MULTIPHASE PROGRAM FOR INVESTMENT AND FINANCIAL AND INSTITUTIONAL STRENGTHENING OF STATES AND MUNICIPIOS. PHASE I

(ME-0231)

EXECUTIVE SUMMARY

Borrower: Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS)

Guarantor: United Mexican States

Executing agency: BANOBRAS

Amount and source:

	Phase I (three years)	Phase II (three years)	Phase III (three years)
IDB: (OC)	US$300 million	US$300 million	US$400 million
Local:	US$300 million	US$300 million	US$400 million
Total:	US$600 million	US$600 million	US$800 million

Financial terms and conditions:

Amortization period:	25 years
Grace period:	3 years
Disbursement period:	3 years
Interest rate:	variable
Inspection and supervision:	1%
Credit fee:	0.75% on the undisbursed balance
Currency:	U.S. dollar drawn on the Single Currency Facility

Objectives: The general objective of the program is to support the decentralization process in Mexico by enhancing the management capacity and financial situation of subnational governments.

The specific objectives are to: (i) introduce best practices geared towards strengthening the management of public funds by subnational governments; (ii) strengthen these governments' financial situation; and (iii) finance investment projects with high social return and technical assistance to expand these governments' capacity to deliver public services.

Rationale for a multiphase program: Unlike other projects that seek to solve a specific problem, this program will support the decentralization process that has been stepped up since 1998 and will continue beyond the program's nine-year implementation period at various levels and with various actors (federal, state, and municipal). In addition to providing financing for infrastructure and public, financial, and social services projects, the Bank will support: (i) the administrative and financial modernization of subnational governments; (ii) preparations to help these governments improve their access to credit; and (iii) compliance with Bank policies on economic, financial, and environmental viability, sector criteria, and public utilities.

It is proposed that the multiphase modality be used, which has been adopted satisfactorily in other operations in Mexico, and holds important advantages inasmuch as it will allow the Bank to adjust its support for subnational governments and BANOBRAS in accordance with the changing economic, legal, political, financial, and social context of the decentralization process. The first phase will focus on verifying the effectiveness of the new eligibility criteria, especially in the financial sphere, and on testing BANOBRAS's capacity to absorb the allocated resources effectively and its institutional strengthening and modernization. During the second phase, any necessary changes will be made in order to adjust, enhance, and consolidate the new criteria, mechanisms, and products. During the third phase, adjustments will continue to be made and program coverage will be expanded. The present proposal is to approve the format of a multiphase program and a loan for the first phase.

Description: The credit line (US$297 million for phase I) will be administered by BANOBRAS so as to encourage the subnational governments to adopt a series of best practices in their financial and institutional management. As the agreed best-practice targets are attained, the subnational governments will gain access to program resources to finance part of their investment plans on a gradual basis. Financing will be provided for up to 50% of the investment plans presented by the subnational governments (up to a maximum of US$100 million per accredited entity).

The credit line will also be used to finance, on a pilot basis, up to 50% of the investment plans (up to US$1 million) of approximately 10 municipios classified in the category of medium to high marginality, some of which are located in the country's 250 microregions with highest marginality.

This credit line will make it possible to continue and expand the financial and institutional strengthening launched under the State and Municipio Strengthening Program (FORTEM, loan 1214/OC-ME) and meet the growing demand for this type of operation. It will operate along the same lines as the FORTEM program, with the function performed by the seven criteria being expanded through a manual on financial and institutional best practices, an institutional and financial analysis manual, and a core action plan. A new structure will give greater flexibility for adapting program actions to the requirements of each subnational government. All Bank criteria concerning economic, financial, and environmental viability, sustainability of investments, and the public utilities policy will be observed.

The Bank's country and sector strategy: The proposed program is consistent with the 2001-2006 National Development Plan and the Bank's strategy for Mexico. Specifically, it seeks to strengthen structural reforms for decentralization with an eye to effecting greater social change, reducing poverty, and fostering more harmonious regional development that is both socially equitable and geographically balanced. The program is also consistent with the Bank's subnational development strategy, which includes among its proposed areas of intervention building institutional capacity among subnational governments and developing financing vehicles for subnational entities.

Environmental and social review: Pursuant to the recommendations made at the 31 August 2001 meeting of the Committee on Environment and Social Impact, it was decided that the instruments contained in the program—i.e., its operations manual, the financial and institutional best practices manual, and the financial and institutional analysis manual—will include an environmental component as a core element of subnational government management. Details on the program's environmental strategy can be found in chapter IV and Annex II.

Benefits: Mexico currently has no programs that focus on enhancing subnational government management systems. The proposed program's activities will encourage subnational governments to strengthen their financial management as a complement to the decentralization measures taken by the federal government, and the mechanisms to be implemented will yield important benefits for subnational governments. The adoption of financial best practices will make for more efficient use of public funds and prevent the overcommitment of these resources.

The financial and institutional analysis manual will provide a more complete description of the desirable features of a subnational government and ensure greater rationality and coherence in the actions taken by those governments under the program. Likewise, the program will identify best practices and benchmarks against which the governments can measure their performance and against which the public can assess how well their government is working. The manual is also expected to become a tool for disseminating best practices. For instance, proper regulation of Ramo 33 (one of the mechanisms used by the federal government to transfer resources to subnational governments) and better management of investments and audit, budgeting, and accounting systems would allow subnational governments to meet citizens' needs more efficiently and with greater equity. Similarly, making operations more transparent will give financial agents as well as the general public better criteria for assessing subnational government performance.

Risks: There is a risk that the activities to prepare diagnostic studies and approve financing could generate a conflict of interest within BANOBRAS during program execution. In this connection, BANOBRAS's recent reorganization established a clear and transparent separation of the processes of promotion, approval, lending, and monitoring for financed operations of subnational governments. A key consideration is that the process will include the Center for Studies on the Economic Evaluation of Projects (CEPEP), an agency that operates within BANOBRAS as a select group of professionals with recognized experience in project analysis who will be responsible for the projects' socioeconomic appraisal and will check that the individual projects to be funded meet the economic, financial, and environmental viability and sustainability criteria.

Special contractual clauses: The first disbursement of program funds will be released upon fulfillment of the following conditions and approval by the Bank:

(i) Adoption of the program's operations manual, prepared in accordance with terms previously agreed with the Bank (paragraph. 3.13)

(ii) Adoption of the manual on financial and institutional best practices, prepared in accordance with terms previously agreed with the Bank, which will be used by BANOBRAS to prepare the action plans for the subnational governments (paragraph 3.17)

(iii) Adoption of the financial and institutional analysis manual, prepared in accordance with terms previously agreed with the Bank, which will be used by BANOBRAS to produce a financial and institutional analysis of the subnational governments participating in the program (paragraph. 3.18)

(iv) Presentation of the model agreement that BANOBRAS will use with each of the participating subnational governments (paragraph. 3.28)

Condition for execution

During execution of the program, BANOBRAS is to: (i) ensure institutional separation between its area of promotion, technical assistance, and planning; and (ii) keep the necessary technical capacity in order to ensure application of the viability and sustainability criteria for projects to be financed.

Prior to approval of this operation, BANOBRAS fulfilled the condition of adopting an ex ante review system for the procurement of works, goods, and consulting services by subnational governments (paragraph 3.40).

Poverty-targeting and social sector classification: This operation qualifies as a social equity enhancing project as described in the key objectives for the Bank's activity set forth in the report on the Eighth General Increase in Resources (document AB-1704). The experience gained under the FORTEM operation in the states of Quintana Roo, Oaxaca, and Veracruz indicates that there is an unmet demand for programs to provide institutional and financial strengthening in subnational governments in whose territory a high percentage of the population is poor. This demand was taken into account in the design of the proposed program, which expects to secure greater participation in the lower-income states, such as Campeche, Puebla, and Yucatán. The program also includes a pilot project to strengthen the governments of municipios classified in the category of medium to high marginality, with the objective of supporting BANOBRAS in designing and implementing new intervention methodologies that could be replicated on a larger scale during a second phase of the program. The operation does not qualify as a poverty-targeted investment (PTI).

Exceptions to Bank policy: None

Procurement: Bank policies and procedures will be followed for the procurement of all goods, services, and works.

International competitive bidding will be used whenever the estimated value of the goods or related services being procured is US$350,000 or more, with a threshold of US$5 million for works procurement. International open calls for proposals will be used for consulting services estimated at US$200,000 or more.

Consulting services estimated at less than US$200,000 will be procured in accordance with the provisions of Annex D to the loan contract.

Recognition of expenses: Not applicable