances have improved in 26 states, and debt ratios have fallen in 21. Important improvements were observed in Coahuila, Nayarit, Nuevo León, and Quintana Roo, where overall deficits narrowed to less than 20 percent of NER (Figure 7) and debt levels fell substantially, though not below 100 percent of NER (Figure 8). Less-indebted states, including Aguascalientes, Baja California Sur, Hidalgo, and Zacatecas, significantly improved their overall balances and reduced their debt levels, while Guanajuato and Querétaro sustained their strong fiscal indicators. However, fiscal balances remained low in Chihuahua, Michoacán, and Veracruz, and their debt positions worsened.

² Mexico’s 32 federative entities (*entidades federativas*) include 31 states and Mexico City.

Figure 7: Overall Balances as a Share of Non-Earmarked Revenue, 2014-2017

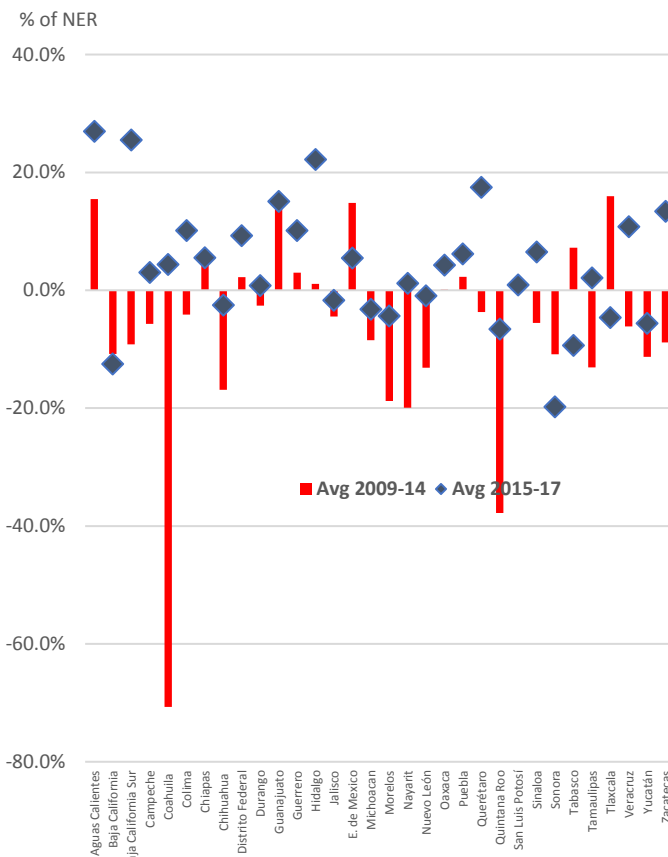
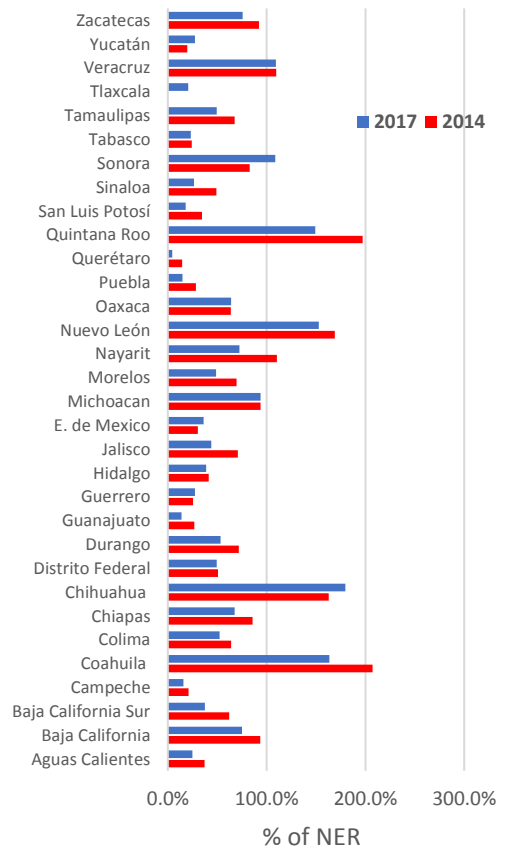


Figure 8: Debt as a Share of Non-Earmarked Revenue, 2014-2017



Source: SHCP

13. **Improved fiscal balances and debt stabilization have reduced borrowing spreads, while debt maturities have remained constant.** Although state debt is backed by federal revenue-sharing transfers, debt-repayment risks are not necessarily low, and borrowing costs do not reflect those paid by the federal government, as the flow of revenue-sharing transfers depends on the evolution of federal rather than state revenues. Financial institutions have imposed higher interest rates on states with larger debt stocks, and the debt-to-NER ratios of states correlate with the interest-rate spreads paid by the federal government. SNG financing spreads fell from an average of 225 basis points in 2014 to less than 100 in 2018, with declining trends observed in most states. The average maturity of new debt issuances has fluctuated between 14 and 15 years since 2014.

Figure 9: Average Interest-Rate Spread and Debt Maturity at the State Level, 2014-2018

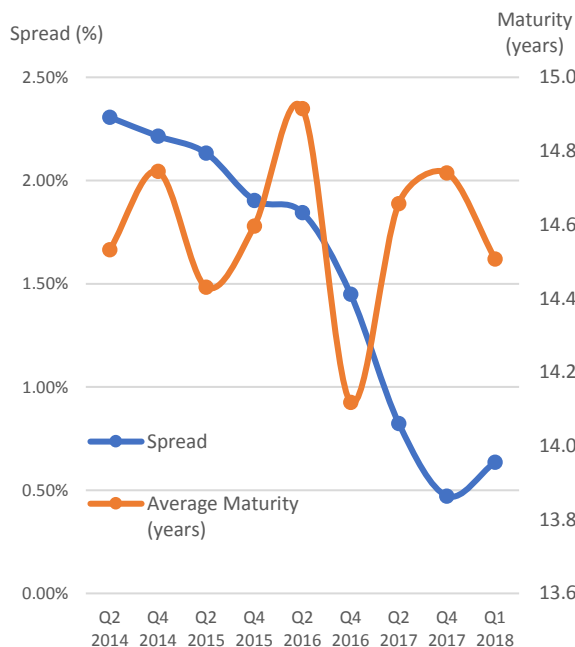
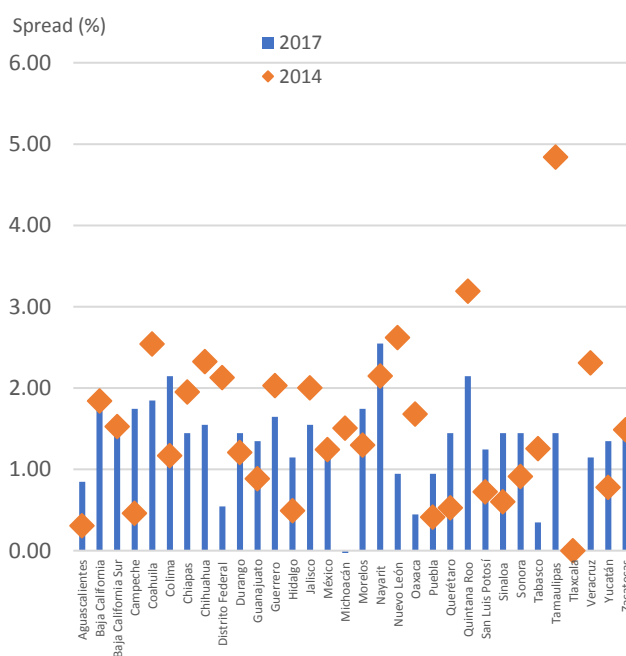


Figure 10: Interest-Rate Spreads by State, 2014 and 2017



Source: SHCP

14. In summary, while successful fiscal adjustments have contributed to declining debt levels and borrowing costs among SNGs since 2014, their limited capacity for own-source revenue mobilization and the rising share of current spending in total spending threaten the fiscal sustainability of SNGs. While some SNGs have strengthened their own-source revenue collection, increased federal transfers and steadily diminishing levels of public investment have driven the fiscal adjustments observed among SNGs. Sustaining fiscal consolidation over the medium term will require structural reforms to attenuate expenditure rigidity and enhance own-source revenue mobilization, which will expand the fiscal space for investment and enable SNGs to improve the quality of service delivery.

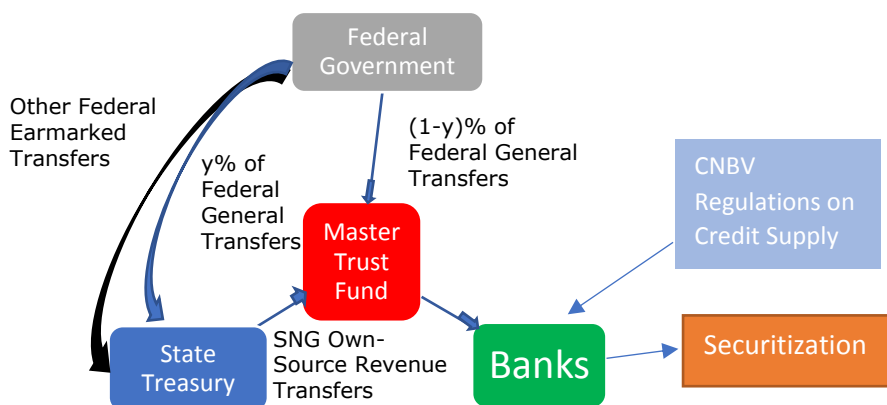
III. The Fiscal Responsibility Law for Subnational Governments (LDFEFM)

15. Mexico’s subnational debt framework was reformed in 2000 to support the development of markets for SNG borrowing. The revised regulatory framework for SNG debt includes: (i) MTFs, which provide a secure source of funds for SNGs to repay debt; (ii) supply-side constraints, which limit the exposure of private creditors to SNG debt and enable lenders to more accurately assess idiosyncratic subnational risks; and (iii) the mandatory registration of subnational loans with the SHCP and their conformity with financial transparency requirements (Figure 11).

16. The establishment of MTFs significantly reduced credit risks and expanded the market for SNG borrowing during the 2000s. Each SNG can set up an MTF tailored to suit its local legal context. However, the MTF regulations define common debt-contracting and repayment procedures, under which federal revenue-sharing transfers are deposited in the MTFs via an irrevocable instruction to the federal treasury. The irrevocable nature of the deposits facilitates a legal analysis of the securitized debt by isolating the

payment source from the borrower. The legal strength of MTFs has greatly reduced the likelihood that a state government will attempt to use federal revenue-sharing transfers to finance current spending rather than servicing debts contracted through the MTF.

Figure 11: Subnational Borrowing in Mexico in the 2000s



Source: World Bank staff

17. **Credit ratings and supply-side regulations further reinforced the marked-based framework for subnational borrowing.** By 2010, all 32 federative entities and about 50 municipalities had received credit ratings from at least one recognized rating agency. As a result, SNG finances have been subject to growing surveillance and scrutiny by private markets and rating agencies. In addition, the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores, CNBV*) regulates SNG lending operations by banks based on credit ratings and expected losses, further limiting the supply of credit to SNGs.

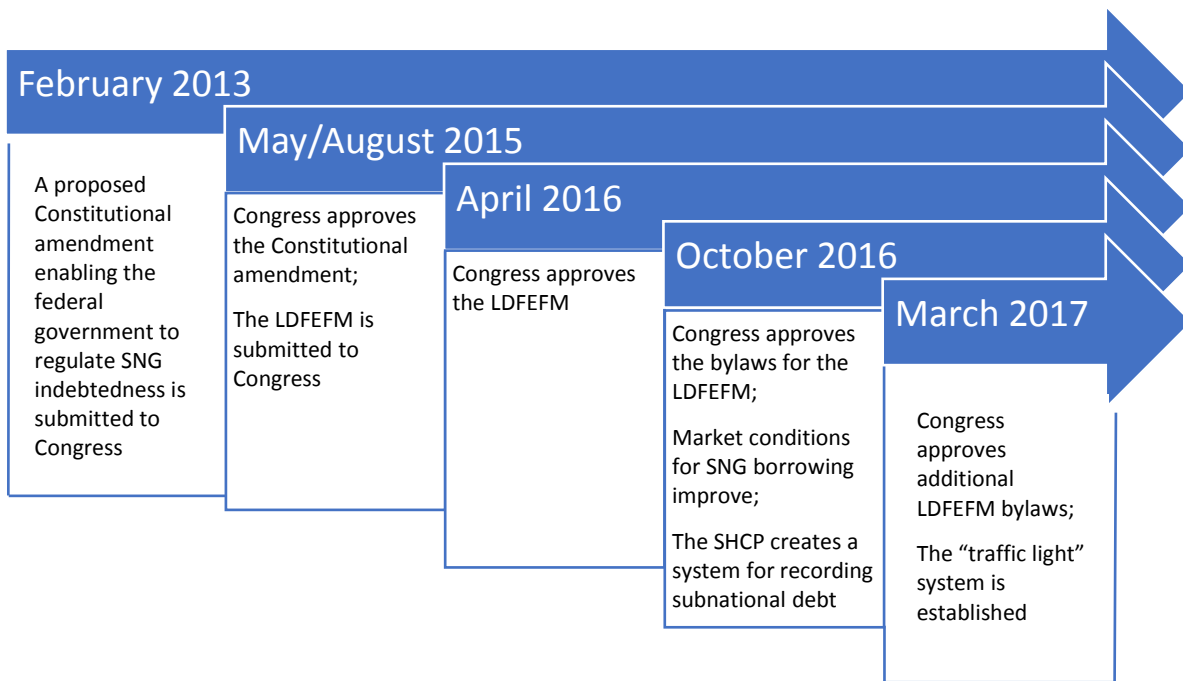
18. **While the reformed SNG debt framework has facilitated the robust expansion of the market for SNG lending, four important systemic weaknesses persist.** These include:

- a) **Incentives for lenders to focus on MTFs rather than on the borrower's fiscal situation.** Given the critical role of the MTFs in ensuring debt repayment, the fiscal position of SNGs is at best a secondary concern when assessing credit risk. Creditors tend to focus myopically on the legal strength of the MTFs and the expected inflows of federal transfers to them, while thorough assessments of the fiscal situation of SNGs are relegated to a complementary role or even dispensed with altogether. Consequently, SNGs have little incentive to improve their fiscal positions to obtain credit on better terms.
- b) **A disconnect between credit risks and borrowing costs.** The certainty that federal revenue-sharing transfers will fund MTFs implies that repayment risks for MTF-secured subnational debts should be similar to those for federal debt, since in both cases repayment depends on future federal revenue inflows. However, SNG borrowing remains subject to high risk premiums.
- c) **The proliferation of trust funds and the excessive commitment of federal transfers and other forms of NER to finance debt service.** Encouraged by the success of MTFs in expanding access to private credit, SNGs and creditors created new trust funds for specific operations. These funds were secured by future state tax revenue or NER inflows, and in some cases they used federal revenue-sharing transfers that had already been committed to an existent debt liability.

d) **Weak fiscal management by SNGs.** The limited availability and reliability of fiscal data, inadequate fiscal reporting by public-sector agencies, and the absence of mandatory registration for short-term SNG obligations and other subnational liabilities, including those arising from public-private partnerships (PPPs), prevent an accurate assessment of the financial solvency of SNGs.

19. **The Mexican authorities are aware of the fiscal risks posed by rising SNG debt levels, and the LDFFEM is the centerpiece of an institutional framework for controlling SNG indebtedness.** To prevent the unsustainable accumulation of subnational debt, a market-based approach to fiscal discipline must be supported by well-designed federal regulations, including borrowing restrictions and monitoring and control mechanisms. As the Mexican Constitution grants SNGs full autonomy over their fiscal and debt policies, a Constitutional amendment was necessary to authorize federal regulation of SNG borrowing. This amendment was presented to Congress in 2013,³ and its adoption in 2015 enabled the approval of the LDFFEM the following year. Complementary regulations issued in 2016 and 2017 further elaborated the new institutional framework for regulating SNG indebtedness (Figure 12). This new regulatory framework has been adopted by state governments since 2017 and by municipalities since 2018⁴.

Figure 12: The Establishment of the New Framework for Controlling SNG Indebtedness



Source: World Bank staff

20. **The new institutional framework for controlling SNGs indebtedness is designed to ensure the sustainability of SNG finances and enhance fiscal planning and expenditure execution at the subnational**

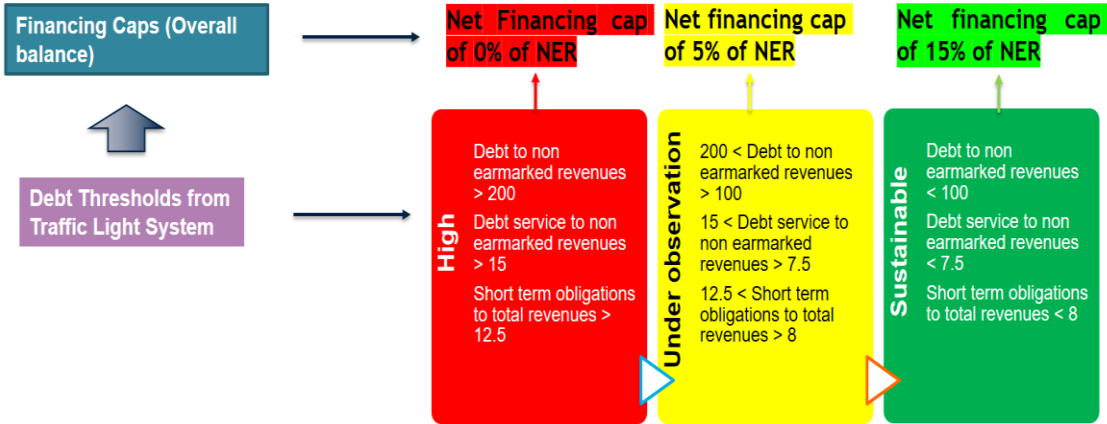
³ Per the provisions of the Mexican Constitution, this amendment required the approval of Congress and the legislatures of all 32 federative entities.

⁴ LDFFEM regulations applies to the SNGs general government and to their dependent and autonomous entities at the individual level.

level. The framework consists of: (i) the LDFEFM itself; (ii) its three complementary regulations: the “traffic light” system, a public debt registration system, and regulations for contracting debts at the lowest cost; and (iii) access to guaranteed federal debt (*deuda federal garantizada*) to be used in debt-restructuring operations between SNGs and creditors under fiscal-adjustment agreements.

21. **To ensure the fiscal sustainability of SNGs, the LDFEFM includes a fiscal-balance rule that imposes financing caps according to a set of debt thresholds defined in the “traffic light” system.** Based on three debt indicators—the debt-to-NER ratio, the debt-service-to-NER ratio, and the short-term-obligation-to-total-revenue ratio—the “traffic light” system classifies SNG indebtedness as either: sustainable (green), in observation (yellow), or high (red).⁵ Each classification imposes a ceiling on net financing, which is equivalent to the overall balance. For SNGs with sustainable levels of indebtedness, the ceiling is set at 15 percent of NER; for SNGs with debt levels in observation, the ceiling is set at 5 percent; and for highly indebted SNGs, the ceiling on net financing is set at zero, which implies a balanced budget (Figure 13)⁶. Because these ceilings are inversely related to debt levels, compliance with the “traffic light” system is expected to automatically prevent excessive indebtedness.

Figure 13: LDFEFM Fiscal Rule and the “Traffic Light” System



Source: World Bank staff

22. **The LDFEFM also establishes the following rules for SNG fiscal management:**

- a) The “golden rule,” which states that borrowing should finance productive public investment rather than current spending or the current-account deficit;
- b) A cap on the annual growth of personnel expenditures equal to either the real GDP growth rate or 3 percent in real terms, whichever is lower;

⁵ The debt to NER ratio has a predominant role in the final rating in case of different ratings for each of the three indicators. SNG indebtedness indicators and classifications are updated quarterly. Classifications corresponding to the second quarter define the financing cap for the next year’s budget.

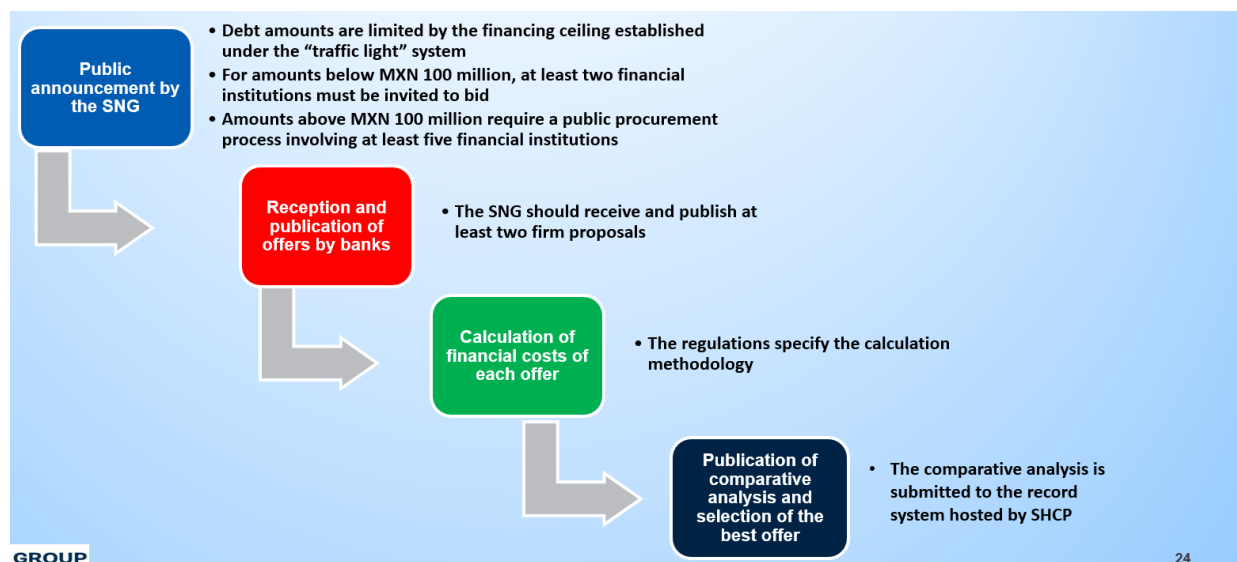
⁶ The LDFEFM establishes a transition period until 2020 in which SNGs that had deficits higher than the ceiling will gradually reduce them until reaching the net financing ceiling.

- c) A provision that when actual revenues exceed the levels projected in the budget law, the excess should be used to finance anticipated debt repayments or accumulated in a natural-disaster fund;
- d) A provision that when actual revenues are below the level projected in the budget law, spending on non-productive expenditure items (e.g., communications) should be cut; and
- e) An escape clause that enables the authorities to temporarily suspend the application of the fiscal rules, which can be triggered in the event of a natural disaster or a severe economic slowdown.

23. **The system for recording subnational debt is designed to enhance transparency by providing detailed, timely information on SNG debt stocks, borrowing operations, interest rates, maturities, and debt-service flows.** The system’s governing regulations oblige borrowers and creditors to register all borrowing operations in an SHCP database. The system also contains provisions for registering other SNG liabilities, including PPP obligations and associated contingent liabilities. A standardized record of the public debts of federative entities helps ensure that taxpayers, firms, subnational officials, and the federal government have access to reliable, up-to-date information on the debt obligations of each state and municipality, and it enables all stakeholders to make decisions based on the same information. The data recorded in the system are also used to calculate the “traffic light” indicators described above.

24. **To enhance competition, reduce borrowing costs, and promote transparency in lending operations, the revised framework also regulates how SNGs contract debt.** These regulations mandate that SNGs contract debt through competitive auctions with a minimum number of participants, and they include guidelines for defining borrowing costs, selecting offers with the lowest costs, and publishing both the details of the offers received and the outcome of the selection process (Figure 14).

Figure 14: Steps and Guidelines for Contracting Credit Operations



Source: SHCP

25. **The LDFFEM allows for the possibility of debt restructuring, provided that a fiscal-adjustment agreement is in place.** The law defines the conditions for using federal guarantees linked to fiscal-adjustment agreements to support debt restructuring. To obtain a federal guarantee, the SNG must sign

a fiscal-adjustment agreement with the federal government that defines multiyear targets for the fiscal balances, spending levels, and own-source revenue generation. Moreover, the LDFEFM requires that highly indebted SNGs have their fiscal-adjustment plans approved by the SHCP. Under these conditions, federal guarantees for debt-restructuring operations are intended to enhance the federal government's ability to positively influence the fiscal performance of SNGs and reduce borrowing costs.⁷

26. The LDFEFM also contains regulations to improve budgeting, public financial accounting, and fiscal planning. The law mandates that:

- a) Budget preparation must observe the limits on fiscal balances and expenditures imposed under the LDFEFM, as well as any other applicable restrictions. Revenues and expenditure arrears accrued during previous years must be used and recorded in line with LDFEFM regulations. Budgets should include an assessment of contingent liabilities and the actuarial balances of social security systems, as well as an analysis of the budgetary impact of any new policy initiatives.
- b) SNGs must adopt harmonized rules for public financial accounting that encompass the entire government sector as defined by the SHCP and the National Council of Public Accounting.
- c) SNGs must prepare medium-term fiscal frameworks, with a five-year horizon for states and a three-year horizon for local governments, and include them in annual budget laws.

27. Overall, the LDFEFM and its supporting regulations provide a sound framework for controlling subnational indebtedness. The main fiscal rule that underpins the LDFEFM is simple and transparent, and it provides clear operational guidance for fiscal policy. The “traffic light” system not only defines the financing ceilings for the fiscal rule, but also provides information to creditors and taxpayers on the fiscal solvency of SNGs. Likewise, the public debt record system is designed to offer reliable, regularly updated information to market participants. Regulations requiring that debt be contracted under the best market conditions help improve transparency and lower financing costs, and the rules regarding federal guarantees for debt-restructuring operations are expected to enhance the federal government's leverage over the fiscal performance of highly indebted SNGs and reduce the frequency of debt restructuring. Finally, the LDFEFM also contains important budget-preparation and execution rules, such as the mandatory inclusion of medium-term fiscal frameworks in SNG budget laws, which is expected to improve fiscal planning and enhance expenditure efficiency.

IV. Areas for Improvement and Challenges Ahead

28. A thorough evaluation of the LDFEFM's impact is premature, as the law's main provisions only took effect in 2017, but early indications suggest that it is effectively strengthening fiscal discipline among SNGs. Since 2013, when the government began reforming the institutional framework for controlling SNG borrowing, the accumulation of subnational debt has slowed, halted, and ultimately reversed. This trend has been broadly consistent across jurisdictions, as most state governments have

⁷ Since 2013, several highly indebted state governments have undertaken debt-restructuring operations with private banks based on fiscal-adjustment plans agreed upon with the SHCP. As the indebtedness framework did not provide a formal role for the federal government in these agreements, the participation of public banks served as an indirect way for the SHCP to reduce restructuring costs and impose targets to strengthen the fiscal position of the states.

reduced their fiscal deficits and debt ratios—underscoring the positive impact of tighter borrowing controls. Moreover, the steady increase in current spending, which had contributed to the mounting fiscal distress of SNGs, appears to have ceased in 2017.

29. **While the technical design of the LDFEFM is generally sound, revising three aspects of the law could further strengthen its ability to prevent excessive indebtedness and improve fiscal management.**

These reforms include:

- a) **Adjusting the thresholds of the “traffic light” system.** The current thresholds are too high, which weakens the system’s ability to differentiate between the fiscal situations of SNGs and prevent excessive indebtedness.
- b) **Reducing the number of regulations embedded in the LDFEFM.** The law’s complexity reflects an effort by the federal government to micromanage SNG finances, and its numerous regulations complicate fiscal management, make compliance difficult to verify, and create overlapping or inconsistent targets.
- c) **Clarifying guidelines for using federal debt guarantees and fiscal-adjustment agreements.** More-explicit regulations regarding the concession of federal debt guarantees and the design, implementation, oversight, and enforcement of fiscal-adjustment agreements could ensure that these tools are used effectively.

30. **The high thresholds used by the “traffic light” system limit its ability to differentiate between the indebtedness levels of SNGs.** Because high thresholds create large intervals, states with substantially different debt-sustainability conditions are classified in the same indebtedness group. Indeed, the current thresholds are so high that only one state government is classified as highly indebted under the “traffic light” system (Figure 15). Since states that are not classified as highly indebted are not constrained by the fiscal rule, they may continue to contract debt until their debt levels reach the threshold of 200 percent of NER, which undermines the core objective of the LDFEFM.

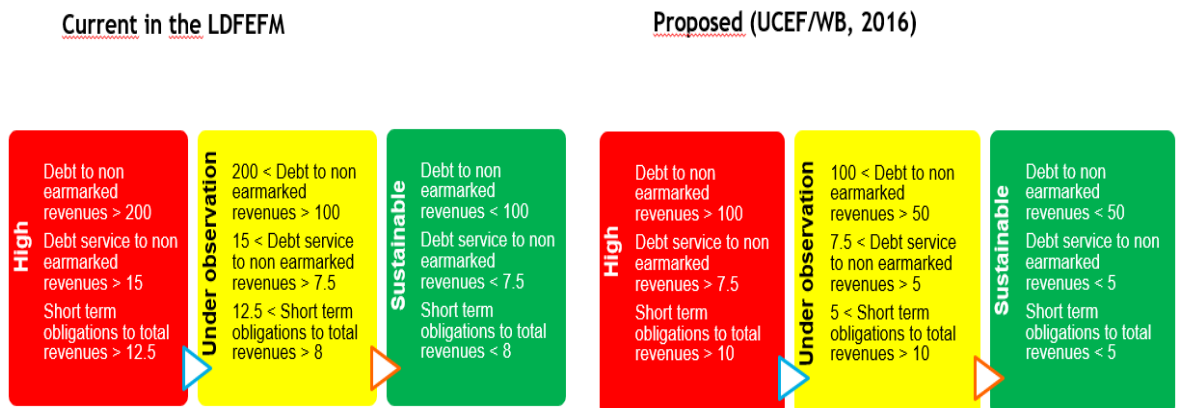
Figure 15: State Indebtedness Levels under the “Traffic Light” System, 2017



Source: SHCP and World Bank staff

31. **Reducing the thresholds could enhance the ability of the “traffic light” system to distinguish between different debt-sustainability conditions and strengthen the effectiveness of the fiscal rule in preventing excessive indebtedness among SNGs.** Halving the debt-to-NER thresholds and adjusting the debt-service and short-term debt indicators accordingly (Figure 16) could significantly enhance the system’s precision and strengthen its impact on SNG debt dynamics.⁸

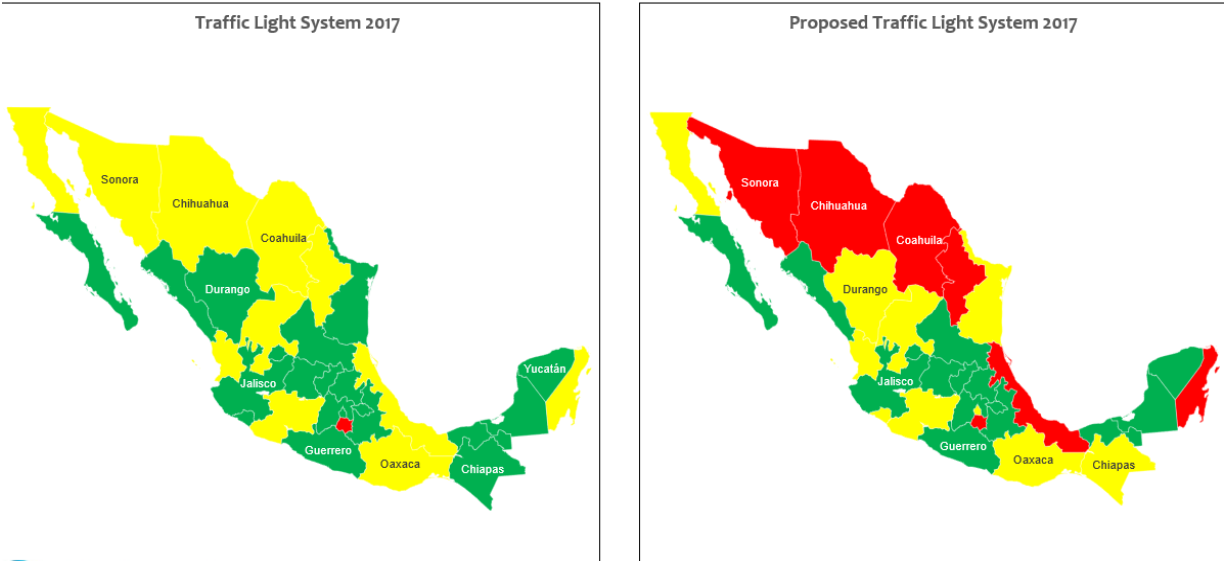
Figure 16: Current and Proposed Thresholds for the “Traffic Light” System



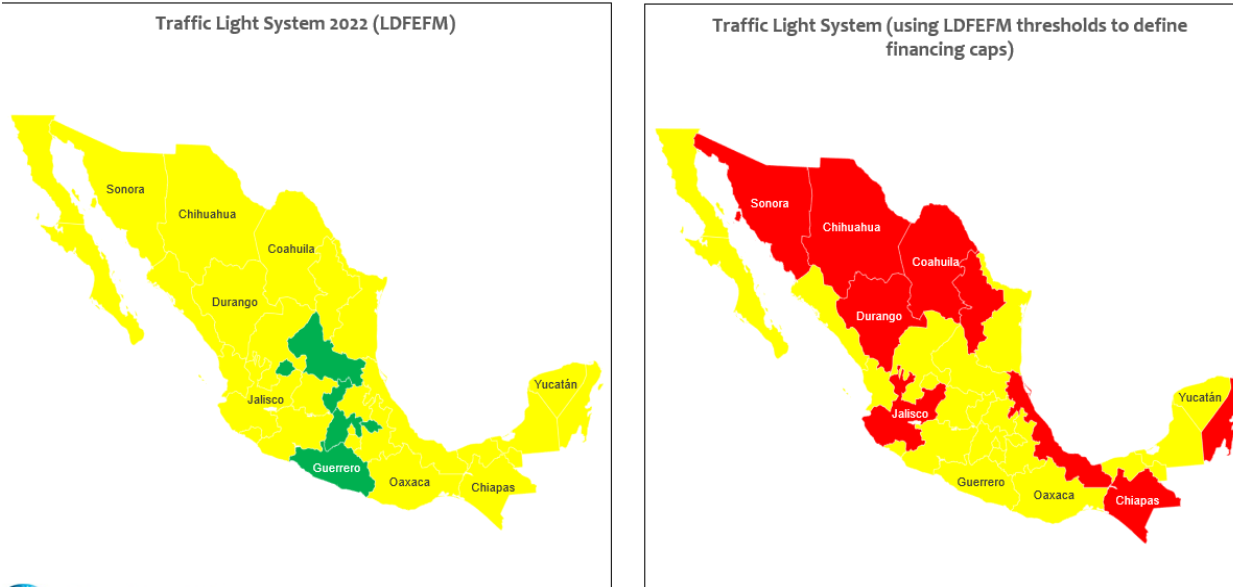
⁸ When the “traffic light” system was being designed, the World Bank and SHCP teams assessed several options for the thresholds and initially agreed on the lower proposed thresholds described in this section.

32. **The lower proposed thresholds for the “traffic light” system would produce a more heterogenous distribution of SNGs across the three intervals of indebtedness, clarifying key differences in their debt situations.** Under the lower proposed thresholds, the number of highly indebted states would increase from one to six, and fewer states would be classified as having sustainable debt levels (Figure 17, top panels). The proposed adjustment would enhance the impact of the LDFEFM’s fiscal rule on SNG debt trajectories, as a larger number of SNGs would face lower financing ceilings. Projections based on the lower proposed thresholds—and the assumption that each state would fully utilize its available borrowing space under the fiscal rule⁹—indicate that differences in the “traffic light” system’s ability to discriminate between different fiscal situations would increase over time (Figure 17, bottom panels). Under the current thresholds and corresponding financing ceilings, no state would be classified as highly indebted in 2022, and six states would be classified as having sustainable debt levels. Under the proposed thresholds, nine states would be classified as highly indebted in 2022, and no state would be classified as having a sustainable debt level. However, due to the more stringent application of the fiscal rule under the revised thresholds, the states classified as highly indebted in 2022 would have lower debt levels than would be the case under the current thresholds.

Figure 17: Indebtedness Classifications of States under the Current and Proposed Thresholds for the “Traffic Light” System, 2017 and 2022 (projected)



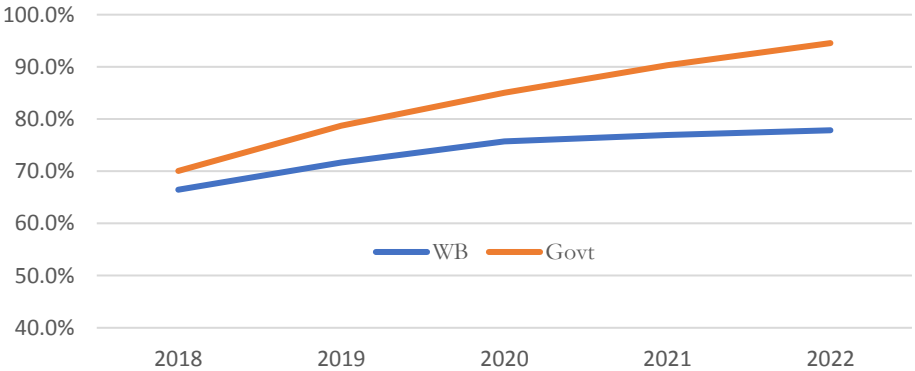
⁹ States classified as having a low indebtedness level (green) would borrow up to their 15 percent financing ceiling; states with indebtedness levels under observation (yellow) would borrow up to their 5 percent financing ceiling; and highly indebted states (red) would not borrow at all. The simulations assume that SNGs will fully use their net financing ceiling, the projected indebtedness levels may represent upper bound projections. Simulations do not consider the transition period in which states with higher 2017 net financing ceiling than the set in the LDFEFM can gradually reduce their deficits toward the LDFEFM net financing ceiling.



Source: SHCP and World Bank staff calculations
 Note: The projections presented in the bottom two panels use the “traffic light” system’s current thresholds (left) and proposed thresholds (right). Unlike the top two panels, which show how the change affects the current classification of each state, the projections in the bottom panels assume that the lower thresholds will cause states to change their borrowing patterns to maintain compliance with the fiscal rule.

33. **The lower proposed debt thresholds would also reduce aggregate debt at the state level.** Under the existing thresholds, the aggregate debt-to-net-current-revenue ratio is projected to rise to 95 percent by 2022. By contrast, under the lower proposed thresholds the ratio would remain below 80 percent¹⁰ (Figure 18). In sum, the lower proposed thresholds would reduce both aggregate indebtedness at the state level and the number of states with debt levels above 100 percent of NER.

Figure 18: Aggregate Debt Levels under the Current and Proposed Thresholds for the “Traffic Light” System, 2017 and 2022



Source: SHCP and World Bank staff calculations

¹⁰ In terms of GDP, SNGs debt level will go to 4.5 percent of GDP by 2020, while with the lower thresholds it will reach 3.8 percent of GDP.

34. **In addition to the design issues described above, the LDFEFM faces multiple implementation challenges.** These include:

- a) **Weak public financial management and reporting among SNGs.** The LDFEFM establishes various requirements related to budgeting, fiscal reporting, and expenditure planning that SNGs' current PFM systems are unable to meet. Improvements in SNGs' financial accounting and fiscal reporting capacity will be critical to ensure compliance with the LDFEFM and related regulations. While the recent adoption of a new General Governmental Accounting Law has improved accounting and reporting at the subnational level, SNGs continue to suffer from deficiencies in data availability and data harmonization, weaknesses in the registration of debt and arrears, and delays in the publication of fiscal accounts.
- b) **The federal government's limited ability to monitor compliance.** The LDFEFM imposes numerous regulations on SNGs that the federal authorities are obliged to monitor. However, the federal government's institutional and technical capacity to verify compliance is limited, and the excessive complexity of the regulatory framework compounds the challenge of monitoring compliance.
- c) **Soft budget constraints.** The frequent discretionary use of federal transfers to close financial gaps erodes hard budget constraints and may negatively affect the credibility of the LDFEFM.
- d) **Structural problems.** Due to the statutory division of tax bases between the federal and subnational levels, SNGs have very limited capacity to mobilize own-source revenues. Consequently, rising current-expenditure obligations are expected to undermine medium-term fiscal sustainability. Subnational fiscal rules are not a substitute for the structural reforms necessary to develop a more sustainable fiscal federalism framework.