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Report No: PGD348

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A
PROPOSED LOAN

IN THE AMOUNT OF US$700 MILLION

TO THE

UNITED MEXICAN STATES

FOR THE

MEXICO INCLUSIVE AND SUSTAINABLE ECONOMIC GROWTH

Development Policy Loan

May 3, 2022

Macroeconomics, Trade, and Investment Global Practice
Latin America and the Caribbean Region

(Mexico)

United Mexican States

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of April 27, 2022)

Currency Unit = Mexican Peso (MXN)

MXN 20.40 = US$1.00

ABBREVIATIONS AND ACRONYMS

AP	Approach Paper
ASF	Mexican Supreme Audit Institution (*Auditoría Superior de la Federación*)
ATM	Automated Teller Machines
CFE	Mexican state-owned electric company *(Comisión Federal de Electricidad)*
CONAFOR	National Forestry Commission *(Comisión Nacional Forestal)*
CONEVAL	National Council for the Evaluation of Social Development Policy *(Consejo Nacional de Evaluación de la Política de Desarrollo Social)*
CPF	Country Partnership Framework
DOF	Official Gazette of the Federation *(Diario Oficial de la Federación)*
DPF	Development Policy Financing
DPL	Development Policy Loan
ENIF	National Financial Inclusion Survey (*Encuesta Nacional de Inclusión Financiera*)
FCL	Flexible Credit Line
FDI	Foreign Direct Investment
FIGI	Financial Inclusion Global Initiative
FONDEN	Mexico's National Disaster Fund (*Fondo de Desastres Naturales de México*)
FOREX	Foreign Exchange
FTE	Fiscal Transparency Evaluation
GDP	Gross Domestic Product
GHG	Green House Gas
GoM	Government of Mexico
GRID	Green, Resilient, and Inclusive Development
GRS	Grievance Redress Service
GVC	Global Value Chain
IADB	Inter-American Development Bank
IFC	International Finance Corporation
ILO	International Labour Organization

IMF	International Monetary Fund
INAI	National Institute of Transparency, Access to Information, and Protection of Personal Data *(Instituto Nacional de Transparencia, Acceso a la Información y Protección de Datos Personales)*
INE	National Electoral Institute *(Instituto Nacional Electoral)*
INEGI	National Institute of Statistics and Geography (*Instituto Nacional de Estadística, Geografía e Informatica*)
INPI	National Institute of Indigenous Peoples *(Instituto Nacional de los Pueblos Indígenas)*
IP	Indigenous People
ISSTE	Mexican Institute for Social Security and Services for State Workers *(Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado)*
LAC	Latin America and the Caribbean
LULUCF	Land Use, Land Use Change, and Forestry
MSMEs	Micro, Small, and Medium Enterprises
NDC	Nationally Determined Contribution
NDP	National Development Plan
NPA	Natural Protected Area
OECD	Organisation for Economic Co-operation and Development
PEMEX	Mexican state-owned petroleum company (*Petróleos Mexicanos*)
PFM	Public Financial Management
POS	Point-of-Service
PSBR	Public Sector Borrowing Requirements
PSIA	Poverty and Social Impact Assessment
RENAPO	National Population Registry (*Registro Nacional de Población)*
RIF	Tax Incorporation Regime (*Régimen de Incorporación Fiscal*)
SCCP	Public Procurement and Purchasing System of Mexico (*Sistema de Compras y Contrataciones Públicas de México)*
SEMARNAT	Ministry of Environment and Natural Resources *(Secretaria de Medio Ambiente y Recursos Naturales)*
SHCP	Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*)
SIAFF	Integrated Financial Management System (*Sistema Integrado de Administración Financiera Federal*)
SSPC	Ministry of Security and Civil Protection (*Secretaría de Seguridad y Protección Ciudadana*)
TA	Technical Assistance
UMIC	Upper-Middle-Income Country
USPSS	Insurance, Pensions, and Social Security Unit *(Unidad de Seguros, Pensiones y Seguridad Social)*
WBG	World Bank Group

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UNITED MEXICAN STATES

MEXICO INCLUSIVE AND SUSTAINABLE ECONOMIC GROWTH DPL

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The Inclusive and Sustainable Economic Growth DPL was prepared by an IBRD team consisting of Rafael Muñoz Moreno (Lead Economist, ELCDR) and Katharina Siegmann (Sr. Environment Specialist, SLCEN) and a team consisting of Ana Cebreiro Gómez (Sr. Economist, EMFTX), Angélica Calderón (Program Assistant, LCC1C), Anjali Shahani Moreno (Operations Officer, ELCMU), Beatriz Elena Franco (Program Assistant, LCC1A), Carmina Isabel Jiménez Quiroga (Junior Professional Associate, SLCEN), Claudia Lucía Vargas Pastor (Public Sector Specialist, EMFTX), Diana Martínez (Program Assistant, LCC1C), Douglas Randall (Financial Sector Specialist, ELCFN), Eduardo Olaberría (Sr. Economist, ELCMU), Eva M. Gutiérrez (Lead Financial Economist, ELCFN), Fernando Gabriel Im (Sr. Economist, ELCMU), Fredesvinda Montes (Sr. Financial Sector Specialist, EFNFI), Gabriela Olvera Cravioto (Country Officer, CLAMX), Henry Forero (Sr. Public Sector Specialist, ELCG2), Jack Campbell (Sr. Disaster Risk Management Specialist, SLCUR), Joaquín Toro (Lead Disaster Risk Management Specialist, SLCUR), José Ángel Villalobos (Sr. Financial Sector Specialist, ELCFN), Juan Carlos Serrano-Machorro (Sr. Financial Management Specialist, ELCG1), Karim Lara (Operations Officer, LCC1C), Lucía Madrid (consultant, SLCEN), María Gabriela Inchauste (Lead Economist, ELCPV), María Virginia Hormazabal (Finance Officer, WFACS), Mary Elinor Boyer (Disaster Risk Manager Specialist, SLCUR), Miguel Eduardo Ceara (Sr. Operations Officer, LCCCO), Pilar González (Sr. Counsel, LEGLE), María Pía Cravero (Counsel, LEGLE), Rosa María Martínez (Social Development Specialist, SLCSO), Santiago Andrés Justel (ET Consultant, ELCMU), Tom Witt (Climate Change Analyst, SLCEN), Truman G. Packard (Practice Leader, HLCDR), and Sebastian S. James (Senior Economist, EMFTX). Carole Megevand (Sector Leader, SMNDR), Frederico Gil Sander (Lead Economist, EAEM1), and Stefano Curto (Senior Economist, EECM2) were peer reviewers.

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic
P178224	No

Proposed Development Objective(s)

The DPL supports policy measures of the authorities that: (a) support vulnerable groups and regions to reap the benefits of economic recovery and (b) reform key policies and institutions that enable sustainable economic growth.

Organizations

Borrower: UNITED MEXICAN STATES

Implementing Agency: Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público)

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**700.00**

DETAILS

International Bank for Reconstruction and Development (IBRD)	700.00

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Moderate

Results

Indicator Name	Baseline	Target
Results Indicator 1: Number of procedures to comply with tax payment obligations	8-10 (2021)	6 (12/2023)
Results Indicator 2: Number of active accounts in Mexican development banks opened by Mexicans abroad	0 (2020)	5,916 (12/2023)
Results Indicator 3: Percentage of adults with access to at least one financial product[1]	68.3% (2018)	77.2% (12/2023)
Results Indicator 4: Average gender gap in ownership of various financial products (percentage points)	7.4 (2018)	0 (12/2023)
Results Indicator 5: Number of risk financing instruments internally requested, and supported by sound technical analysis	0 (2021)	1 (12/2023)
Results Indicator 6: Authorizations of land use change in forest lands that include mandatory measures to mitigate the reduction of carbon storage capacity	0 (2021)	100% (12/2023)
Results Indicator 7: Land use change authorization requests in previously deforested lands that are denied authorization	0 (2021)	100% (12/2023)
Results Indicator 8: Authorizations of land use change in forest lands located in indigenous territories that include a free, prior, and informed consultation process	0 (2021)	100% (12/2023)
Results Indicator 9: Increase of area under conservation through a new Natural Protected Area expressed as (i) hectares and (ii) equivalency in Carbon Storage[2]	0 (2021)	(i) 89,361 ha, (ii) 1.1 million tons of carbon (equivalent to 4.2 million tons of CO_2) (12/2023)

[1]Given that the indicator will be obtained by the National Survey of Financial Inclusion (ENIF, 2024), indicators 3 and 4 will be measured and reported in 2024. Complementary data might be gathered and reported.
[2]Carbon Storage was calculated as of March 2022 based on emission factors published in Mexico's National Forest Emissions Reference Level reported to the UNFCCC (https://redd.unfccc.int/submissions.html?country=mex).

IBRD PROGRAM DOCUMENT FOR A PROPOSED LOAN TO THE UNITED MEXICAN STATES

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Development Policy Loan (DPL) operation supports the Government of Mexico (GoM) program to foster inclusive and sustainable economic growth.** It aims to support components of the authorities' policy measures to: (a) support vulnerable groups and regions to reap the benefits of economic recovery; and (b) reform key policies and institutions that enable sustainable economic growth. It will accomplish this by focusing on reforms that continue simplifying the business environment for micro, small, and medium enterprises (MSMEs); fostering financial inclusion; and strengthening institutions and capacity for sustainable management and conservation of forest and disaster risk management. This approach provides flexibility in a highly uncertain environment while ensuring adequate focus on supporting the vulnerable and addressing institutional bottlenecks while maintaining fiscal and environmental sustainability.

2. **Mexico is an upper middle-income country and a member of the OECD, but its development model fails to deliver in terms of economic growth, inclusion, and poverty reduction compared to its peers (Box 1).** In fact, Mexico's development level masks significant divisions across income, rural, gender, ethnicity, or geographical aspects, among others. The national multidimensional poverty rate reported by CONEVAL was 43.9 percent of the population (55.7 million people) in 2020. On average, female-headed households have an income of MXN 4,500 compared to MXN 4,520 for male-headed households. Rural households have an income of MXN 2,935 compared to MXN 4,989 for urban households (World Bank estimates based on 2020 ENIGH). Institutional weaknesses, whether at the federal or subnational level, hamper access to public services or financial services, which in turn further limit job opportunities. Rural areas particularly suffer from a vicious cycle of low productivity, low investments in physical and human capital, and high poverty rates, especially in the south of the country.[3]

3. **GoM priorities of addressing regional and income inequality[4] over the last two years have been severely undermined by the ongoing COVID pandemic.** Due to the pandemic, economic growth in 2020 was −8.2 percent, the largest output collapse in Mexico since the 1930s. Gross domestic product (GDP) growth in Mexico was 4.8 percent in 2021 driven by strong US growth and recovery of services, the reopening of the economy and a steady vaccination pace. According to INEGI's monthly employment survey - ENOE, by July 2020, 6.5 million jobs had been lost due to the pandemic, but by February 2022, the economic recovery had managed to create an additional 300,000 jobs beyond pre-pandemic levels. Still, employment remains precarious, and more than 30 million workers (54.6 percent of total employment) were informally employed in February 2022, a slight decrease compared to pre-pandemic levels. Unemployment and underemployment remain above pre-pandemic levels, and a higher share of workers earn less than the minimum wage. Women have been especially hard hit by the pandemic, and female labor force participation is yet to recover from its already low pre-pandemic level.[5] The employment recovery also remains uneven across states, with regions like Sinaloa, Tabasco, Veracruz, and Mexico City still below pre-pandemic employment levels. More than half of the households in rural

[3] Southern states such as Oaxaca, Guerrero, and Chiapas have multidimensional poverty rates that are above 60 percent.
[4] National Development Plan (NDP) 2019–2024. https://lopezobrador.org.mx/wp-content/uploads/2019/05/PLAN-NACIONAL-DE-DESARROLLO-2019-2024.pdf.
[5] At 43.5. percent female labor force participation continues to be well below the OECD and regional averages.

areas still report lower income than before the pandemic, and 19 percent of rural households report food insecurity, compared to 10 percent before the pandemic (World Bank High Frequency Survey, 2021). Remittances from migrants abroad have been especially useful during the pandemic, as remittance income represented 6.5 percent of incomes in the poorest decile in 2020 (World Bank estimate based on 2020 ENIGH).

4. **This DPL fosters institutional strengthening; and supports both the provision of global public goods and Mexico's climate change agenda:**

- Persistent institutional constraints hamper Mexico's economic development. Institutional weaknesses hamper financial sector competition and limit access to finance to most productive firms as well as households' financial inclusion. As a result, most productive firms cannot grow and households, particularly headed by women, cannot build productive assets. Moreover, institutional constraints to formalization, such as an overly complex business environment force many firms to remain in the informal sector, further hampering chances to increase their productivity. Low revenue mobilization is partially explained by tax expenditures or low subnational receipts. This affects the fiscal space available to expand access to and quality of public services and infrastructure development. It also provides insufficient resources to close the income gaps across Mexico's regions. Reforms supported by this operation will strengthen institutions to cope with some of these challenges. Reforms supported will provide Mexico's Internal Revenue Service with new monitoring tools to combat tax evasion and avoidance. Also, the adoption of secondary regulations to the 2018 Fintech Law will enhance regulatory certainty and strengthen institutions on regulatory governance, quality, and enforcement. Furthermore, the reforms supported by this operation will strengthen the Ministry of Environment's (SEMARNAT) capacity to protect ecosystems and, in collaboration with the National Institute of the Indigenous Peoples (INPI), preserve the rights of Indigenous Peoples (IPs) to land and natural resources.

- Global public goods are supported around forest management and conservation, and the conservation of carbon stocks in line with Mexico's Nationally Determined Contribution (NDC). The operation also contributes to climate change adaptation and mitigation challenges, as forest conservation is key in achieving the NDC's mitigation and adaptation targets. Forest sector removals already represent 22 percent of Mexico's total emissions and Mexico has established a zero net deforestation target. Better preserved forests and enhanced conservation areas will support the country and local population in enhancing adaptive capacities. This is particularly relevant given Mexico's high vulnerability to natural hazards and exposure to climate change impacts,[6] mainly earthquakes and climate-induced hydro-meteorological events. The country lies over five tectonic plates[7], two of which cross the San Andreas Fault, making it one of the most seismologically active regions in the world[8]. Hydro-meteorological events such as floods, storms,

[6] Mexico ranks among the top 30 countries worldwide most exposed to disasters from natural hazards, experiencing an increase in the intensity of droughts, rain, and tropical cyclones and stronger extreme weather events from El Niño. University of Notre Dame. 2015. *Global Adaptation Index Country Index Technical Report*. https://gain.nd.edu/assets/254377/nd_gain_technical_document_2015.pdf.

[7] Servicio Geológico Mexicano, (2017). Evolución de la tectónica en México. Gobierno de México. https://www.sgm.gob.mx/Web/MuseoVirtual/Riesgos-geologicos/Evolucion-tectonica-Mexico.html

[8] https://climateknowledgeportal.worldbank.org/country/mexico.

and landslides happen more frequently than earthquakes and are likely to be exacerbated by climate change. Also, the Mexican coasts are exposed to hurricanes and cyclones during summers, and to “El Niño” weather events regularly, and their frequency and severity are also likely to increase due to climate change. The potential rise in sea level would directly affect coastal and marine ecosystems. This climate-driven increase in vulnerability could destroy public and private infrastructure,[9] jeopardize food systems, deepen inequality disproportionally affecting the most marginalized and vulnerable populations[10], and eroding efforts to reduce poverty, as around 60 percent of the Mexican population affected by natural disasters are poor.[11] Mexico is ranked as the 82nd least vulnerable country to climate change but also the 83rd least ready country[12], showing the country’s inadequate response capacity, particularly in good governance and institutional strengthening, promotion of education, and social innovation.

5. **The proposed operation follows the Green, Resilient, and Inclusive Development (GRID)** and promotes economic growth with environmental goals (forest protection), equitable (rural development) and social inclusion (access to financial services), and sustainable management of forest protection that will be a source of equitable economic growth, helping to close the rural/urban income gap, by creating jobs around sustainable natural resource management. Strengthened institutions in the environment sector will protect natural resources that are a key component of Mexico’s sustainable growth model, and the source of income and jobs, mostly for poor rural populations, many of them vulnerable and a large share of which are IPs. Institutions to deliver assistance in case of disaster would mitigate economic losses and protect vulnerable populations against income losses. Also, the adoption of a simplified regime for MSMEs and self-employed individuals reduces administrative costs while strengthening the tax authority's capacity to combat tax evasion and avoidance, a critical structural challenge in Mexico. The operation supports policies and institutional reforms to facilitate financial inclusion, with a focus on Mexican migrants in the United States, facilitating remittances and access to finance to build productive assets for economic growth. It also regulates the market for digital payment systems to further increase financial inclusion and increase financial sector competition to overcome constraints to productivity growth. It will also create more resilient payment systems that can be instrumental during natural disasters, mainly in rural areas. Policy reforms under pillar 2 will specifically benefit vulnerable populations and regions in rural areas in Mexico and link the provision of global public goods to local co-benefits through enhanced adaptative capacity and better preservation of local income opportunities based on natural resource management. This is aligned with the GRID approach that seeks to foster solutions that do not leave anyone behind and reduce disparities in opportunities and policy outcomes.

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[9] According to annual damage reports from CENAPRED compiled by the World Bank, during the period 2000 – 2019, disaster related damages in public and private infrastructure totaled 733 billion pesos. Mexico is particularly vulnerable to the impacts of global climate change, including sea-level rise affecting coastal areas and inland basins, an increase in the sea surface temperature in the Gulf of Mexico, intensified hurricanes, increasingly heavy rains and strong storms, longer and more frequent droughts, and net decreases in water run-off. CENAPRED annual "Impacto Socioeconómico de los Principales Desastres Ocurridos en México", compiled by the World Bank. Original reports are available:
http://www.cenapred.unam.mx/PublicacionesWebGobMX/buscar_buscaSubcategoria.

[10] Climate change impacts and natural disasters disproportionately affect women, indigenous peoples (IPs), Afro-descendants, and people with disability in Mexico, who often experience higher rates of mortality, morbidity, and diminished earnings. Climate change also disproportionally affects most vulnerable Mexican populations who are more prone to health risks and often have less access to health services and preventive measures. *México Atlas Nacional de Vulnerabilidad*.

[11] GoM NDC.

[12] https://gain-new.crc.nd.edu/country/mexico.

Box 1: Mexico's challenges to accelerating economic growth

Mexico has held a strong track record of prudent macroeconomic policies and reforms to liberalize domestic markets and open to trade. It has become the world's 17th largest exporter in US$ terms and Foreign direct investment (FDI) reached 2.5 percent in 2021, integrating into regional and global value chains (GVCs). Yet, the country has underperformed in terms of economic growth, inclusion, and poverty reduction compared to its peers. Mexico's economic growth averaged 2.2 percent between 1990 and 2019 and productivity has been negative during this period, compared to an annual productivity increase of 0.8 percent in Latin America and the Caribbean average. Between 2004 and 2014, moderate poverty at US$5.5/day per capita (2011PPP) in Mexico declined from 37.4 percent to 33.3 percent (compared to a reduction from 42.2 percent to 25.4 percent in the Latin America and the Caribbean region, over the same period).

Much of the limitations of Mexico's development model are explained by its underperforming productivity.[13] Firms in Mexico do not grow, creating an excess of micro/small firms and a lack of large ones. This means that too few formal and good jobs are created in Mexico compared to too many informal and low-paid ones. Also, unproductive firms remain in the market and do not exit, absorbing too many resources that could be redeployed to the most productive firms. The main constraints on efficient firm entry-and-exit dynamics in Mexico are stringent regulatory barriers and an outdated bankruptcy regime. A crucial driver of the inability of Mexican firms to accelerate productivity growth is inadequate access to finance as innovative and younger firms have less access to credit. Furthermore, institutional problems such as crime and corruption or inadequate competition reduce incentives for firms to invest in improving their management and organization. As a result, the economy has made little progress in technological upgrading and increasing local value-added, which could broaden productivity gains across the economy. This is manifested in low use of domestic intermediate inputs, high concentration in manufacturing, and the exclusion of many domestic firms, sectors, and regions from GVCs entirely. This translates into significant regional disparities in Mexico with growing productivity divergence between states (North and Center vs South). Yet, fast-growing municipalities are also observed in the South of Mexico – unfortunately, there are too few of them which leads to States not converging. This means that with adequate urbanization and agglomeration policies the South could grow much faster.

2. MACROECONOMIC POLICY FRAMEWORK

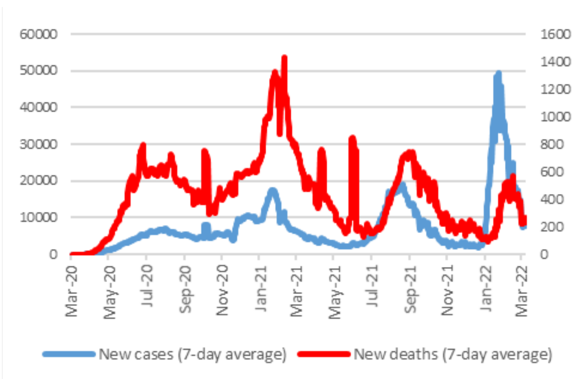
2.1. RECENT ECONOMIC DEVELOPMENTS

6. **Mexico's real GDP grew 4.8 percent year-over-year in 2021, following a pandemic-induced contraction of 8.2 percent in 2020.** The COVID-19 pandemic resulted in high human and social costs, with more than 300,000 excess deaths in 202014. The 2020 output collapse was the largest since the 1930s. Real GDP contracted by −9.9 percent year-over-year during the first half of 2020 due to demand and supply shocks stemming from the COVID-19 pandemic. Economic recovery started to gain pace in the second half of 2020, as mobility restrictions were eased domestically, and US demand accelerated. The

[13] "Productivity growth in Mexico: Understanding main dynamics and key drivers". World Bank, 2022.
[14] According to Ministry of Health.

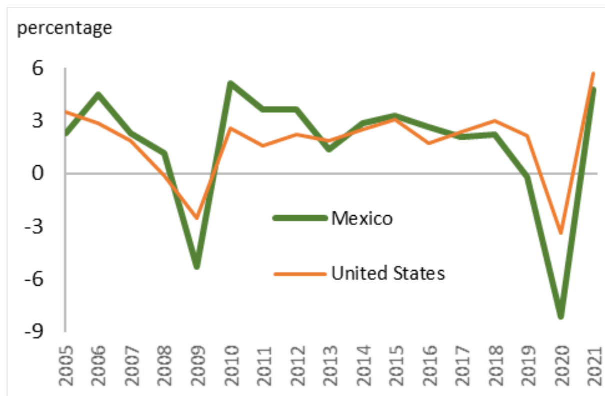
rebound in economic activity maintained its momentum in the first half of 2021 driven by strong US growth and the recovery of services, with the reopening of the economy and a steady vaccination pace, but lost steam toward the second part of 2021. The mild rebound in 2021 after the sharp activity decline in 2020, implies that the Mexican economy is below 2017 GDP level. Manufacturing recovery was robust during 2021 but constrained by supply chain shortages. The bounce-back was supported by manufacturing, wholesale, and retail, with annual growth of 8.6, 10.7, and 9.9 percent, respectively. While economic activity is near pre-pandemic levels[15] (Figures 5 and 6), subsectors such as construction and services related to food and entertainment are still lagging.[16]

Figure 1. After the last wave, COVID cases and new deaths remain contained



Source: Our World in Data.

Figure 2. The pandemic had a severe impact on the Mexican Economy and the United States …

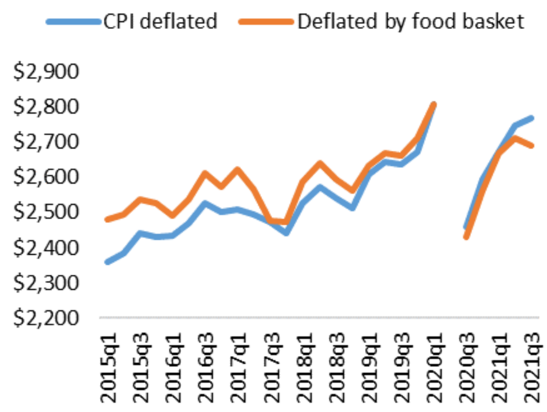


Sources: World Development Indicators, World Bank.

[15] GDP is currently 3.8 percent below the 2019 level.

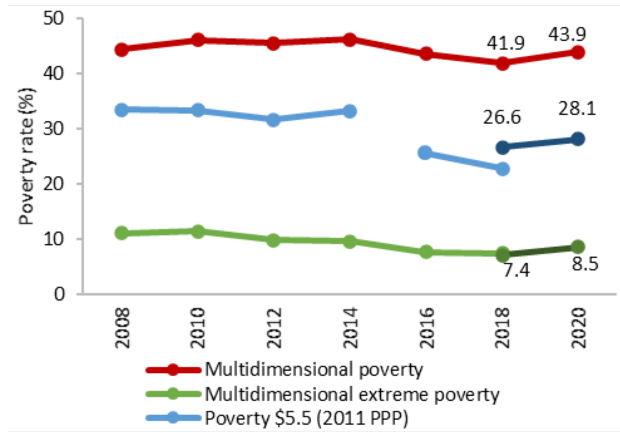
[16] Administrative and Support Services was recovering during 2021. However, in Q3, the so-called outsourcing reform was implemented which affected critically this sector, explaining the 46.2 percent decrease of sectoral output for 2021 Q3 compared to the average GDP in 2019. The same sector was 9.3 percent above the 2019 GDP level in Q2.

Figure 3. … affecting labor income per capita…
(Constant 2010-Q1 Mexican Pesos)



Source: National Council for the Evaluation of Social Development Policy (CONEVAL) estimations using ENOE 2005 Q1–2021 Q3.

Figure 4. … consequently, poverty increased in 2020



Sources: Total Economy Database; World Bank calculations.

Figure 5. While total GDP is currently near pre-pandemic levels, GDP 2019 versus GDP 2021 shows differences across sectors

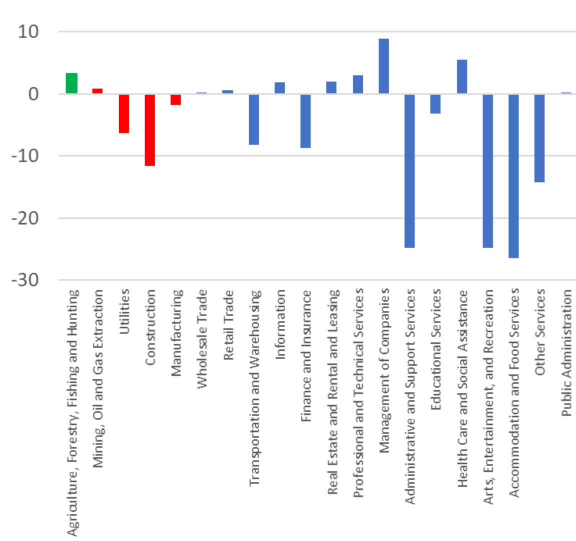
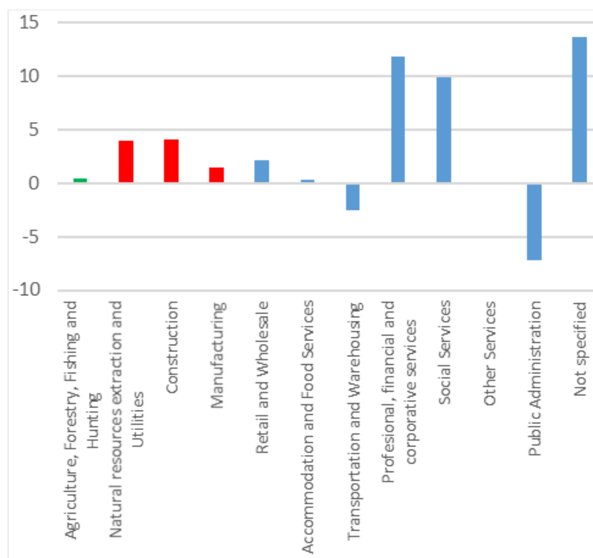


Figure 6. Employment shows recovery across sectors when comparing 2019 Q4 to 2021 Q4



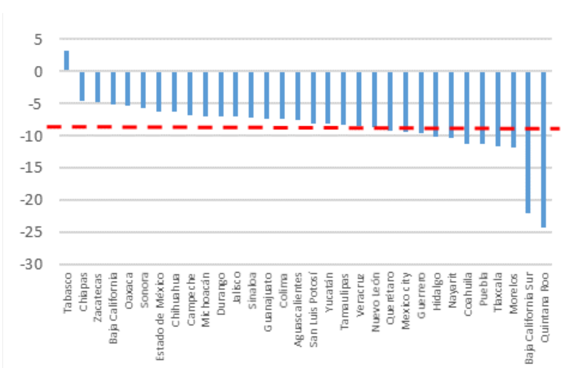
Sources: National Institute of Statistics and Geography (*Instituto Nacional de Estadística, Geografía e Informatica*, INEGI).
Note: Green, primary sector. Red, secondary. Blue, tertiary sector.

7. **Poverty is expected to have declined in 2021 as employment and labor income grew in line with the growth of economic activity but remained above the pre-crisis level.** The sharp decline in labor income per capita in mid-2020 turned into a robust recovery beginning in the third quarter of 2020

through the third quarter of 2021 (Figure 3). The share of households with labor incomes below the basic need basket declined from 46 percent in the third quarter of 2020 to 41 percent in the third quarter of 2021 which is still higher than the 36.6 percent observed before the pandemic. However, while the unemployment and underemployment rates have declined and total employment has recovered pre-pandemic levels, the recovery has been uneven. Most job creation has taken place in the informal sector and low-wage jobs, with a growing share of jobs having meager earnings, either below or just above the minimum wage; and with women's employment lagging that of men and having not yet reached pre-pandemic levels (43.5 percent of women participation in February 2022 compared to 45.1 percent in February 2020). Moreover, inflation has led to a reduction in the purchasing power of households in 2021 and early 2022, with potential impacts on food insecurity. Labor income growth and social transfers are expected to have reduced monetary poverty from 28.1 percent in 2020 to 26.4 percent in 2021, which is estimated to be above pre-pandemic levels of 23.1 percent in 2019. Other nonmonetary dimensions of poverty are expected to have improved, including access to health and social security. However, expected setbacks with respect to education as measured by a reduction in the share of youth engaged in studies compared to pre-pandemic levels may have lasting effects on labor earnings.

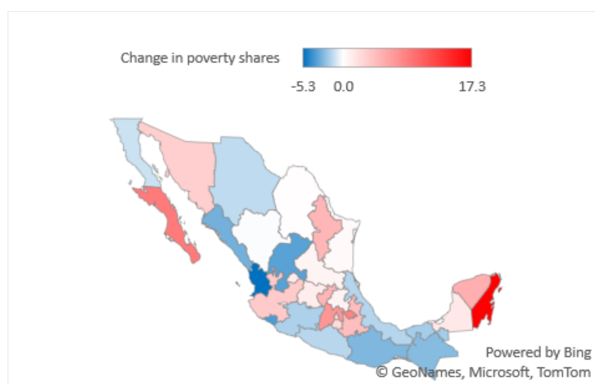
8. **The effects of the pandemic have been severe in Mexico, particularly across states.** Of the total 32 states, 28 have not yet reached pre-pandemic activity levels, although total employment is near pre-pandemic levels in most states. While output decreased 8.2 percent in 2020, Quintana Roo and Baja California Sur, where tourism is an essential part of the economy, shrunk more than 20 percent (Figure 8). These regions, together with manufacturing-intensive states, also suffered more significant job losses and increments in poverty in 2020. During 2021, the activity and employment recovery have also been unequal (Figures 9 and 10) as some industries have not returned to pre-crisis activity levels (for example, international tourism).

Figure 7. Activity index declined in 2020 for almost all states…



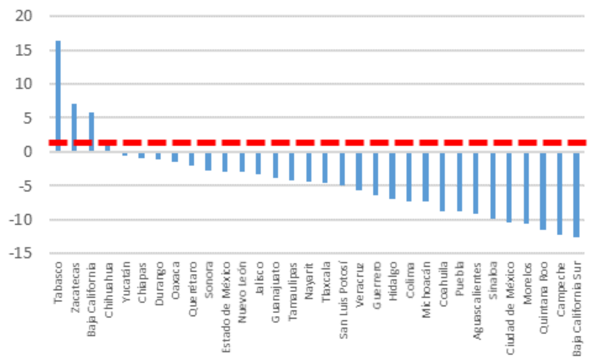
Source: INEGI.
Note: Dashed line. Countrywide growth.

Figure 8. …increasing the share of poor population in 2020 compared to 2018 in 19 states



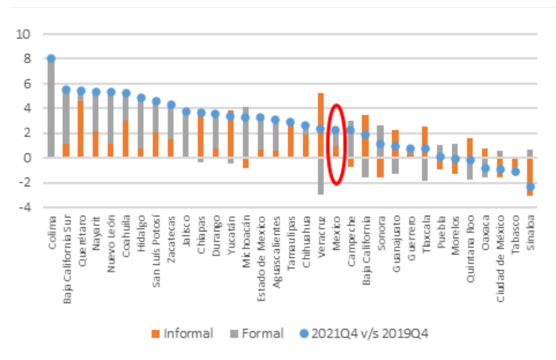
Source: CONEVAL based on national multidimensional measure of poverty.

Figure 9. Uneven activity index recovery in 2021Q3 compared to 2019 across states...



Source: INEGI.
Note: Percentage. Dashed line. Countrywide growth.

Figure 10. …reflected in unequal employment recovery in 2021-Q4 compared to 2019-Q4



Source: INEGI
Note: Percentage. Red circle indicates countrywide employment growth

9. **A current account deficit of 0.4 percent of GDP in 2021 reflects a rebound in exports, a fast recovery in imports, and strong remittances.** Export of goods and services grew 202.3 percent year-over-year in 2021, explained by the solid US demand. Imports also increased 32.4 percent during the same period as inventories were restocked. Remittances reached US$51.6 billion in 2021 (27 percent annual growth). These developments follow a current account surplus of 2.4 percent of GDP in 2020, primarily explained by a 17 percent import contraction larger than the 11.9 percent decline in exports and a substantial increase in remittances. Solid FDI of 2.5 percent of GDP, in line with previous years' levels, supported the expansion of international reserves to US$202 billion by early March 2022, covering almost five months of imports and more than 300 percent of short-term external debt. External reserves that include US$12 billion of new International Monetary Fund (IMF) SDR allocation are complemented by a Flexible Credit Line (FCL) with the IMF for US$50 billion that was renewed in November 2021 for two years and will be phased out over time as the global pandemic subsides.

10. **Despite a credit rating downgrading in 2020, the sovereign remains one to three notches above investment grade, depending on the agency.** Spreads have gotten closer to pre-pandemic levels in 2021, and external financing has remained favorable. Despite significant capital outflows and an increase in spreads above most emerging economies in 2020, spreads have returned to near pre-pandemic levels (Figures 13 and 14). Mexican bond spreads remain above emerging-market peer countries, reflecting PEMEX's financial situation.[17] Access to markets remains comfortable with foreign-denominated borrowing of US$15 billion in 2020, above historical levels, and US$10 billion in 2021. In addition, local investors increased their position relative to nonresidents (from January to December 2021, nonresidents reduced holdings by US$15.2 billion, while residents increased their exposure by US$31.2 billion), reducing vulnerability to capital outflows.

[17] Other risk measures that exclude SOEs such as CDS 5y or EMBI+ show Mexico's risk below countries like Brazil and Colombia.

Figure 11. Mexican bond spreads remain above emerging market peer countries and near pre-pandemic levels, although the Ukraine-Russia war is affecting perceived risks

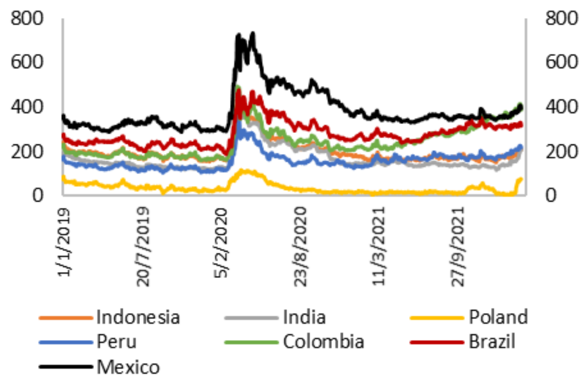


Figure 12. During the pandemic, Mexico has fared worse than emerging markets in the capital flow index (1/1/2019 = 100) but has closed the gap…

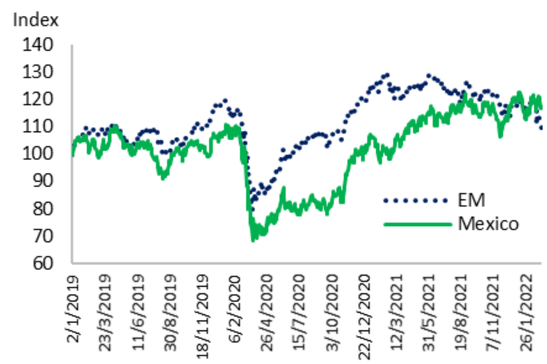
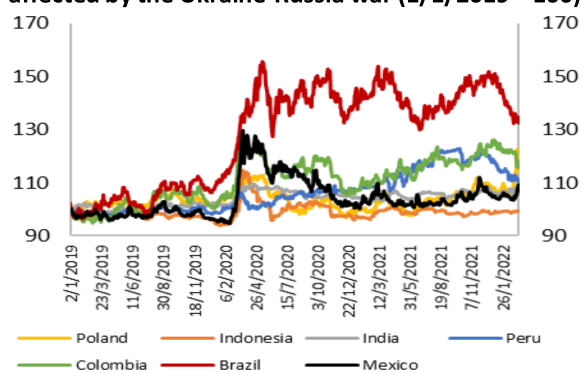


Figure 13. …with a stable exchange rate, recently affected by the Ukraine-Russia war (1/1/2019 = 100)



Source: Bloomberg

11. **Headline inflation of 7.45 percent in March 2022 remains above the central bank's target, but expectations remain anchored.** A surge in energy and agricultural prices has trickled down to the rest of the consumption basket, as core inflation has increased to 6.78 percent in March 2022. Inflationary pressures have been reinforced by supply chain problems and imported inflation from the United States. The high inflation has been more persistent than initially expected, but medium-term expectations remain within the Central Bank's band (3 percent ± 1 percent), supported by Banxico's increase in its policy rate from 6.0 to 6.5 percent in March 2022 that the market welcomed as evidence of its commitment to maintaining price stability.

12. **The financial sector entered the pandemic well-capitalized and is recovering profitability.** As of December 2021, capital to risk-weighted assets of the banking system was 18.6 percent, well above the 10.5 percent capital requirements. Similarly, the median liquidity coverage ratio for the system in November 2021 reached 231.9 percent, and the requirement for most banks is 100 percent. Liquidity measures provided to help the banking sector at the onset of the crisis have been mostly removed after limited use. Delinquency rates declined from 2.4 percent in March 2021 to 2.0 percent in December 2021.

The average return on equity increased to 14.5 percent in 2021, after a sharp decline to 5.2 percent in 2020 due to higher provisions.

13. **The authorities' countercyclical fiscal response remains cautious with public sector borrowing requirements (PSBR) of 3.8 percent of GDP during 2021.** Direct budgetary support in 2020 amounted to 0.7 percent of GDP whereas guarantees and loans to MSMEs by development banks amounted to 1.2 percent of GDP, focused on increased public health spending, small credits to MSMEs and the informal sector, and targeted social transfers to vulnerable groups. Mexico's overall PSBR were 4 percent of GDP in 2020, driven by a moderate increase in public spending and sustained revenues fueled by strong tax administration measures and tax settlements with large companies. Yet, net public debt as a share of GDP increased to 52.4 percent due to the fiscal deficit, debt reevaluation determined by foreign exchange (FOREX), and the large contraction in nominal GDP in 2020. The fiscal response during the pandemic, albeit at the risk of a deeper contraction and the sharp depreciation led to an increase in public indebtedness, below however to what was observed in other emerging markets. The 2021 fiscal situation benefited from the economic recovery and higher oil prices, an expenditure that continues part of the pandemic fiscal stimulus centered on public health and social transfers and implementing large public investment projects.

14. ***Petróleos Mexicanos* (PEMEX) has continued to report losses, equivalent to MXN 224 billion (US$10.9 billion) in 2021. Financial support from the Government during 2019–2021 (amounting to a cumulative 2.7 percent of 2021 GDP) and higher oil prices mitigated these losses.** Federal government support to PEMEX came in the form of tax relief (US$12.7 billion), financing debt repayments (US$10 billion), and direct funding for investment projects (US$6.5 billion), and cash support for other obligations (US$6.7 billion), totaling US$35.9 billion (2.7 percent of GDP)[18]. This financial support was aimed to partially compensate for the US$41.6 billion losses of 2019 and 2020. PEMEX's financial debt remains high and total financial obligations reached MXN 2243 billion (US$109 billion) at the end of 2021. PEMEX is expected to benefit from the higher oil prices as the Mexican-Mix oil price averaged US$35.7 per barrel in 2020, to reach US$64.7 in 2021, while averaging almost US$90 per barrel in the first quarter of 2022. PEMEX's oil production declined from an average of over 2 million barrels per day during 2015-2017, to around 1.75 million barrels per day in 2021. The fiscal support improves some of PEMEX challenges related to significant tax burden and high financial cost. A turnaround of PEMEX finances would also require to prioritize profitable business areas by redirecting investment for replacing reserves, scaling down large investment projects and focusing on maintaining and upgrading existing refineries, stimulating synergies with the private sector in exploration and oil production, and selling noncore assets. PEMEX remains three notches below investment grade for Fitch and Moody's after a downgrade by Moody's by one notch in July 2021 (it is still investment grade for S&P). The fiscal support to PEMEX as well as its balance and debt are part of the fiscal account figures reported for the consolidated public sector (tables 1 and 2).

15. **The 2022 public budget approved aims to stabilize the overall fiscal deficit at 2.7 percent of GDP and stabilize the net public debt-to-GDP ratio at 49.6 percent over the medium term.[19]** On the

[18] Box 2. IMF, Mexico Article IV, November 2021.
[19] Considering the most updated fiscal scenario, *Precriterios de política económica para el 2023.*

expenditure side, the budget envisions a re-prioritization of expenditures toward health (a 27.6 percent increase in real terms compared to 2021) and social assistance programs (real increment of 12.8 percent) to vulnerable groups while keeping public investment at 3.1 percent of GDP, mainly for flagship projects. The impact of the pandemic-induced economic downturn in 2020 on debt is not expected to affect the debt consolidation process, based on a contained fiscal deficit under the long-standing prudent fiscal policy of Mexico, further supported by the limited fiscal impulse to remove. The budget envisages increases in public revenues driven by the recovery in economic activity and efforts to tackle elusion and evasion. Also, to simplify the tax filing process, reducing costs, and increasing the tax base, the new budget law adopts (a) a simplified tax filing regime for independent workers that limits deductions and (b) a special regime for small firms with accelerated depreciation to boost investment and employment.

Table 1. Mexico Key Macroeconomic Indicators, 2019-2025

				Projected			
	2019	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
Real sector							
Real GDP	-0.2	-8.2	4.8	2.1	2.1	2.0	2.0
Contributions:							
Consumption	0.0	-7.1	5.0	1.9	1.7	1.6	1.6
Investment	-1.1	-3.9	1.9	0.5	0.4	0.4	0.5
Net exports	0.8	2.4	-2.2	-0.3	-0.1	0.0	-0.1
Unemployment rate	3.5	4.7	..	..	..	..	..
GDP deflator	4.1	4.0	7.1	6.2	4.5	3.5	3.5
CPI (period average)	3.6	3.4	5.7	6.0	3.9	3.5	3.5
Fiscal accounts							
Revenues	22.0	22.9	22.7	22.2	22.0	21.5	21.3
Expenditures	24.3	26.8	26.5	25.6	25.3	24.7	24.4
Fiscal balance	-2.3	-4.0	-3.8	-3.4	-3.3	-3.3	-3.2
Net public debt	44.5	51.7	50.0	49.0	49.0	49.5	49.9
Gross public debt	53.3	60.3	61.5	57.6	57.6	58.0	58.5
Monetary accounts							
Base money	5.8	11.3	9.4	17.9	8.6	7.9	8.3
Policy interest rate	7.25	4.25	5.5	..	..	..	..
External sector							
Current account balance	-0.3	2.4	-0.4	-0.9	-1.2	-1.6	-1.7
Imports (% change, real)	-0.7	-13.7	13.7	7.2	6.1	5.1	5.0
Exports (% change, real)	1.5	-7.3	6.9	6.4	5.9	5.0	4.9
Foreign direct investment	1.9	2.3	2.5	2.3	2.1	2.0	2.0
Gross reserves (USD billion)	183.1	199.1	207.7	212.9	212.9	206.2	197.9
In months of imports	4.4	5.8	4.6	4.2	3.8	3.4	3.0
% of short-term ext. debt	292.0	400.4	321.5	308.8	294.9	274.5	253.1
Terms of trade (% change)	2.3	-1.2	-2.8	1.1	0.2	-0.1	0.4
Exchange rate MXN/US$)	19.3	21.5	20.3	..	..	..	..

Source: World Bank's staff estimations. Projections as of March 15, 2022.

Table 2. Mexico: Key Fiscal Indicators for the Public Sector, 2019–2025 (% of GDP)

				Projected			
	2019	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
Total Revenue	**22.0**	**22.9**	**22.7**	**22.2**	**22.0**	**21.5**	**21.3**
Federal Government	16.4	17.5	16.5	15.4	15.4	15.3	15.3
Tax revenue	13.1	14.3	13.6	13.1	13.2	13.1	13.3
Nontax revenue	3.3	3.2	2.9	2.3	2.2	2.1	2.0
Oil	1.8	0.8	1.4	1.5	1.4	1.3	1.2
Revenue Stabilization Fund/oil hedge*	0.5	1.0	2.0	0.0	0.0	0.0	0.0
Other**	1.0	1.4	-0.5	0.8	0.8	0.8	0.8
Agencies and Public enterprises	5.6	5.4	6.3	6.8	6.6	6.2	6.0
PEMEX	2.1	1.7	3.0	3.4	3.3	3.0	2.8
CFE, IMSS, ISSSTE	3.5	3.6	3.3	3.4	3.3	3.2	3.2
Total Expenditure	**24.3**	**26.8**	**26.5**	**25.6**	**25.3**	**24.7**	**24.4**
Budget expenditure	23.7	25.7	25.7	25.1	24.9	24.3	24.0
Programmable	17.3	19.1	19.6	18.5	17.7	17.0	16.5
Current	14.3	15.7	15.1	15.1	14.5	14.1	13.7
Wages	5.0	5.5	5.2	5.1	4.8	4.6	4.4
Pensions	3.6	4.1	4.0	4.1	4.0	3.9	3.9
Subsidies and transfers	3.1	3.5	3.4	3.3	3.1	3.1	3.0
Other operating expenses	2.6	2.6	2.6	2.6	2.5	2.5	2.4
Capital	3.0	3.4	4.4	3.4	3.2	2.9	2.9
Physical capital	2.3	2.8	2.6	3.0	2.9	2.6	2.6
Financial capital	0.7	0.6	1.8	0.4	0.4	0.3	0.3
Nonprogrammable	6.4	6.6	6.1	6.6	7.1	7.3	7.5
Revenue sharing	3.6	3.6	3.5	3.8	3.8	3.7	3.6
Interest payments	2.7	2.9	2.6	2.7	3.3	3.6	3.8
Other	0.1	0.1	0.0	0.1	0.1	0.1	0.1
Primary Budget Balance	1.1	0.1	-0.3	-0.3	0.4	0.7	1.1
Budget Balance	-1.6	-2.9	-2.9	-3.0	-2.8	-2.8	-2.7
Adjustments to the budget balance***	-0.7	-1.1	-0.8	-0.4	-0.4	-0.4	-0.4
Overall Fiscal Balance (PSBR)	**-2.3**	**-4.0**	**-3.8**	**-3.4**	**-3.3**	**-3.3**	**-3.2**
Gross Financing Needs	**10.6**	**13.1**	**13.0**	**11.4**	**11.5**	**11.8**	**11.7**
Overall fiscal balance (PSBR)	2.3	4.0	3.8	3.4	3.3	3.3	3.2
Amortizations	8.2	8.6	8.8	8.4	8.9	8.8	8.8
Net public debt****	44.5	51.7	50.0	49.0	49.0	49.5	49.9
Gross public debt	53.3	60.3	61.5	57.6	57.6	58.0	58.5

Source: World Bank's staff estimations. Projections as of March 15, 2022.
Note: a. Includes the payout of oil price hedge acquired by the Ministry of Finance.
b. Includes revenue from the sale of financial assets such as from the trust fund to be extinguished and dividends from the central bank.
c. Includes the inflationary component of inflation-indexed debt, income from debt repurchase, and an adjustment for income derived from the net sale of financial assets and the net acquisition of liabilities other than public debt.
d. Net of cash balances and financial assets of nonfinancial public sector entities, including public sector trust funds.

Table 3. Balance of Payments Financing Requirements and Sources, 2019–2025 (US$, billions)

				Projected			
	2019	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
Financing requirements	**103.7**	**93.6**	**106.2**	**125.8**	**131.4**	**137.9**	**144.1**
Current account deficit	3.5	-26.2	5.2	12.6	16.9	24.5	27.0
External debt amortization	97.6	107.8	91.1	108.0	114.5	120.1	125.3
Medium and long term	36.4	45.1	41.4	43.4	45.6	47.9	50.2
Short term	61.1	62.7	49.7	64.6	69.0	72.2	75.1
Gross reserve accumulation	2.6	12.0	9.9	5.2	-0.1	-6.7	-8.3
Financing sources	**103.7**	**93.6**	**106.2**	**125.8**	**131.4**	**137.9**	**144.1**
FDI (net)	6.2	-10.3	-41.6	-23.6	-6.2	7.9	10.9
External debt disbursements	117.9	106.4	126.0	134.5	140.7	146.5	152.5
Medium and long term	55.2	56.7	61.4	65.5	68.6	71.4	74.3
Short term	62.7	49.7	64.6	69.0	72.2	75.1	78.2
Other capital flows (net)	-20.4	-2.4	21.8	14.9	-3.1	-16.4	-19.3

Source: World Bank's staff estimations. Projections as of March 15, 2022.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

16. **The Mexican economy is expected to grow 2.1 percent in 2022 before converging towards 2.0 in 2023, in line with Mexico's potential GDP growth.** The moderate economic growth will be driven by contained private consumption, due to a slow recovery in the labor market. Labor income is expected to remain constrained as new positions consist primarily of low-paid jobs and high inflation will dent household's purchasing power. Private investment is expected to remain constrained as regulatory uncertainties remain. The impulse in public investment will support the recovery. Despite supply chain shortages, the manufacturing sector is expected to grow 2.9 percent in 2022 before its impulse fades towards 2023 (2.1 percent). The service sector is expected to grow in line with private consumption at 1.9 percent in 2022 and 2023. Mexico is projected to attain pre-pandemic GDP levels at the beginning of 2023 and pre-pandemic real GDP per capita by late 2026.

17. **Poverty will continue to decline as employment and real wages recover.** Continued employment and labor income growth, together with social transfers, are expected to lead to a gradual reduction in monetary poverty from 28.1 percent in 2020 to 26.4 percent in 2021 (based on the US$5.5 a day poverty line) and a further decline to 26 and 25.4 percent in 2022 and 2023, respectively. Inflation is expected to continue to reduce the purchasing power of incomes in 2022. While the 22 percent increase in the minimum wage for 2022 could benefit formal workers, it could also lead to higher informality as it comes after similarly large increases in each of the last three years. Social transfers are expected to increase, largely through an expansion in the coverage of the noncontributory social pension which will likely help reduce poverty in households with elderly members. Some nonmonetary poverty indicators are expected to decline in line with increases in economic activity (food security and access to social security) and increases in public spending (access to health), but budget cuts to other social spending (education) could pose a further setback.

18. **The current account balance will move to a deficit of 0.9 percent of GDP in 2022 as imports recover pre-pandemic dynamism and remittances stabilize.** As the external sector stabilizes and remittances lose dynamism, the current account deficit is expected to widen over the medium term to 1.2 percent of GDP in 2023 and 1.6 in 2024, toward historical values in the long run. Foreign direct investments (FDIs) are projected to remain stable at around 2.0 percent of GDP, fully financing the current account deficit over the medium term. External reserves, currently at record levels, are expected to decrease to about US$190 billion toward 2025, converging to historical levels in the medium term, comfortably covering three months of imports and more than 250 percent of short-term external debt. Despite domestic and financial volatility, Mexico's public and private sectors are expected to keep fair access to external finance supported by a historically high level of international reserves (over US$200 billion in March 2022), exchange rate flexibility, and a moderate economic recovery based on the manufacturing sector.

19. **High inflationary pressures are expected to maintain above-target average inflation of 6.04 percent in 2022 before receding to 3.9 percent in 2023.** Despite the negative output gap, energy and imported goods are expected to maintain inflation outside Banxico's band during 2022 while converging in 2023. These shocks initially expected to be transitory have proved to be more persistent over time. Although the monetary policy rate is currently in neutral territory, the Central Bank is projected to further increase its policy rate in 2022 to preserve its long-established credibility in maintaining price stability and ensure that inflation expectations remain anchored within the Central Bank's 2–4 percent band of tolerance over the medium term. The federal government is also trying to contain inflationary pressures stemming from gas and electricity prices and has committed to reducing excise taxes on gas and increasing subsidies for electricity to maintain price stability. These policies are expected to continue during 2022 as the inflationary pressures on these sectors remain.

20. **The overall PSBR balance is expected to reach 3.4 percent of GDP in 2022 and stabilize around 3.2 percent in the medium term, helped by contained public expenditure, completion of flagship investment projects, and a boost in oil revenue due to higher prices.** The World Bank's projection is more conservative than those included in the budget presented by the authorities.[20] The 2022 budget envisions narrowing the overall fiscal deficit to 2.7 percent by 2025 and stabilizing the net debt-to-GDP ratio at around 46.9 percent. Absent additional tax reforms, revenues as a share of GDP are expected to slowly decline toward 2025 as tax administration measures and tax settlements from past years and the use of trust funds fade over time.[21] With eroded fiscal buffers and growing spending pressures—including the need for higher infrastructure investment to support economic growth—additional fiscal space will be needed, calling for tax reform. Reforms to the Personal and Corporate Income Taxes, Value Added Taxes,

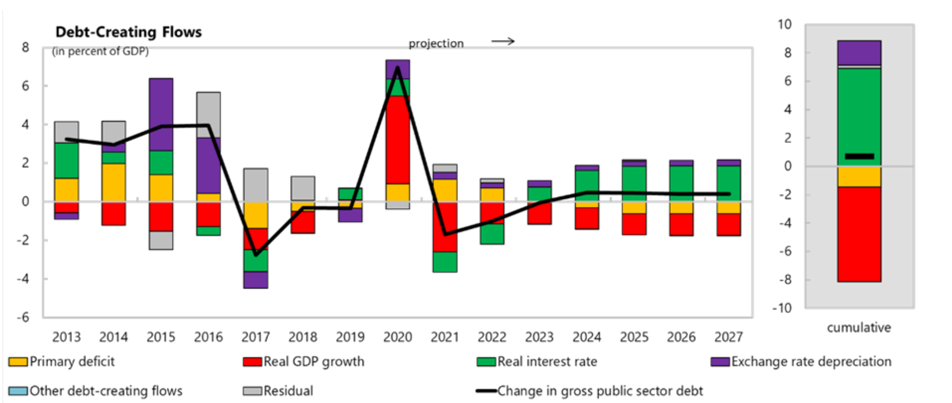
[20] World Bank's staff see a less favorable impact on revenue of the new tax filing regimes. We also include the non-anticipated reduction in revenue in excise taxes on gas and an increase in electricity subsidies as well as higher oil prices compared to the budget assumptions. Compared to the 2022 budget, for the overall fiscal position, we expect a net benefit from the high oil prices of 0.5 percent of GDP. However, since a large share of the oil revenues will go directly to PEMEX, these developments and policies would imply a cost for the federal government of 0.25 percent of GDP.

[21] The revenue stabilization funds were significantly used during the pandemic. For example, the largest fund, the FEIP (*Fondo de Estabilización de los Ingresos Presupuestarios*), shrunk by 96.5 percent, going from 280 billion pesos in 2018 to 9.9 billion at the end of 2021. The FEIEF (*Fondo de Estabilización de los Ingresos de las Entidades Federativas)* also decreased significantly going from 89 billion pesos in 2018 to 21.4 billion pesos in 2021. These funds have not yet been rebuilt, compared to the amounts they held at the end of 2021.

selected Excise taxes, and the property tax can enhance progressivity in the system, reduce taxpayer compliance costs, and foster the competitiveness of the economy by broadening tax bases, reducing exemptions, enhancing tax policy and administration, and encouraging formalization. While PEMEX's financial situation is projected to improve in the coming years given the higher oil prices and government financial support proposed in the budget,[22] it still poses a contingent financial risk. Nevertheless, the medium-term macro framework remains broadly credible, given the Government's conservative fiscal stance and track record of responsible fiscal management.

21. **Net public debt-to-GDP is expected to stabilize at around 50 percent in 2025.** Public debt is projected to decrease moderately over 2022 and 2023 driven by the boost in oil revenues due to the significant increment in international prices and the on-going economic recovery. At the end of 2023, net public debt is expected to reach 49 percent of GDP (57.6 percent of gross terms), beginning to gradually increase over the medium term as oil prices and inflation recede, despite a decreasing overall fiscal year deficit. Fiscal gross financing needs would stabilize below 12 percent of GDP by 2024, in line with a contained fiscal deficit and long-term maturity of public debt. Stress test scenarios suggest that public debt sustainability is relatively resilient to different shocks. Rollover and FOREX debt risks are moderate since more than two-thirds of public debt is denominated in local currency and the sovereign benefits from a long maturity structure.[23] World Bank's staff analysis forecasts PEMEX's financing needs are projected to represent about 1.6 percent of GDP in 2022 and decrease to 1.2 percent by 2025.

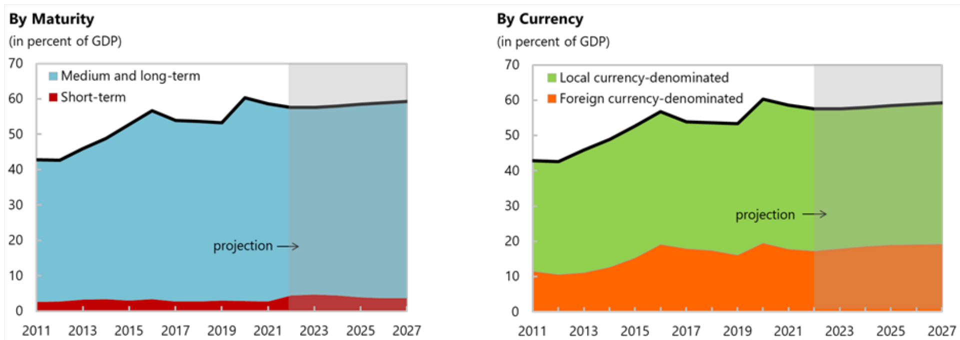
Figure 14. Mexico Debt Sustainability Analysis Debt-Creating Flows (% of GDP)



Source: World Bank's staff estimations.

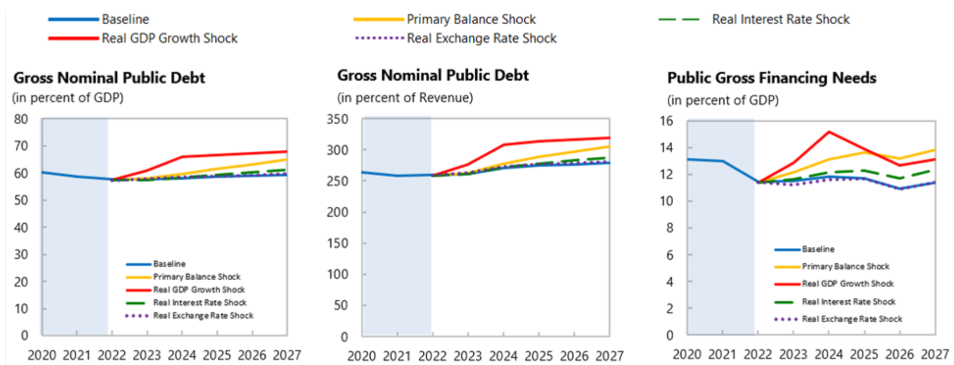
[22] In the form of direct tax rate reduction from 54 to 40 percent.
[23] The federal government debt denominated in pesos had an average maturity of about 7.3 years in 2021 and expected to reach 8.6 in 2025. The average maturity of FOREX bonds was 21.4 years in 2021 and expected to decrease to 18.9 years in 2025.

Figure 15. Mexico Debt Sustainability Analysis Composition of Public Debt



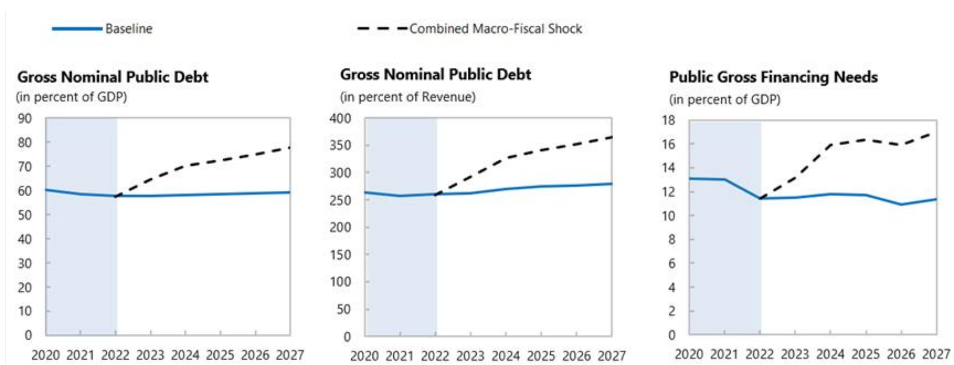
Source: World Bank staff estimations.

Figure 16. Mexico Debt Sustainability Analysis Stress Test



Source: World Bank staff estimations.

Figure 17. Additional Stress Tests



Source: World Bank staff estimations.

22. **The macroeconomic policy framework is adequate for this proposed operation.** Mexico's ongoing economic recovery, supported by a manufacturing sector driven by strong US economic growth and a services sector supported by the reopening of the economy driven by a robust pace in vaccination, is recuperating jobs and reducing poverty caused by the pandemic. The debt trajectory remains sustainable despite the deep economic recession in 2020, supported by a moderate public expenditure

trajectory, and endures different stress test scenarios. The inflation targeting, Central Bank's credibility, and fiscal responsibility law maintain inflation expectations well anchored despite a substantial increment in inflation above its tolerance band (3 percent ± 1 percent). The flexible exchange rate regime (supported by a historically high level of international reserves, swap lines with the US Federal Reserve, and the IMF's current FCL), a mild deficit in the current account, and solid FDI have further strengthened Mexico's external buffers. The financial sector remains well capitalized and is well regulated.

23. **Main risks to the macroeconomic framework stem from persistence in international supply chains bottlenecks and inflation, but there are also important mitigation factors.** Despite strong US demand, persistent bottlenecks of international supply chains could hamper manufacturing and exports. Also, global uncertainty related to the Ukraine-Russia war can lead to financial outflows and/or additional inflationary pressures (i.e., energy, food). The flexible exchange rate remains the first line of defense against external shocks, further supported by significant external reserves (over US$200 billion by March 2022). Growing inflation pressures or an accelerated normalization of US monetary policy may call for Banxico to further expedite interest rate increases. Banxico has well-established credibility and has maintained medium-term inflation expectations anchored. Also, the financial sector entered the crisis well-capitalized. World Bank's staff assessment identifies the main fiscal risks emerging from the medium-term vulnerabilities PEMEX poses that may require further government support or have further credit rating downgrades affecting the sovereign credit rating. Despite significant erosion during the pandemic, fiscal buffers can support liquidity in the short term, helped by additional oil revenues and Mexico's strong track record of responsible fiscal policy. Additionally, private investment represents a medium-term risk as Mexico's declining trajectory is worrisome and may be reduced even further if uncertain regulatory changes, are not resolved, particularly in the energy industry. New variants of the Covid19 virus could reverse the pace of economic recovery but the high vaccination rate mitigates this risk.

Box 2: The economic impact of the Ukraine-Russia war in Mexico

The Russian invasion of Ukraine may affect Mexico through trade, financial markets, inflation, fiscal stance, poverty, and distribution

Trade. Mexico has limited exposure to Ukraine and Russia through trade, with exports/imports less than 1 percent of total Mexican exports/imports. Mexico exports minor amounts of aluminum, grains, and fertilizers and does not compete globally with Ukraine and Russia. The rise in prices of these commodities could make these sectors competitive and increase their export volumes. In the medium term, growing trade uncertainty could favor Mexico if the U.S. increases nearshoring of its supply chains.

Financial Market. The impact of the war on financial markets has been limited so far. Initially, equity prices fell, and demand for USD increased, including the yields of 10-year U.S. government bonds used as safe investments. Overtime, the Mexican peso has appreciated compared to early March, and yields have also recovered. The Ukraine war might affect capital flows and risk in developing economies. These risks are mitigated for Mexico due to its floating exchange rate regime, significant international reserves, and independent central bank.

Inflation. Commodity prices have soared as a result of the war, including oil (37.9 percent increase since early in 2022), natural gas (44.7 percent), and grain prices (e.g., wheat, 36.2 percent, corn, 27 percent, and soybeans, 23.5 percent). These developments are expected to increase around 0.6 percent points inflation forecast in 2022 to 6 percent. Banxico has also updated its projections for annual inflation in 2022 from 5.2 percent to 6.4 percent.

Fiscal stance. Mexico's fiscal position is expected to improve through increased oil revenues. However, to mitigate additional inflationary pressures, the government relies on the revenue increase to cut excise tax on gas and lower the income tax and VAT on gasoline distributors. World Bank's staff analysis projects that the windfall is expected to increase PEMEX revenues by around 0.8 percent of GDP. The federal government is expected to increase revenues by 0.3 percent of GDP with tax exemption cost estimated to be 0.6 percent of GDP, totaling a net cost of 0.25 percent of GDP for the federal government (and a 0.5 percent net benefit for the public sector).

Poverty and distribution. The cost of the basic food basket increased by 13.9 (12.8) percent in rural (urban) areas in the 12 months to end-February, significantly above the average food inflation observed in LAC (9 percent). Food expenditures represent more than 50 percent of total expenditures of the bottom 15 percent of the distribution and more than 40 percent of total expenditures of the bottom 60 percent of the distribution. As such, the purchasing power of poor and vulnerable households will be affected, potentially leading to heightened food insecurity, particularly in urban areas, where the largest number of poor reside.

2.3. IMF RELATIONS

24. **On November 3, 2021, the Executive Board of the IMF considered the staff report that concluded the Article IV consultation with Mexico.** A two-year precautionary FCL arrangement for SDR 44.6 billion (about US$61 billion, at the time of signing) was approved on November 22, 2019. The arrangement was renewed for two years to an initial amount equivalent to SDR 35.7 billion (about US$50 billion at the time of signing) that will be phased out at the request of the Mexican authorities as the risks continue to decline. The IMF and World Bank maintain close collaboration on macroeconomic and structural issues.

3. GOVERNMENT PROGRAM

25. **The National Development Plan (NDP) 2018–2024 includes the programs and public policies reaffirming the GoM's commitment to sustainable development and maintaining a sustainable fiscal framework**. The NDP seeks to relaunch economic growth, anchored on formal jobs creation, by boosting employment generation, improving education, health, and the population's overall well-being. It also pursues balancing economic growth with regional integration and regional economic convergence. The NDP emphasizes interventions that benefit the most vulnerable groups, particularly the poor and the underserved population in rural areas, and policies and programs to achieve the government's target of reducing poverty.

26. **As the government starts the second half of its six-year mandate, the 2022 public budget aims to consolidate the economic recovery following the impact of the pandemic by increasing and**

redirecting expenditures towards health, social programs, sustainable rural development, and public investment in flagship projects. The 2022 public budget[24] aims to prioritize and contain spending while increasing revenue resulting from the economic recovery and growing tax collection, partly due to the simplified tax regime supported by this operation, and higher oil prices. The budget's focus is to prop up the economic recovery by boosting social protection and public health systems and increasing public investment in flagship projects, particularly in the South and Southeast regions of the country, to improve job creation, GDP growth and productivity convergence with the rest of the country. The government has also adopted a new simplified regime for low-income earners to strengthen the tax authority to combat evasion and avoidance, a critical structural challenge in Mexico. The reform is designed to be revenue-neutral in the short term to support the economic recovery and positively impact revenues in the medium term once the recovery occurs due to an increase in formalization resulting from decreasing compliance costs. In addition, Mexico increased the environmental expense budget by 30 percent from 2021 to 2022, ensuring that sustainable forest management and climate change adaptation policies are integrated into Mexico's efforts to boost economic growth, enhance income opportunities, and improve livelihoods for urban and rural populations.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

27. **The development objective of the proposed operation is to support policy measures of the authorities that: (a) support vulnerable groups and regions to reap the benefits of economic recovery; and (b) reform key policies and institutions that enable sustainable economic growth.**

28. **The operation is structured around two pillars.** Pillar 1 supports: (i) adopting a new, simplified regime for MSMEs and self-employed individuals; and (ii) policies and institutional reforms to facilitate financial inclusion, particularly for Mexican migrants in the United States. Pillar 2 supports reforms that: (i) improve the management of climate-induce disasters; (ii) ensure sustainable management and conservation of forests; (iii) enhance conservation areas that mutually store carbon and improve resilience; and (iv) enhance the voice and agency of vulnerable rural populations around natural resource management.

29. **The operation is aligned with the government program.** The operation supports key priorities adopted by the government in the 2022 public budget, including the simplified tax regime and the financial mechanisms to ensure support in case of natural disasters. It also supports key government priorities, such as strengthening the forestry law to bring additional regulatory certainty and regulations to increase financial inclusion. These reforms are expected to benefit the poorest rural areas contributing to closing regional income gaps, one of the main objectives of the government as stated in the NDP.

[24] *https://www.finanzaspublicas.hacienda.gob.mx/work/models/Finanzas_Publicas/docs/paquete_economico/cgpe/cgpe_2022.pdf.*

30. **The design of this DPL includes lessons learned from prior policy operations.** Recent DPFs in Mexico show that stand-alone DPFs provide the needed flexibility for supporting reforms led by the Government in stages, as it builds consensus along the process. DPFs in Mexico have proven more impactful when complemented by a program of technical and analytical tools that help build support around evidence of the reforms and ensure that the World Bank's analytical work is closely aligned to Mexico's demands and reform momentum. The analytical underpinnings of this operation have been based on the broad Technical assistance (TA) and analytical work carried out in the recent past. TA and analytical work are expected to continue in order to support policy implementation under the operation.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Inclusive economic growth

31. **Pillar 1 of the operation focuses on reforms supporting vulnerable groups and regions to better reap the benefits of economic growth, deepening reforms in long-standing areas of engagement with the GoM.** It will do so by (PA 1) simplifying the declaration and payment of taxes for MSMEs, (PA 2) facilitating the identity verification of Mexicans in the US to open bank accounts in Mexico, and (PA 3) expanding the supply of financial services through electronic payment systems.

Prior Action 1: : *The Borrower has enacted an amendment to the Income Tax Law to: (a) strengthen the tax framework by closing loopholes for tax evasion and avoidance, providing the tax authority with new tools to combat tax evasion and avoidance, including in mergers, acquisitions and restructurings; and (b) introduce new simplified regimes for enterprises with income up to an amount of 35 million Mexican Pesos and self-employed, reducing the number of procedures to declare and pay taxes, as evidenced, respectively, by the following provisions under the amendment to the Income Tax Law published in the Official Gazette on November 12, 2021: (i) amendments to Articles 24 and 161 of the Income Tax Law; and (ii) introduction of articles 113-E to 113-J under Title IV, Chapter II, Section IV, called 'Simplified Trust Regime', and Articles 206 to 215 under Title VII, Chapter XII, called "Simplified Trust Regime for legal persons" in the Income Tax Law.*

32. **Rationale.** Mexico has multiple tax regimes with significant administrative burdens that deter formalization, especially for small taxpayers. In Mexico, enterprises require 241 hours a year on average to comply with their tax obligations, compared to 161 hours in OECD member countries. Furthermore, the Tax Incorporation Regime (*Régimen de Incorporación Fiscal, RIF*) introduced in 2014 was not effective in increasing formality or helping business growth. There are 2.1 million taxpayers, individuals, and micro and small establishments in Mexico subject to the same obligations as large companies, raising administrative costs. As a result, tax avoidance and evasion are widespread in Mexico. Several studies show that tax evasion is estimated to be between 2.6 and 6.2 percent of GDP.[25]

33. **Substance of the prior action.** The reform aims to reduce the procedures and time allocated to declare and pay taxes in Mexico to increase tax compliance and facilitate formalization. Implementing measures to reduce informality has become particularly urgent as the share of informal workers has increased. The reform seeks to reduce the cost of compliance for taxpayers with less administrative capacity. The new simplified regime aims to maintain similar effective rates for income tax for individuals

[25] Buehn and Schneider 2016; San Martin et al. 2017.

with lower incomes, calibrating the reform to ensure its revenue-neutrality in the short term. The new regime allows for the auto-population of the monthly tax returns based on e-invoices, significantly simplifying tax filing for small and micro enterprises. Informality will be deterred by simplifying the calculation, reducing the amount of taxes, and fighting the use of invoices—both false and real—currently used to deduct taxes. The reform simplifies the tax regimes for MSMEs and self-employed, and grants, accelerated depreciation to support investment. The RIF's new simplified system for income tax extends to a broader set of taxpayers (i.e., professionals) for individuals with a gross income of up to MXN 3.5 million per year (around US$170,000) and legal entities with an income of up to MXN 35 million annual gross income (around US$1.7 million). The new regime simplifies compliance with tax obligations, preventing the taxpayer from keeping all the digital tax receipts or invoices, since the tax collection will be calculated directly on the total income.

34. **Expected results.** The reform is designed to be revenue-neutral in the short term to support the economy's recovery. Still, it is expected to raise revenues once the economic recovery is well established, partly due to the increase in formalization associated with the reduction in compliance costs.[26] International experience suggests that revenue gains can be large; for instance, in India, Argentina, Switzerland, Chile, and Canada, similar reforms increased 15–30 percent in the taxpayer base over two to three years. The indicator proposed tracks the reform's impact during the timeline of the operation and reduces the number of procedures to comply with tax payment obligations from 8 or 10 in 2021 to 6 in 2022, depending on the taxpayer´s activity, therefore the net reduction in the tax procedures would be equivalent to 2 or 4, respectively. The new regime is expected to increase the taxpayer base above GDP growth in the medium to long term.[27] Also, the reform will improve tax administration by strengthening tax enforcement and simplifying tax compliance. The SAT (Mexico's Internal Revenue Service) will have new monitoring tools to combat tax evasion and avoidance, among others, during mergers, acquisitions, and restructurings.[28] Finally, by reducing informality in the long term, this reform will also lead to higher social security contributions.

Prior Action 2: *The Borrower's Securities and Banking Commission has amended provisions applicable to credit institutions to facilitate financial inclusion for Mexican migrants in the United States and improve the safety and affordability of remittances flows by enabling them to remotely open transaction accounts with Mexican development and commercial banks and including additional credentials to be used as valid documents to prove their identity, as evidenced by the resolution issued by the Borrower's Securities and Banking Commission amending general provisions applicable to credit institutions, published in the Official Gazette on May 21, 2021.*

[26] Materializing the full impact of this reform may require policy makers to act on several fronts at the same time, including simplifying related areas (i.e. labor market regulations) in order to tilt the cost–benefit analysis of firms toward formality by combining both positive and negative incentives.

[27] Most of these will come from a reduction of tax expenditures associated with discounts of personal income taxes, value added tax (VAT), and the special tax on production and services (IEPS) benefiting taxpayers currently filing taxes under the RIF, which represented MXN 13.5 billion (MMP) in 2021. The approved modifications of personal deduction due to donations, which accounted for a MXN 1.1 billion in 2021, are also expected to be reduced by around 30 percent.

[28] For example, in case of identifying a corporate restructuring or a merger whose only reason is the reduction of tax obligations (without a business reason), the legal classification could be changed to an alienation of goods. Also, the reform modifies obligations for natural and legal persons residing abroad. Among these is the obligation to present information on transfer prices to people with a source of wealth located in the national territory.

35. **Rationale.** Remittances represent around 4 percent of Mexico's GDP and are a critical source of financial support for vulnerable households. Mexico's Central Bank estimates that informal remittances account for 3 percent of total remittances. Still, survey-based research indicates that the share is significantly larger and that up to 50 percent of Mexicans residing in the United States use informal channels to remit.[29] Informal channels to send remittances can be costly and carries significant risks for senders and receivers (for example, loss of funds without recourse). Even among those using formal channels, there are opportunities to significantly reduce remittance costs by shifting transactions toward account-based transfers and away from in-person, cash-based methods (for example, some services offered by money transfer operators). For example, some banks now offer zero-cost account-to-account remittance transfers while the cost of a remittance transfer through a money transfer operator can often exceed 5 percent of the total transfer value.[30] Part of the challenge to increasing account-based remittance transfers is related to the relatively stringent criteria for Mexican migrants living in the United States to open bank accounts in Mexico. While some financial institutions recognize '*matrículas consulares'* as a valid identification to open an account, such a standard has not been consistently adopted or mandated. Also, it is mandated that the information at the credential presented by the client for biometric data and the client information at the National Electoral Institute (*Institution Nacional Electoral,* INE) database must match at least 98 percent. Overall, facilitating the shift of remittance transfers to account-based channels can improve the affordability and security of remittance transfers, as well as support financial inclusion and the financial well-being of remittance senders and receivers through greater use of complementary financial products and services (for example, savings accounts and access to credit).

36. **Substance of the prior action.** The reform supported enables Mexican migrants in the United States to remotely open peso-denominated accounts in Mexican banks to have a more secure and efficient flow of remittances. The reform allows for additional credentials—besides the ID card issued by INE—to facilitate account opening by Mexican migrants, including passports and '*matrículas consulares*'. Banco del Bienestar, a state-owned development bank that provides retail financial services, has been particularly active in facilitating account opening among Mexican migrants using passports and '*matrículas consulares*' through their '*Debicuenta Expres'* product; these accounts can be opened online or via their branches in 11 consulates. The measure also reduces the percentage of matching biometric data between the INE database and credentials presented by the client from 98 to 90 percent to reduce the incidence of false match rejections. The ID verification process established in the regulation requires verification of the credentials against a third-party independent source such as RENAPO (*Registro Nacional de Población)* or INE and reduces the accountability of the financial institution if the ID source database does not respond to the inquiry in a prompt manner. Finally, the reform also expands the availability of product and price comparison tools and exchange rate services at ports of entry between Mexico and the United States. Measures taken by the financial authorities complement the objectives of this prior action: expanding the list of municipalities that can receive USD-based transfers conditional on AML/CFT risks mitigation allows greater consumer choice and facilitate lower exchange rate fees.

[29] Dinarte, Jaume, Medina-Cortina, Winkler. 2021. "Neither by Land nor by Sea: the Rise of Electronic Remittances during COVID-19." World Bank Policy Research Paper.
[30] The average cost of sending remittances from the United States to Mexico is 3.65 percent (for a US$200 transfer), which remains above the Sustainable Development Goal of 3 percent.

37. **Expected results.** The reform is expected to support greater uptake and use of transaction accounts by Mexican migrants in the United States. It facilitates remittance flows of Mexican migrants and their families reducing transaction costs and increasing their net disposable income. Remittance's beneficiaries are largely women, children, and the elderly population in low-income segments. The results will be measured by the number of active accounts in Mexican development banks opened by Mexicans abroad[31] (baseline 0 [2020], target 5,916 [December 2023]).

***Prior Action 3:** The Borrower's Securities and Banking Commission and the Borrower's Central Bank, as applicable, have taken measures to promote digital financial inclusion by: (a) issuing secondary regulations for electronic payment institutions under the Fintech Law to ensure adequate consumer protections and cybersecurity of digital payment services, as evidenced by the provisions issued by the Borrower's Securities and Banking Commission and the Borrower's Central Bank applicable to electronic payment institutions referred to in Articles 48, second paragraph, 54, first paragraph, and 56, first and second paragraphs of the Fintech Law, published in the Official Gazette on January 28, 2021; and (b) updating retail agent banking regulations, to ease contracting processes, strengthen security standards, and establish clear rules for contracts with agent network managers, as evidenced by the resolution issued by the Borrower's Securities and Banking Commission that modifies the general provisions applicable to credit institutions published in the Official Gazette on September 23, 2021.*

38. **Rationale.** Digital financial services are a key enabler of the digital economy, allowing for fast and secure transactions between individuals, businesses, and the Government. Robust empirical evidence has also demonstrated that access to digital payment services can improve the financial resiliency of households during economic shocks, including those resulting from climate change. For example, evidence from Kenya has shown that access to mobile money strengthened the adaptive capacity of households to negative shocks (including droughts and floods) by enabling them to receive timely and affordable remittances from their social networks.[32] This positive impact was more pronounced for women—indicating that safe and affordable digital payment services can be of particular benefit to women and help close gender gaps in financial inclusion.[33] Widespread ownership of transaction accounts also enables governments to provide emergency financial support in the wake of climate-related or public health crises. Mexico remains a cash-based economy, with just 47 percent of adults owning a transaction account[34] and 22 percent of banked adults using a mobile phone to make financial transactions. The financial inclusion gender gap is significant, with only 33 percent of women reporting owning a transaction account compared to 41 percent of men and only 28 percent of women reporting making digital payments in the past year compared to 36 percent of men.[35] Lack of physical access to financial institutions has also

[31] SHCP expanded the monitoring of accounts openings by Mexican abroad beyond the US to include Mexican in other countries.
[32] Jack, William, and Tavneet Suri. 2014. "Risk Sharing and Transactions Costs: Evidence from Kenya's Mobile Money Revolution." American Economic Review 104 (1): 183–223.
[33] Jack, William, and Tavneet Suri. 2016. "The Long-Run Poverty and Gender Impacts of Mobile Money." Science 354 (6317): 1288–1292.
[34] Compared to 73 percent across all upper-middle-income economies.
[35] Mexico's 2018 National Financial Inclusion Survey finds a somewhat smaller gender gap in account ownership of three percentage points.

historically been a key driver of financial exclusion, particularly among rural communities that are not well served by traditional financial infrastructure.[36]

39. In line with international good practice and experience, Mexican financial sector authorities recognize that market entry of electronic payment institutions and the expansion of agent-based distribution channels are necessary to overcome financial exclusion, including physical distance, high costs and poor product design.[37] Many of these barriers are particularly acute for women—for example, due to lower incomes—and are compounded by lower levels of access to financial education (see annex 5 for a detailed gender analysis).[38] Electronic payment institutions were introduced under the 2018 Fintech Law (supported by the Mexico Financial Inclusion DPF (P167674) and enable a range of entities, including non-banks (e.g., fintechs, mobile network operators, and bigtechs) to provide basic digital payment services to underserved consumers. The 2018 Fintech Law regulates two types of fintechs: (a) electronic payment institutions; and (b) crowdfunding institutions; however, several provisions of the law required further development via secondary regulations to provide regulatory certainty to market participants and support the safe and sustainable development of the industry.[39]

40. Agent-based models, in which retailers act on behalf of a financial institution to facilitate basic financial transactions, allow financial institutions to leverage existing retail infrastructure and serve consumers at a significantly lower cost than through brick-and-mortar branches or automated teller machines (ATMs). Retail agent networks have been a critical component of successful financial inclusion strategies in many countries, including Brazil, Kenya, China, and India. Yet retail agent networks in Mexico remain underdeveloped, particularly in rural areas where the potential impact is largest.[40]Within Mexico, the states with the highest penetration of retail agents are mostly in the north (for example, Nuevo Leon (8.5) and Baja California Sur (8.1)), while many southern states have low retail agents penetration (for example, Campeche (4.9)). Just 31 percent of rural municipalities have one or more retail agents.[41] Prior diagnostic work by the World Bank has identified onerous requirements and bottlenecks in the agent authorization process, which have discouraged the use of agents by financial institutions.

41. **Substance of the prior action.** Part (i) of the reform supports secondary regulation to define necessary identity authentication, cybersecurity, technological infrastructure, and consumer protection rules for electronic payment institutions licensed under the Fintech Law, thereby fostering the safe and

[36] For example, adults in the northeast are 50 percent more likely to have an account compared to those in the southeast and 29 percent of unbanked Mexicans report that they do not have an account because financial institutions are "too far away" (Global Findex 2017).
[37] See, for example, Objective 3.1 of Mexico's 2020–2024 National Financial Inclusion Policy.
[38] See, for example, United Nations. 2020. *Los Servicios Financieros en México con Perspectiva de Género: Avances y Áreas de Oportunidad.* https://www.mx.undp.org/content/mexico/es/home/library/poverty/los-servicios-financieros-en-mexico-con-perspectiva-de-genero--a.html.
[39] Mexico's 2020–2024 National Financial Inclusion Policy (PNIF - *Política Nacional de Inclusión Financiera*) establishes national objectives and reform actions to increase financial inclusion. The PNIF emphasizes the role of catalytic role of fintech to achieving national financial inclusion goals, and authorities have prioritized legal and regulatory reforms to develop a fintech ecosystem in Mexico.
[40] Mexico has just 4.8 agents per 10,000 adults, significantly lower than regional peers including Colombia (56) and Peru (73).
[41] About 36 percent of municipalities in Mexico remain unserved by retail agents.

sustainable development of Mexico's digital financial services ecosystem. The regulation also allows retail agents operating on behalf of fintechs to perform several customer services (e.g., cash-out, transfers, and bill payments) subject to certain rules. These provisions are critical to ensure that digital financial services offered by fintechs are safe for consumers and do not threaten the integrity and stability of the financial system. The regulation, particularly the provisions on cybersecurity and consumer protections, is expected to address some of the drivers of the financial inclusion gender gap, given higher observed levels of distrust and risk perception among women. The overall anticipated increase in consumer choice and competitive pressure toward more affordable options—with more providers and products entering the market—is also expected to help close persistent financial inclusion by increasing the supply of affordable financial products that meet the needs of underserved groups, including women.

42. The development of regulations under the Fintech Law (including the regulation supported under the Prior Action) delayed the initial authorization processes for new fintech firms. However, the pace of authorizations has accelerated since 2021. As of October 2021, 22 fintech firms have received licenses under the Fintech Law, including both e-money and crowdfunding entities. The remaining challenges and opportunities to foster an innovative, safe, and sustainable Fintech ecosystem will be analyzed in the forthcoming Financial Sector Assessment Program.

43. Part (ii) of the reform supports revisions to existing agent banking regulations to ease contracting processes, strengthen security standards, and establish clear rules for contracts with agent network managers, thereby promoting sustainable growth in retail agent networks.[42] The revised regulation establishes a risk-based approach to classifying financial transactions processed through agents and outlines detailed requirements for the minimum contents of contracts between credit institutions and agents, in line with international good practice. The new regulation also promotes a greater role for agent network managers: third parties contracted by banks to manage their agents. It provides regulatory certainty on key aspects of their operations and contracts to facilitate their role in the responsible growth of agent networks. Finally, the revised regulation strengthens security standards for retail agents to ensure the reliability and security of services offered to financial consumers through retail agents. The reform complements the Government's policy to expand the branch network of *Banco del Bienestar* to provide convenient access to a range of financial services and providers in most rural areas.

44. **Expected results.** The reforms are expected to support the safe and sustainable development of Mexico's digital financial services ecosystem.[43] The results will be measured by the percentage of adults with access to at least one financial product (baseline: 63.8% [2018]; target: 77.2% [December 2023]) and

[42] For example, the prior action removes a previous requirement for credit institutions to seek regulatory authorization for each individual agent; under the new regulation, credit institutions can seek a blanket authorization for agent networks as part of their strategic plan (including business model and master contract).
[43] For example, according to the *Digital Development Gender Strategy (WB, 2021)*, consumer protections that support clear, transparent, and simple language about product pricing and terms, as well as effective redress mechanisms, can help address women's needs and ensure data protection and privacy.

the average gender gap in ownership of various financial products (percentage points) (baseline: 7.4 percentage points [2018]; target: 0 [December 2023])[44].

Pillar 2: Sustainable economic growth

45. **The policy reforms supported by this operation show a progressive ambition of Mexico's sustainable growth policies.** Pillar 2 of the operation supports reforms that foster sustainability and resilience, addressing risks to people and the economy in an integrated manner, in line with the World Bank GRID framework. Supported reforms include new regulatory and policy instruments that tackle deforestation (PA 6) and mitigate CO_2 emissions from land-use change (PA 5). They also reduce the vulnerability of the population most exposed to climate-induced impacts through enhanced disaster risk management (PA 4) and expansion of NPAs to improve climate change adaptation (PA 8). They also enhance the voice of IPs and those underrepresented, specifically women (PA 7).

***Prior Action 4:** The Borrower has taken measures to strengthen its capacity to rapidly mobilize and target funds post-disaster by establishing provisions detailing budgetary mechanisms for financing projects and programs to respond to natural emergencies and disasters, as well as promoting the use of financing and risk transfer mechanisms to complement budgetary mechanisms, as evidenced by the specific provisions that establish the budgetary mechanisms to execute programs and projects to address the damages from natural phenomena issued by the Head of the Policy and Budgetary Control Unit of the SHCP, published in the Official Gazette on November 23, 2021.*[45]

46. **Rationale.** Mexico is highly exposed to natural hazards and climate risks and has historically been a global champion and standard setter for proactive, data-driven approaches for identifying and managing climate and disaster risks and impacts.[46] In addition, effective disaster risk management is an integral part of countries as they pursue sustainable, resilient economic growth. Enhancing Mexico's capacity to manage disasters is also required to enhance the country's adaptation capacities. Effectively managing emergencies after disasters will significantly enhance Mexico's capacity to address disaster impacts and plan better for future scenarios, with important benefits for the country's economic growth strategies in light of increasing climate impacts. For that reason, Article 37 of the Federal Law of Budget and Fiscal Responsibility (*Ley Federal de Presupuesto y Responsabilidad Hacendaria*) establishes that the federal budget must include provisions for preventive actions or execute programs and projects to address the damages provoked by natural disasters. Budget availability and clear processes to dispose of and manage that budget are key aspects of public policies to reduce the vulnerability of local populations to climate change effects.

[44] The baseline for both indicators will be updated during the supervision of the operation to include the results from the financial inclusion survey that will be released in mid-2022.
[45] https://www.dof.gob.mx/nota_detalle.php?codigo=5636005&fecha=23/11/2021.
[46] The backbone of Mexico's disaster risk management system is the legal, regulatory, and operational framework shared between the Secretariat of Security and Civil Protection (*Secretaría de Seguridad y Protección Ciudadana,* SSPC) and SHCP on financial and operational aspects of disaster management.

47. Furthermore, the budget assigned for 2022 for emergency-related expenditures only covers financing needs for an average (or below average) year in terms of annual losses. Mexico is currently quite financially exposed to another high-impact event like the 2017 earthquake. An event of this scale would exceed the 2022 budget and, in the absence of alternative risk financing arrangements, would negatively impact other development programs' budgets. Since the abrogation of the Mexico's National Disaster Fund (FONDEN), the Ministry of Security and Civil Protection (SSPC) has clarified operational aspects, including assessing damages. There was the risk that without clarity on assessing damages and budgetary mechanisms, in the event of a disaster, public financial resources could not be deployed or be done with delay.

48. **Substance of the prior action.** The provisions published by the Ministry of Finance and Public Credit (SHCP) under the Federal Law on Budget and Financial Responsibility establish budgetary mechanisms for financing emergency response and reconstruction (housing and public infrastructure) projects and programs. They clarify the procedures for line ministries to request resources following the Declaration of a Natural Disaster by SSPC or a corresponding declaration of health emergency by the General Health Council. These new provisions are a tool to guarantee the Government's timely response to climate-induced natural disasters to assist affected populations, especially the most vulnerable, by deploying financial resources. The provisions also cover procurement of insurance and risk transfer instruments for damage caused by natural phenomena and further specify that these schemes must be contracted to protect the public balance sheet under the leadership of the Insurance, Pensions, and Social Security Unit (Unidad de Seguros, Pensiones y Seguridad Social - USPSS) of SHCP. USPSS would be responsible for developing schemes to define the details of the Government's disaster risk financing strategy going forward. Thus, the new budgetary provisions also enable Mexico to better establish an effective response to climate-linked natural disasters.

49. **Expected results.** The prior action is expected to facilitate the flow of resources to sectors and states affected by climate-induced natural disasters, particularly the southern states, that are more vulnerable to climate-induced natural hazards and have less financial space to address them. It is also expected to promote internal institutional collaboration within the Ministry of Finance on the interface between prearranged budgetary and financial mechanisms to prepare for disaster and climate shocks, for example, procurement of disaster insurance schemes. The results will be measured by the number of risk financing instruments internally requested and supported by sound technical analysis. These instruments will be selected and ultimately designed based on commercially-credible actuarial analysis to support optimal cost efficiency and coverage. This result will ultimately enable Mexico to strengthen its capacity to better prepare for future climate-induced external shocks and integrate disaster risk management budget planning as an essential element to the country's long-term adaptation planning.

Prior Action 5: *The Borrower has enacted an amendment to the Forest Law to establish that SEMARNAT can only authorize land use change in forest lands for projects that, among others, mitigate the loss of forests' carbon storage capacity, as evidenced by the amendment to the first paragraph of Article 93 of the Forest Law published in the Official Gazette on April 26, 2021.*

50. **Rationale.** Regulating land use change is an integral tool for sustainable development as it establishes the conditions under which natural vegetation, including forests, can be removed to facilitate infrastructure development. In Mexico, the forest legal framework regulates the mitigation and compensation of the environmental impacts of these land use change activities. Removal of forest vegetation is prohibited except if the proposed project obtains a land use change authorization from SEMARNAT, which needs to verify that biodiversity will be maintained and how the impacts on water and soils will be mitigated. These projects must also contribute to CONAFOR's '*Fondo Forestal Mexicano'* to restore forests in other areas of the same watershed where the land use change occurred. However, before 2021, the law did not consider measures to demonstrate that the loss in carbon storage capacity would be mitigated, diminishing these ecosystems' capacity to act as carbon sinks. Forests play a crucial role in achieving Mexico's NDC targets (the land use, land use change, and forestry [LULUCF] sector removals are 163 $MtCO_2$ per year, which is 20 percent of the country's emissions). However, according to Mexico's Forest Emissions Reference Level, the country emitted 20.2 $MtCO_2e$ per year from 2007 to 2016 due to deforestation and forest degradation. Only a portion of this deforestation is legal.

51. **Substance of the prior action.** In 2021, the GoM amended Article 93 of the Forest Law to establish that projects in forest lands seeking land use change authorization must mitigate their impacts on the loss of carbon stocks of forests. This will mitigate emissions from the LULUCF sector, which according to Mexico's updated NDCs in 2020 were 36 $MtCO_2$ and are expected to further increase (in the business-as-usual scenario) to 49 $MtCO_2$ in 2030. Hence, this policy will help Mexico attain its NDC, which pledges a reduction of 22 percent of greenhouse gas (GHG) emissions by 2030.

52. **Expected results.** It is expected that 100 percent of the land use change authorizations in forest lands will include mandatory measures to mitigate the reduction of carbon storage capacity. In addition, at project closure it will be possible to quantify the reduction of stored carbon that was avoided through these measures.[47] Without this prior action, the carbon stored in forests affected by land use changes would have been released into the atmosphere (up to 0.88 million tCO2 based on the area that obtained land use change authorizations in previous years) as no mitigation measures were mandated by the Forest Law before.

Prior Action 6: *The Borrower has enacted an amendment to the Forest Law to enhance forest protection by forbidding the issuance of land use change authorizations in forest lands that were previously deforested, as evidenced by the amendment to Article 97 of the Forest Law dated April 20, 2021, and published in the Official Gazette on April 26, 2021.*

53. **Rationale.** Mexico lost almost 1 million ha of forests from 2014 to 2016 due to deforestation.[48] First, this generated GHG emissions of around 26 million tons of CO2 per year (around 3.2 percent of Mexico's yearly emissions). This is particularly important considering that Mexico's forests currently represent a carbon sink (they remove more CO2 than they emit). However, the LULUCF sector generates 4.5 percent of all emissions. Second, the loss of natural ecosystems particularly increases the vulnerability of marginalized communities to climate change and reduces their opportunities to generate sustainable

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[47] A quantification at project preparation is not possible given the uncertainty on the number and scope of permits to be requested. An ex-post analysis is feasible based on actual permits requested and endorsed.
[48] These are the most recent official data for deforestation: CONAFOR. 2020. Mexico's proposed reference level. Available online at: https://redd.unfccc.int/files/nref_2007-2016_mexico.pdf.

rural local economies as they have a high dependency on natural phenomena.[49] In Mexico, forests are mainly owned by communities.[50] Around 3,520 of them have management plans for timber or non-timber forest products[51] that enable them to generate income and employment from its sustainable use and commercialization. Deforestation affects the possibilities of scaling up these initiatives to foster sustainable rural livelihoods. However, the efforts to halt deforestation are challenged by several negative incentives to illegally change land use,[52] such as establishing high-value commercial crops or constructing the infrastructure that can affect communities' capacity for long-term sustainable development. Before 2021, landowners could deforest their land expecting not to be detected, and if caught, they could pay the fine and then ask for a land use change authorization to legalize the land use change[53].

54. **Substance of the prior action.** The law modification prevents the authorization of land use changes in forest lands that were previously deforested, eliminating perverse incentives to deforestation and compelling land managers/owners to use the legal channels to ask for land use change authorizations before developing any project. When done through these legal channels, land use change projects must mitigate their environmental impacts and pay a compensation fee to CONAFOR's 'Fondo Forestal Mexicano' to be used in ecosystem restoration activities. The policy reform specifically prohibits land use change authorization in forest lands for 20 years after the deforestation occurred and until the forest has completely regenerated, hereby recognizing the long-term value of forests to sustainable growth.

55. **Expected results.** It is expected that 100 percent of the land-use change authorization requests in previously deforested will be denied authorization from SEMARNAT. This will directly contribute to Mexico's NDC target of zero net deforestation by removing some incentives to deforest illegally.

Prior Action 7: *The Borrower has enacted an amendment to the Forest Law to introduce free, prior, and informed consultation for authorizing land use changes in forest lands that are located in indigenous territories, as evidenced by the amendment to the second paragraph of Article 93 of the Forest Law published in the Official Gazette on April 26, 2021.*

56. **Rationale.** IPs represent 21.5 percent of Mexico's population (25.7 million).[54] Historically, they are among Mexico's most vulnerable and marginalized population groups and suffer from exclusion to services and markets in higher numbers than non-IPs. In 2020, 73.2 percent of IPs lived in poverty (29.2 percent in extreme poverty), compared to 47.1 percent of the non-indigenous population (6.4 percent in extreme poverty). In addition, 19 percent of the municipalities highly vulnerable to climate change are classified as indigenous municipalities, and the effect of climate change on the livelihoods of the most vulnerable is disproportionally high. Thus, both extreme climate and slow-onset climate change events, represent additional stressors that will most likely worsen the situation of vulnerable populations in the country. Article 27 of the Mexican Constitution establishes that the law must protect the integrity of the lands of the IPs, which are key for the conservation of their natural heritage and the creation of thriving and resilient livelihoods. Mexico has adopted legal and institutional instruments that recognize the IPs'

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[49] World Bank. 2018. Mexico - Systematic Country Diagnostic (English). Washington, DC: World Bank Group.
[50] Madrid, L., Núñez, J. M., Quiroz, G., & Y., R. 2009. *La propiedad social forestal en México. Investigación Ambiental.* Instituto Nacional de Ecología.
[51] SEMARNAT. 2021. *Anuario estadístico de la producción forestal 2018*.
[52] CONAFOR. 2019. *Estado que guarda el sector forestal en México*.
[53] According to CONAFOR (2019), from December 2018 to June 2019, there were 383 inspections by PROFEPA to land use changes.
[54] INEGI's Census 2020: https://www.inegi.org.mx/programas/ccpv/2020/.

rights to consultation regarding any legal or administrative government measure that may affect them.[55] However, before 2021, the environmental legal framework did not include the IPs' consultation as part of the processes of the main environmental administration procedures, such as the environmental impact evaluation or the land use change authorization. For that reason, this 2021 reform to the Forest Law strengthens the environmental policy instruments for more inclusive and sustainable economic growth. The aforementioned enhances the voice and agency of rural indigenous communities and enables an inclusive process within the country's growth strategies.

57. **Substance of the prior action.** In line with the constitutional rights of IPs in Mexico, in April 2021, the borrower approved a reform to Article 93 of the General Law of Sustainable Forest Development (Forest Law),[56] establishing that land use change authorizations in forest lands located in indigenous territories must be accompanied by a free, prior, and informed consultation. For that, SEMARNAT must coordinate with the National Institute of the Indigenous Peoples (*Instituto Nacional de los Pueblos Indígenas*), which is legally in charge[57] of leading IPs' consultations. Hence, no land use authorizations in forest lands may be granted in indigenous territories without this process. This participatory process in land use changes will lead to social inclusion in climate-relevant actions, empowering IPs and enhancing the voice and agency over land use change processes in their territory and associated mitigation actions established as part of the authorization. This enables IPs to engage in decision-making over climate change solutions on the ground.

58. **Expected results.** The prior action will improve the right to information and self-determination of IPs as well as the right to preserve their territories, established in the Mexican Constitution and align with Convention No. 169 of the ILO. The results will be measured considering the percentage of land use change authorizations in forest lands affecting indigenous territories that include a free, prior, and informed consultation process. These consultations will ultimately enable rural indigenous communities to protect their territories and natural resources against external threats, which also enhances their capacity to generate local income opportunities through natural resource management. In addition, as all consultations under this policy reform relate to land use changes that if agreed include mandatory mitigation measures on biodiversity and carbon, among other, the reform also fosters local nature-based solutions for climate change adaptation.

Prior Action 8: *The Borrower has declared a new natural protected area in the Sierra of San Miguelito to enhance protection of natural capital and climate change resilience, and foster sustainable development, as evidenced by the Presidential Decree published in the Official Gazette on December 13, 2021.*

59. **Rationale.** Mexico ratified the Paris Agreement in September 2016 and has pledged to reduce 22 percent of its GHG emissions by 2030,[58] including a specific objective of enhancing conservation,

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[55] Mexico is a signatory party of the Indigenous and Tribal Peoples Convention (No. 169) of the International Labour Organization (ILO). Mexico has developed legal and public policy instruments, such as the Law of the National Institute of the Indigenous Peoples, the 2019 published protocol for the free, prior, and informed consultation of indigenous peoples and Afro-descendants (http://www.inpi.gob.mx/gobmx-2019/convocatorias/inpi-protocolo-consulta-reforma-constitucional-derechos-pueblos-indigenas.pdf), and the National Program for the Indigenous Peoples 2018–2024 (https://www.gob.mx/cms/uploads/attachment/file/423227/Programa-Nacional-de-los-Pueblos-Indigenas-2018-2024.pdf).

[56] https://www.diputados.gob.mx/LeyesBiblio/pdf/LGDFS_260421.pdf.

[57] Law of the National Institute of the Indigenous Peoples: https://www.gob.mx/cms/uploads/attachment/file/421725/ley-INPI-dof-04-12-2018.pdf.

[58] 2020 Update of Mexico's NDCs.

restoration, and sustainable use of biodiversity and ecosystem services. This objective addresses both climate change mitigation and adaptation targets by recognizing the fundamental role of nature-based solutions in enhancing resilience and natural ecosystems' capacity to store carbon. The objective is implemented by expanding natural protected areas (NPAs) and strengthening their management and connectivity, among other actions, as NPAs conserve forest carbon stocks, mitigate climate change, and increase the resilience of local communities against the effects of climate change. To date, Mexico's NPA system has a clear legal and institutional framework that effectively protects ecosystems. With this new declaration, Mexico now has 184 federal NPAs that account for 90.9 million ha, of which 21.48 million ha is terrestrial. NPAs are one of the main nature conservation instruments established in the Mexican environmental law. In the case of Sierra de San Miguelito this was threatened by the disorganized growth of urban areas of the capital city and extensive wildfires that had degraded a large area of pine forests. In addition, in and around the new NPA, various extractive activities threatened the natural ecosystem, resulting in the loss of critical forest coverage.[59]

60. **Substance of the prior action.** The declaration of 'Sierra de San Miguelito' as a natural protected area provides a protection status under the Mexican environmental law to 111,160 ha. This will benefit around 1 million people living in and around the broader NPA through critical ecosystem services.[60] The NPA is also the habitat of 700 vegetation and 300 animal species, 50 of which are under threat. The decree (a) forbids land-use change, mining, and other extractive activities in the 'core zone' of the NPA (24,516 ha); (b) restricts potentially harming activities in the 'buffer zone' (85,122 ha); and (c) regulates how to sustainably manage the ecosystems and natural resources in the NPA sustainably. The type of NPA selected allows for a broad variety of sustainable natural resource management and development activities for local inhabitants, complemented by governmental support programs to develop economic activities linked to conservation.

61. **Expected results.** The prior action will ensure the conservation of 89,362 hectares of ecosystems that store approximately 1.1 million tons of carbon, equivalent to 4.2 million tons of CO_2.[61] The indicator recognizes the natural protected areas' carbon capture capacity. In absence of the NPA decree, this capacity to store carbon was at risk, given important drivers of deforestation in the area and expansion of urban centers. Through the decree, carbon capture capacity has been secured. This will directly benefit Mexico's NDC, that includes a zero net deforestation target and largely depends on enhanced carbon sinks to achieving its mitigation targets. The newly declared area will also enhance adaptative capacity of local populations through enhanced natural resources management.

Table 4. DPL Prior Actions and Analytical Underpinnings

Prior Actions	**Analytical Underpinnings**
Prior Action 1	• WBG (2018). Mexico: Systematic Country Diagnostic, that identifies the need to raise tax collection to improve public service and infrastructure services, while reducing reductions to business environment.

[59] Previous Technical Study of the NPA of Sierra de San Miguelito. https://www.conanp.gob.mx/anp/consulta/1.%20EPJ%20Sierra%20de%20San%20Miguelito%2028ene2021_reduc.pdf
[60] NPA technical study.
[61] Carbon Storage was calculated as of March 2022 based on emission factors published in Mexico's National Forest Emissions Reference Level reported to the UNFCCC (https://redd.unfccc.int/submissions.html?country=mex).

Prior Actions	Analytical Underpinnings
	• WBG (2021). Mexico Review of Tax Revenues: Options for Reform Identifies reform options to improve equity, simplicity, and efficiency of Mexico Tax system, eliminating tax exemptions, broadening tax bases, enhancing tax policy and administration and encouraging formalization.
Prior Action 2	• WBG (2018). Mexico: Systematic Country Diagnostic that identifies the need to increase financial inclusion. • WBG Financial Inclusion Global Initiative (FIGI) TA (2018–2021). Support measures to improve ID ecosystem in Mexico. • The World Bank through the Financial Inclusion Global Initiative ASA (P167371) has been supporting the adoption of measures to improve ID ecosystem in Mexico and broaden the types of credentials accepted by financial institutions for client onboarding and contributed to the establishment of an ID verification service at RENAPO. • The ASA "Design of the Foundational Digital ID System in Mexico" (2021) provided RENAPO support on consensus building around the ID system, data quality assessments on the biometric data.
Prior Action 3	• WBG (2018). Mexico: Systematic Country Diagnostic that identifies the need to increase competition in the financial sector and boost financial inclusion. • WBG (2022). Productivity Growth in Mexico that identifies the need to boost competition and access to finance for most productive firms. • WBG FIGI TA (2018–2021). Support the development of Mexico's regulatory framework for Fintech. • The development of Mexico's regulatory framework for fintech has been supported by TA under the Financial Inclusion Global Initiative ASA (P167371). For example, the World Bank provided detailed technical comments on a series of technical notes prepared by financial sector authorities to inform the drafting of secondary regulations under the Fintech Law. • The World Bank through the Financial Inclusion Global Initiative ASA (P167371) has supported the development of Mexico's regulatory framework for retail agents, including through a 2018 diagnostic on challenges and opportunities to promote retail agent models.
Prior Action 4	• WBG (2018). Mexico: Systematic Country Diagnostic, that highlights Mexico's vulnerability to climate induced natural hazards and the need to strengthen institutions for DRM. • WBG ASA Supporting Financial Preparedness and Sustainable, Resilient and Inclusive Cities in Mexico ASA (P174703) identifies the need to align budgetary mechanisms for disaster response to average annual losses, and to develop risk financing strategies to protect the public balance sheet and transfer risks to the private sector where this is cost effective.
Prior Action 5	• WBG (2018). Mexico: Systematic Country Diagnostic, that showcases the importance of Mexico's forest for climate change adaptation and mitigation, and a source of income and livelihoods for rural and indigenous communities. • Mexico: Programmatic Forest Country Note (2018), that includes forests' contribution to Mexico's growth and competitiveness, and highlights the needs to strengthen institutions for forest management and protection.

Prior Actions	Analytical Underpinnings
	• WBG ASA Climate Change Mitigation and Adaptation Policies (P177455). It supports the GoM with analytic underpinnings for the identification of transition pathways toward a low carbon and climate resilient economy, including the role of forests to achieve the country's NDC.
Prior Action 6	• WBG (2018). Mexico: Systematic Country Diagnostic, that showcases the importance of Mexico's forest for climate change adaptation and mitigation, and the need to better articulate cross sectorial policies to avoid deforestation. • Mexico: Programmatic Forest Country Note (2018), that includes forests' contribution to Mexico's growth and competitiveness, and the main drivers of deforestation including adverse incentives for land use changes. • WBG ASA Climate Change Mitigation and Adaptation Policies (P177455). It supports the GoM with analytic underpinnings for identifying transition pathways toward a low carbon and climate-resilient economy, including the role of forests in achieving the country's NDC.
Prior Action 7	• WBG (2018). Mexico: Systematic Country Diagnostic, which includes the importance of fostering the development, including voice and agency of Mexico's rural population that mostly depends on natural resource management for income generation • Mexico: Programmatic Forest Country Note (2018), that includes a specific analysis of poverty and forest dependency and the importance of enhancing voice and agency of forest dependent. • WBG ASA on Indigenous Peoples and Afro-descendants Inclusion and Resilience in Mexico (P178291). It includes analytical work on the role of social inclusion for Mexico's sustainable growth objectives. • WBG ASA Climate Change Mitigation and Adaptation Policies (P177455). It includes initial assessment of the climate change impact on the poor.
Prior Action 8	• WBG (2018). Mexico: Systematic Country Diagnostic that showcases the importance of Mexico's forest for climate change adaptation and mitigation, and the importance of forest conservation for income and livelihoods of rural and indigenous communities • Mexico: Programmatic Forest Country Note (2018), which highlights Mexico's biodiversity and the importance to protect forest ecosystems. • WBG ASA Climate Change Mitigation and Adaptation Policies (P177455). It supports the GoM with analytic underpinnings for the identification of transition pathways toward a low carbon and climate-resilient economy, including the role of forests to achieve the country's NDC.

4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

62. **The proposed operation is aligned with the three focus areas of the Country Partnership Framework (CPF) for Mexico (FY20-25) (Report No. 137429-MX),** discussed by the Board of Executive Directors in February 2020, and its institutional building features. Under the focus area "Supporting more rapid, and more inclusive growth", this operation contributes to Objective 1: Foster Financial intermediation and inclusion. Under the focus area "Strengthening institutions for public finance, service

delivery, and economic inclusion," the project contributes to Objective 4: Strengthening the institutional capacity to deliver inclusive social service. Under the focus area "Enabling sustainable infrastructure and climate action," it contributes to Objective 6: Provide more inclusive and sustainable infrastructure services and Objective 7: Support the government in reaching the climate change goals.

63. **DPL is also aligned both with the GRID approach paper and the COVID 19 Crisis Response Approach Paper.** As part of GRID approach, the operation promotes economic growth with environmental goals (forest protection), and equitable (rural development) and social inclusion (access to financial services). In terms of the COVID-19 Crisis Response AP, the DPL is mainly aligned with pillar 4 strengthening policies and institutions for restructuring the economy.

64. **The proposed operation builds on recent engagement and complements on-going and pipeline operations.** Pillar 1 complements reforms supported by the 2021 Mexico Strengthening Economic Sustainability DPF (P174150) and the 2020 COVID-19 Financial Access DPF (P172863), particularly those associated with economic resilience, MSMEs regulatory framework, and financial inclusion. Pillar 2 complements reforms supported by the 2021 Environmental Sustainability and Urban Resilience DPF (P174000), particularly those aimed at strengthening the climate-change adaptation capacity of the most vulnerable municipalities. The proposed operation also complements on-going analytical work (Mexico: Financial sector reforms to support sustainable and inclusive post-Covid recovery (P177756) and Mexico: Climate Change Adaptation and Mitigation Policies (P177455)) and investment operations further enhancing Mexico's economic and climate resilience in the agriculture and housing sectors.

65. **Moreover, the program supported is aligned with the WBG maximizing finance for development approach.** Policies to facilitate access to credit were discussed with IFC and aim to attract private finance to improve financial inclusion and develop e-payments through fintech solutions. The operation also incorporates contributions from IFC on private sector issues.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

66. **The Government's reform programs include an open process of consultations.** The approval of laws and regulations follows consultation with public and private sector stakeholders, in general. After the public consultation has been carried out and following publication in the Official Gazette of the Federation, the relevant authority publishes a pronouncement regarding the comments, opinions, and proposals received, specifying, where appropriate, which resulted in adjustments and specifications. These policies reflect the best practices promoted by the OECD. Reforms such as PA1 on tax reform or PA4 on DRM financing that were included in the public budget proposal and submitted to the congress for approval (*Miscelanea Fiscal*), were discussed in several committees as part of the budget approval, calling private sector representatives to present their views as needed (*Parlamento Abierto*).

67. **Environmental sector reforms have been consulted with multiple stakeholders.** The reforms to the Forest Law were consulted under a multistakeholder oversight body, the National Forestry Council (*Consejo Nacional Forestal*, CONAF) with the participation of state governments, academia, forest communities, indigenous communities, and NGOs. The declaration on the new national protected area

was subject to a participatory process in which the Previous Justification Study (Estudio Previo Justificativo) was publicly released and was subject to consultation.[62]

68. **There were inputs from IFC on private sector issues.** IFC provided inputs on some of the financial policy reforms. IFC has an important portfolio with financial intermediaries and fintechs to support credit to MSMEs, Banking on Women, and works with the World Bank on the fintech policy agenda. The World Bank and IFC jointly implement the 30x30 zero program in Mexico, funded by German cooperation, that aims to have 30 percent of banking sector portfolio on assets with zero carbon footprint by 2030. As part of this project, the World Bank is supporting the formulation of a sustainable taxonomy, in close cooperation with the German Agency for International Cooperation (*Deutsche Gesellschaft für Internationale Zusammenarbeit*).

69. **The program is also aligned with the support of other development partners.** The program complements efforts of the Inter-American Development Bank (IADB) and several bilateral development partners across issues. On digital financial services/fintech, the World Bank has been working closely with the Bill & Melinda Gates Foundation (FIGI funders) as well as coordinating with the United Nations Development Fund, the Better Than Cash Alliance, and Queen Máxima from the Netherlands in her capacity as the UN Secretary-General's Special Advocate for Inclusive Finance for Development. Finally, together with the French Development Agency (*Agence Française de Développement*), the World Bank supports Mexico's climate change and green finance efforts. The World Bank exchanges views and information and collaborates closely with the IMF on macroeconomic and structural issues.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

70. **The policy measures supported under this DPL are expected to simplify tax compliance, promote financial inclusion, foster sustainable forests, and improve disaster risk preparedness.** All the proposed actions have the potential to have positive poverty and social impacts. However, in some instances, this will depend on the implementation details, while in other instances, potential negative impacts will be further assessed. In the following paragraphs, these impacts are summarized for each prior action. Details are presented in annex 5.

71. **The expected poverty and social impacts of the income tax amendments are expected to be neutral in the short and long term.** The amended legislation should lower compliance costs for a large set of MSMEs taxpayers. The reform was calibrated to be, on average, revenue neutral in the short run, but the impact may vary for taxpayers depending on their eligibility and the tax exemptions applied before. International literature shows that simplified tax regimes can lower barriers to formalization and broaden the tax base in the short run. However, previous attempts in Mexico have not yielded large effects on formalization, reflecting a broader set of constraints to formalization decisions. The tax amendments are expected to have small or negligible impacts on poverty in the short run. In the long run, poverty and social impacts will depend on how additional revenues are used. Increased formalization could lead to

[62] *https://www.conanp.gob.mx/anp/consulta/1.%20EPJ%20Sierra%20de%20San%20Miguelito%2028ene2021_reduc.pdf*

more workers covered by social security, but the reform could also exacerbate the incentives to remain small, lowering productivity growth and worsening poverty and social outcomes. The expansion of firms depends on several factors and policies beyond the tax regime, and reforms in other key constraints would be key to leveraging significant impact. As a result, the long-run poverty and social impacts are expected to be neutral. In the future, the implementation of the reform will benefit from further empirical analysis.

72. **The poverty and social impact of the proposed financial inclusion reforms are expected to be positive.** Actions aimed at promoting financial inclusion will provide greater access to finance for Mexican migrants abroad which are expected to have positive poverty and social impacts. The evidence suggests that vulnerable Mexican families rely more heavily on remittances than those in higher-income deciles, and that access to bank accounts increases migrants' savings, particularly those of the low-income population. Similarly, measures to ensure consumer protection and cybersecurity for institutions are expected to benefit vulnerable groups, as they often have less financial education and are more vulnerable to cyberattacks. Greater access to retail agent banking could open avenues for underserved areas. Lack of physical access to financial institutions has historically been a key driver of financial exclusion, particularly among poor rural communities which are not well served by traditional financial infrastructure. Agent-based models allow financial institutions to leverage existing retail infrastructure and serve consumers at significantly lower cost. Thus, this reform can open access to financial services and providers in most rural areas.

73. **The poverty and social impact of actions to strengthen disaster risk response are expected to be positive.** The approved guidelines on disaster risk response have the potential to help mitigate the poverty and social impacts of a natural disaster by ensuring that the most affected and most vulnerable populations have help when crisis hits.

74. **Actions to introduce prior consultation to Indigenous populations for land use changes are expected to be positive.** Mexico's forests contribute to the overall economy through the provision of critical ecosystem services that sustain key sectors in rural and urban areas, such as mitigating soil erosion, maintaining soil fertility, supporting the infiltration of water, and providing raw material for productive sectors and natural habitats for biodiversity. It is estimated that forests are home to 12 million people, who are among the poorest and most marginalized segments of the population. About 61 percent of Mexico's forests fall under a system of collective land tenure and are owned by communities and ejidos, the majority of which are indigenous. Reforms of the Forest Law to introduce free, prior, and informed consultation for land use changes in indigenous territories are expected to have positive social impacts, as it would grant voice, control, and decision-making to a vulnerable population on activities to be implemented in their territories.

75. **Actions to amend the Forestry Law to limit land use changes are expected to be positive in the long run but could have some short-term negative impacts on specific population groups.** Actions to strengthen forest protection through changes in land use authorizations are expected to have positive long-term poverty and social impacts. Actions to ensure that projects requesting land use change authorizations mitigate their carbon footprint are expected to have no significant impact on the poor and vulnerable. Similarly, while actions that limit land use change authorizations in lands that were previously deforested will have no impacts on the poor and vulnerable in general, they could have short-term impacts for populations that live in previously deforested lands. This is because projects with a high economic return, and potentially high impact in terms of employment generation, will be turned down in

areas that were previously deforested. As a result, vulnerable populations living in previously deforested lands could be negatively affected by the new guidelines in the short run. The long-term impact of a new natural protected area in the San Miguelito mountains is expected to have positive poverty and social impacts by reducing climate change impacts, including reductions in the risk of forest fires and flooding that could be devastating to populated areas. Given that the proposed area includes multiple zones that would allow for some productive activities, the short-run poverty and social impacts are expected to be neutral.

5.2. ENVIRONMENTAL, FORESTS, AND OTHER NATURAL RESOURCE ASPECTS

76. **Policy measures supported by the DPL are expected to have significant positive effects on climate change and the environment.** The WBG's environmental analysis of the DPL finds that most policies supported, mainly under pillar 2, would have significant positive effects on Mexico's climate change mitigation and environmental priorities. Policy measures of pillar 2 will enhance the environmental and climate change resilience under existing laws and programs that promote environmental sustainability and disaster risk management. Mexico's institutional and regulatory framework to avoid, reduce, mitigate, and manage adverse environmental effects is sufficiently robust and can address potential negative environmental effects arising from these policy reforms.

77. **The policy measures will support Mexico in complying with its NDC by fostering low carbon and climate-resilient growth, enhancing NPA management and forest conservation, and establishing effective disaster risk management.** These policy measures will specifically strengthen the country's adaptation capacity, particularly in the most vulnerable municipalities, and enhance resilience of urban and rural landscapes. The DPL will foster mandatory mitigation measures for land use changes in forest lands (PA 5), enforce measures to avoid deforestation (PA 6), and enhance Mexico's area under conservation status (PA 8), contributing to the preservation of carbon sinks that are essential for Mexico to meet its NDC. The DPL will also strengthen disaster risk management (PA 4) which is expected to have positive environmental effects by fostering enhanced resilience and disaster responsiveness nationally. Policy reforms under pillar 1 around digital financial inclusion could have longer-term positive environmental effects.

78. **Mexico has a solid and comprehensive national environmental legislation to promote sustainability and resilience measures supported by this operation.** The legislation was formally developed based on the General Law of Ecological Equilibrium and Environmental Protection (LGEEPA) of 1988. Since then, Mexico has established laws, policies, programs, and provided resources that set environmental requirements to investments in terms of managing environmental impacts and waste, controlling pollution, and addressing material efficiency and climate change, among other. Regarding the latter, the General Climate Change Law of 2012 supports the transition to a competitive, sustainable, and low-carbon economy; reduces the vulnerability of the population and ecosystems; and assigns responsibilities within the Government. The GoM has committed to supporting climate change mitigation and adaptation as reflected in its updated NDC under the United Nations Framework Convention on Climate Change.

79. **On November 22, 2021, the GoM issued a Presidential Accord declaring the execution of certain infrastructure projects a matter of national security and public interest and ordered federal agencies to**

issue provisional environmental and social permits within five business days from the time of the request, to expedite the execution of said projects. On December 14, 2021, the Mexican Supreme Court partially suspended the Presidential Accord in response to the constitutional controversy raised by the National Institute of Transparency, Access to Information, and Protection of Personal Data (INAI) with respect to any effects and consequences of the Presidential Accord that may derive from the classification of information as of public interest and/or national security. These legal challenges may take up to a year to be resolved, and project-specific provisional permits issued could be challenged by affected parties in courts, seeking temporary suspension of the provisions of the Accord, or an injunction on project-specific related activities, until courts make a final decision. SEMARNAT has informed that, so far, the Accord has not been implemented since approval and that it continues to apply Mexico's environmental management framework, confirming that all environmental legislation remains valid and in place, and would be enforced during the operation's timeline. However, the potential implementation of the Accord poses a significant risk that could weaken Mexico's environmental management framework and undermine the policy measures supported by the DPL under Pillar 2 (see paragraph 95).

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

80. **Mexico's Public Financial Management (PFM) framework is mostly aligned with good international practices, including the use of budget resources and the FOREX internal control system managed by the Mexican Central Bank.** According to the latest Fiscal Transparency Evaluation (FTE) of the IMF (dated October 2018), Mexico scores relatively well compared to other Latin American countries and emerging market economies that have undergone such evaluations. Out of the 48 principles across four pillars in the FTE, Mexico meets 16 principles at the basic level, 9 principles at the good level, and 15 principles at the advanced level. The areas of strength include fiscal reporting, forecasting, and budgeting and resource revenue management. Conversely, the areas for improvement include the need to strengthen the medium-term fiscal framework, the medium-term budget framework, and fiscal risk analysis and management.

81. **Government commitment to support PFM reforms.** Mexico's budget legal and control framework is comprehensive, and the country has demonstrated a good track record in implementing PFM reforms. One of the recent major reforms focused on public sector accountability, integrity, and transparency with the establishment of the Law[63] of the National Anti-Corruption System, which aims to improve coordination among different oversight entities and civil society organizations.[64] However, corruption control is an ongoing concern in the public sector.[65] In addition, Mexico adopted accrual accounting, harmonizing accounting standards across all levels of government through the creation of the National Council of Accounting Harmonization (*Consejo Nacional de Armonización Contable*) and the enactment of the General Government Accounting Law in 2008.

[63] The Law of the National Anti-Corruption System was issued in 2016 and reformed in 2021.

[64] The members of the National Anti-Corruption System include representatives from civil society, the heads of the Supreme Audit Institution, the Ministry of Public Administration, the anti-corruption agency, and INAI, among others.

[65] Mexico scored 31 out of 100 in the Corruption Perception Index prepared by Transparency International, below most of its regional peers.

82. **Budget transparency and control in budget execution.** The general government budget is made publicly available at the SHCP external website.[66] As noted earlier, Mexico's budget transparency framework is aligned with good international practices. According to the open budget survey prepared by the International Budget Partnership, Mexico scores 82 out of 100, above all its regional peers. Mexico produces a wide array of in-year fiscal reports with a high degree of frequency and timeliness. SHCP publishes fiscal reports on a monthly basis with a 30-day lag and the quarterly fiscal report is available within a month from the end of the quarter. SHCP is also responsible for preparing the annual public account (*Cuenta Pública*). The public account contains the accounting, budgetary, programmatic, and complementary information of the executive, legislative, and judicial branches, of the autonomous agencies and parastatal sector, in compliance with the provisions of Article 74, Section VI of the Mexican Constitution and Articles 46 and 53 of the General Government Accounting Law. The transparency section of SHCP's website allows access to information on budget execution based on programmatic, functional, and administrative classifications. There is no evidence of material concerns regarding the data accuracy of these reports.

83. **Budget control and monitoring systems.** Budget execution, control, and monitoring are done through the integrated financial management system (*Sistema Integrado de Administración Financiera Federal,* SIAFF). SIAFF has embedded adequate controls for budget execution, which allows monitoring throughout the different stages of the budget process including commitment, certification, and final payment to beneficiaries. The Single Treasury Account is managed by the Federal Treasury at SHCP. However, some data, such as debt, treasury, and revenues, are still managed through different systems, with processes that in certain cases continue to be manual or through the transfer of flat files or Excel sheets, potentially affecting the quality of some of the financial information. The country has issued a set of internal controls based on the Committee of Sponsoring Organizations framework,[67] which is still being implemented. All in all, the budget control and monitoring systems are reasonably well understood and disseminated.

84. **Public procurement system.** As documented in the 2018 Assessment of the Mexican Procurement System,[68] the Public Procurement and Purchasing System of Mexico (*Sistema de Compras y Contrataciones Públicas de México,* SCCP), at the Federal Government level and principal autonomous entities, has a moderately advanced design and operation, close to best international practices, with important strengths that guarantee a regular supply of goods, services, and works to the Government. The most significant gaps in the SCCP are related to (a) lack of standardization due to the coexistence of many regulatory regimes, (b) lack of Standard Procurement Documents and standard practices, (c) limited use of technology (CompraNet is a tool that enables electronic transactions, but entities make a partial use of

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[66] The general government budget is available at a dedicated website developed by SHCP. https://www.transparenciapresupuestaria.gob.mx/es/PTP/

[67] The Committee of Sponsoring Organizations (COSO) framework for internal controls is the most common internationally recognized framework. COSO emphasizes accountability and ownership of control within an organization and states that management is responsible for establishing an effective internal control system.

[68] Assessment led by the Executive Secretariat of the National Anticorruption System with the participation of the Ministry of Public Function and INAI, with the TA of the IADB and a Technical Advisory Group composed of the World Bank, the European Investment Bank, and the Department of Foreign Affairs, Trade, and Development (Global Affairs) of the Government of Canada, following the Methodology for Assessing Procurement Systems.

the transactional features), (d) tendency to use non-competitive procurement methods, (e) lack of use of consolidation instruments (Framework Agreements), and (f) poor planning and market analysis.

85. **External scrutiny of public expenditures.** The external oversight of public expenditures is under the responsibility of the Mexican Supreme Audit Institution (*Auditoría Superior de la Federación*, ASF). The ASF undertakes a mix of compliance, performance, and financial audits to the public account in accordance with the International Standards of Supreme Audit Institutions and reports the audit results to a surveillance commission of the chamber of deputies, which ensures its independence. The annual public accounts of the Federal Government are prepared and submitted to Congress within four months after the end of each fiscal year. The external audit of the annual public accounts is undertaken by the ASF and submitted to the legislature 14 months after the end of each fiscal year. Audit reports are comprehensive and there is a system in place to follow up on audit findings and recommendations. The results of audits by the ASF are reviewed and assessed by the designated committees appointed by the Congress[69] and made public in the Annual Audit Report on the Federal Public Accounts.

86. **FOREX management.** In the absence of an IMF Safeguard Assessment Report, alternative procedures were undertaken. Such procedures focused mainly on reviewing the 2021 Article IV Consultation Report of the IMF and the audited financial statements of the Central Bank (*Banco de México*) for 2020 (available at the Central Bank website). The review concluded that the FOREX internal control environment does not pose material risks to the development objectives of this operation. The Central Bank financial statements were prepared in compliance with its institutional accounting regime[70] and audited in accordance with the International Standards on Auditing by an audit firm acceptable to the World Bank. The external auditors issued an unmodified opinion.

87. **Disbursement and auditing arrangements.** Upon approval of the operation and effectiveness of the Legal Agreement, the proceeds of the loan will be disbursed into an account at the Central Bank, which is part of the country's FOREX reserves. The funds will then be transferred into the Single Treasury Account managed by SHCP. Transactions and balances will be fully incorporated into the borrower's accounting records and financial statements. The borrower, within 45 days after the withdrawal of the funds from the financing account, shall report to the World Bank (a) the exact sum received into the account, (b) the details of the account to which the local currency equivalent of the loan proceeds was credited, and (c) the record that an equivalent amount has been accounted for in the borrower's budget management systems.

88. **The financial support provided under this operation is not intended to finance goods or services on the list of excluded expenditures.** If the proceeds of the DPL are used for ineligible purposes as defined in the Legal Agreement, the World Bank will require the borrower, promptly upon notice from the World Bank, to refund an amount equal to the ineligible expenditure. Amounts refunded to the World Bank upon such request shall be cancelled. Given that the control environment into which the DPL proceeds would flow is adequate, the World Bank will not require a dedicated account at the Central Bank for loan

[69] Such committee is the oversight commission of the SAI and the Public Accounts Committee at the Congress (*Comisión de Vigilancia de la Auditoría Superior de la Cámara de Diputados* and *Comisión de Presupuesto y Cuenta Pública de la Cámara de Diputados*).

[70] The central bank accounting regime is known as '*Normas de Información Financiera del Banco de México*'. This accounting framework was endorsed by the Mexican Council of Accounting Standards (CINIF).

proceeds. On this basis, no specific audit of the deposit of the credit proceeds will be required and no additional fiduciary arrangements are considered necessary.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

89. **SHCP will be responsible for collecting the data necessary and for monitoring the indicators.** SHCP, in close coordination with other authorities as appropriate, will take the lead in monitoring progress and implementation of this operation, with ongoing support from the World Bank. The results indicators selected to monitor and evaluate implementation progress and the achievement of program outcomes will be monitored by the department that takes the coordination lead for the respective prior actions. The World Bank will refer to the extent possible to indicators already collected by the authorities for their own monitoring purposes. The Results Matrix for the proposed operation can be found in annex 1.

90. **Grievance redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB’s Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB’s independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the WB's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the WB’s corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the WB Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

91. **The overall risk rating of this operation is assessed as Moderate.** The economic recovery in Mexico advanced at 4.8 percent in 2021, supported by a high vaccination rate, and strong exports. Most sectors of the economy have reached pre-pandemic levels, bringing employment to pre-pandemic levels too. Inflationary pressures expected sluggish recovery in aggregate demand and increasing uncertainty due to the Ukraine-Russia war represent important risk factors. Yet, the policies undertaken by the authorities, the U.S. economic expansion, and Mexico’s solid macroeconomic framework will contribute to the containment of such risks. Government efforts, supported by this operation, aim to ensure that the economic recovery is broad based across the population and the regions.

92. **Main risks to the macroeconomy stem from persistence in bottlenecks of international supply chains and inflation into 2022 and 2023.** The persistence of bottlenecks in international supply chains could slow down the recovery of manufacturing and exports, which are the sectors that are contributing to economic growth, given the strong US demand. Continuing inflation pressures may erode households' purchasing power, and expedite interest rate hikes, affecting investment and consumption. An accelerated normalization of US monetary policy may also hamper the recovery, as the Central Bank would have to follow with interest rate increases. These developments may contribute to significant

capital outflows. World Bank assessment identified that the main fiscal risks emerge from the vulnerabilities posed by PEMEX that may require further government support. Mexico has limited direct financial or trade exposure to Ukraine and Russia but the war may worsen global financial conditions. Inflationary pressures may also increase due to global commodity surge and affect poverty and the public sector budget, as the federal government is providing support, in the form of excise tax cuts and subsidies, to contain fuel and electricity prices. Additionally, private investment may be reduced if uncertain regulatory changes are not resolved, particularly in the energy industry. New variants of the COVID virus could reverse the pace of economic recovery, domestically and internationally.

93. **There are also important mitigation factors.** The flexible exchange rate will continue to be the first line of defense against external shocks, further supported by significant external reserves (US$200 billion as of early March 2022). The independent Central Bank has well-established credibility and has maintained medium-term inflation expectations anchored despite more persistent than initially expected inflation pressures. The financial sector entered the crisis well capitalized, and the authorities provided timely financial stability and liquidity measures, although they require close monitoring as many of the furlough measures are discontinued. Fiscal buffers, despite having been significantly eroded during the pandemic, can support liquidity in the short term, further reinforcing Mexico's strong track record of responsible fiscal policy maintained under the current administration. Also, additional oil related public revenues provide additional fiscal space in the short term. On the upside, the United States-Mexico-Canada Trade Agreement that started in 2020 opens new opportunities for future investment, including in onshoring GVCs.

94. **Risks related to Sector Strategies and Policies, and policy implementation are moderate.** Implementation of reforms supported will require political support across administrations to build sustained institutions that deliver the expected public services. The risk is partially mitigated by the focused reform program that includes only two ministries (SHCP and SEMARNAT) as well as the strong coordination role played by the *Secretaria de Asuntos Internacionales* within SHCP. The World Bank's support also includes complementary lending and a TA program to the GoM on the reform areas supported by the DPL. Additional risks stem from the limited fiscal resources available and growing spending pressures that may constrain policy implementation. This is partially mitigated by the introduction of the simplified tax regime that may increase tax collection in the medium term as formalization is expected to increase. This could be further deepened in the medium term by additional fiscal space emerging from reprioritization of public expenditure and, especially, additional tax reforms.

95. **A recently published Presidential Accord may undermine the implementation of policy reforms supported under Pillar 2, especially those related to land-use changes.** On November 22, 2021, the Mexican President issued an accord declaring the execution of certain infrastructure projects by the Government a matter of national security and public interest and ordered federal agencies the issuance of provisional permits within five business days from the time of the request, to expedite the execution of said projects. These provisional permits could impact the implementation of the provisions under Pillar 2 especially those related to land-use changes. SEMARNAT has informed that, so far, the Accord has not been implemented since approval and that it continues to apply Mexico's environmental management framework, confirming that all environmental legislation remains valid and in place, and would be enforced during the operation's timeline. However, the potential implementation of the Accord remains a significant risk that can weaken Mexico's environmental management framework and undermine the policy measures supported by the DPF under Pillar 2. The Accord has been subject to legal challenges

which remain pending and may take up to a year to be resolved. Project-specific provisional permits issued under the Accord could also be challenged by affected parties in courts, seeking temporary suspension of the provisions of the Accord, or an injunction on project-specific related activities, until courts take a final decision. Nevertheless, the Accord remains in place and might be relied upon to apply for provisional permits for certain projects, as previously described, to the detriment of Mexico's environmental management framework. As such, the Environmental and Social risk for this operation is assessed as substantial.

96. **Stakeholder risks are assessed as substantial.** The presidential accord could create uncertainty in the relationship between different government agencies as it relates to the approval process of environmental permits by SEMARNAT. This stakeholder risk could materialize mainly regarding transport and energy projects that historically account for a significant share of land use change requests. Also, implementation of the accord could cause a perception among stakeholders about the lack of effectiveness of the reform program supported, which in turn could lead to a reputational risk for the Bank if the accord were to be applied. However, SEMARNAT has indicated that it will continue to comply with the legal environmental framework in place.

Table 5: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	Moderate
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Moderate
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Low
7. Environment and Social	Substantial
8. Stakeholders	Substantial
9. Other	Moderate
Overall	Moderate

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ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers	Results		
Prior Actions under DPL	**Indicator Name**	**Baseline**	**Target**
Support vulnerable groups and regions to reap the benefits of economic growth			
Prior Action 1: The Borrower has enacted an amendment to the Income Tax Law to: (a) strengthen the tax framework by closing loopholes for tax evasion and avoidance, providing the tax authority with new tools to combat tax evasion and avoidance, including in mergers, acquisitions and restructurings, and (b) introduce new simplified regimes for enterprises with income up to an amount of 35 million Mexican Pesos and self-employed, reducing the number of procedures to declare and pay taxes, as evidenced, respectively, by the following provisions under the amendment to the Income Tax Law published in the Official Gazette on November 12, 2021: (i) amendments to Articles 24 and 161 of the Income Tax Law; and (ii) introduction of articles 113-E to 113-J under Title IV, Chapter II, Section IV, called 'Simplified Trust Regime', and Articles 206 to 215 under Title VII, Chapter XII, called 'Simplified Trust Regime for legal persons' in the Income Tax Law.	**Results Indicator 1:** Number of procedures to comply with tax payment obligations	8-10 (2021)	6 (12/2023)
Prior Action 2: The Borrower's Securities and Banking Commission has amended provisions applicable to credit institutions to facilitate financial inclusion for Mexican migrants in the United States and improve the safety and affordability of remittances flows by enabling them to remotely open transaction accounts with Mexican development and commercial banks and including additional credentials to be used as valid documents to prove their identity, as evidenced by the resolution issued by the Borrower's Securities and Banking Commission amending general provisions applicable to credit institutions, published in the Official Gazette on May 21, 2021.	**Results Indicator 2:** Number of active accounts in Mexican development banks opened by Mexicans abroad	0 (2020)	5,916(12/2023)

Prior actions and Triggers	Results		
Prior Action 3: The Borrower's Securities and Banking Commission and the Borrower's Central Bank, as applicable, have taken measures to promote digital financial inclusion by: (a) issuing secondary regulations for electronic payment institutions under the Fintech Law to ensure adequate consumer protections and cybersecurity of digital payment services, as evidenced by the provisions issued by the Borrower's Securities and Banking Commission and the Borrower's Central Bank applicable to electronic payment institutions referred to in Articles 48, second paragraph, 54, first paragraph, and 56, first and second paragraphs of the Fintech Law, published in the Official Gazette on January 28, 2021; and (b) updating retail agent banking regulations, to ease contracting processes, strengthen security standards, and establish clear rules for contracts with agent network managers, as evidenced by the resolution issued by the Borrower's Securities and Banking Commission that modifies the general provisions applicable to credit institutions, published in the Official Gazette on September 23, 2021.	**Results Indicator 3:** Percentage of adults with access to at least one financial product	68.3% (2018)	77.2% (12/2023)
	Results Indicator 4: Average gender gap in ownership of various financial products (percentage points)	7.4 (2018)	0 (12/2023)
Reform key policies and institutions to enable sustainable economic growth			
Prior Action 4: The Borrower has taken measures to strengthen its capacity to rapidly mobilize and target funds post-disaster by establishing provisions detailing budgetary mechanisms for financing projects and programs to respond to natural emergencies and disasters, as well as promoting the use of financing and risk transfer mechanisms to complement budgetary mechanisms, as evidenced by the specific provisions that establish the budgetary mechanisms to execute programs and projects to address the damages from natural phenomena issued by the Head of the Policy and Budgetary Control Unit of the SHCP, published in the Official Gazette on November 23, 2021.	**Results Indicator 5**: Number of risk financing instruments internally requested, and supported by sound technical analysis	0 (2021)	1 (12/2023)
Prior Action 5: The Borrower has enacted an amendment to the Forest Law to establish that SEMARNAT can only authorize land use change in forest lands for projects that, among others, mitigate the loss of forests' carbon storage capacity, as evidenced by the amendment to the first paragraph of Article 93 of the Forest Law published in the Official Gazette on April 26, 2021.	**Results indicator 6:** Authorizations of land use change in forest lands that include mandatory measures to mitigate the reduction of carbon storage capacity	0% (2021)	100% (12/2023)
Prior Action 6: The Borrower has enacted an amendment to the Forest Law to enhance forest protection by forbidding the issuance of land use change authorizations in forest lands that were previously deforested, as evidenced by the amendment to Article 97	**Results indicator 7:** Land use change authorization requests in previously deforested lands that are	0% (2021)	100% (12/2023)

Prior actions and Triggers	Results		
of the Forest Law dated April 20, 2021, and published in the Official Gazette on April 26, 2021.	denied authorization		
Prior Action 7: The Borrower has enacted an amendment to the Forest Law to introduce free, prior, and informed consultation for authorizing land use changes in forest lands that are located in indigenous territories, as evidenced by the amendment to the second paragraph of Article 93 of the Forest Law published in the Official Gazette on April 26, 2021.	**Results indicator 8:** Authorizations of land use change in forest lands located in indigenous territories that include a free, prior, and informed consultation process	0% (2021)	100% (12/2023)
Prior Action 8: The Borrower has declared a new natural protected area in the *Sierra of San Miguelito* to enhance protection of natural capital and climate change resilience, and foster sustainable development, as evidenced by the Presidential Decree published in the Official Gazette on December 13, 2021.	**Results Indicator 9**: Increase of area under conservation through a new Natural Protected Area expressed as (i) hectares, and (ii) equivalency in Carbon Storage[71]	0 (2021)	(i) 89,361 ha, (ii) 1.1 million tons of carbon (equivalent to 4.2 million tons of CO_2) (12/2023)

[71]Carbon Storage was calculated as of March 2022 based on emission factors published in Mexico's National Forest Emissions Reference Level reported to the UNFCCC (https://redd.unfccc.int/submissions.html?country=mex).

ANNEX 2: FUND RELATIONS ANNEX

PRESS RELEASE

PR21/323

IMF Executive Board Concludes 2021 Article IV Consultation with Mexico

FOR IMMEDIATE RELEASE

Washington, DC – November 5, 2021: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Mexico.

The Mexican economy is rebounding from its deepest recession in decades, driven by strong U.S. growth and the pandemic-related re-opening of sectors. After shrinking 8.3 percent in 2020, real GDP is forecast to grow by 6.2 percent in 2021 and 4 percent in 2022.

Nonetheless, Mexico is bearing a very heavy humanitarian, social, and economic cost from COVID-19. There have been over half a million excess deaths, under-employment remains very high, poverty that was high before the pandemic has increased further, and the young have experienced sizable learning losses with potentially harmful long-term consequences.

The government has emphasized a conservative fiscal stance with a focus on containing debt. The overall deficit target is 4.2 percent of GDP in 2021, with increased allocations for health spending and public investment. Efforts to combat tax evasion have contributed to generally better-than-expected revenues. The gross debt of the public sector (by staff's definition) is estimated at about 60 percent of GDP. With inflation well above its target, the central bank has raised the policy rate to 4.75 percent. The current account, which jumped to a record surplus of 2.4 percent of GDP in 2020, has moderated and is nearly balanced. The banking sector has strong capital positions and nonperforming loans are relatively low at 2.4 percent of total loans (as of May 2021). International reserves remain at a comfortable level, boosted by the new general allocation of SDRs.

Executive Board Assessment[2]

Executive Directors broadly agreed with the thrust of the staff appraisal. They commended the authorities for successfully maintaining economic stability through a challenging period, underpinned by very strong macroeconomic policies and institutional policy frameworks. The economy continues to rebound, despite further COVID 19 waves and supply chain constraints. However, given economic scarring risks and Mexico's low long run growth performance, Directors underscored the need to safeguard the recovery and promote stronger, more inclusive, and greener growth.

Directors generally saw merit in additional well targeted fiscal support using available fiscal space for health and education, social safety nets, and quality public investment. In this

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

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context, a few Directors considered the authorities' conservative approach appropriate to contain public debt. Directors stressed the importance of enhancing spending efficiency and containing the projected rise in pension spending. They also urged reform of Pemex's business strategy and governance.

Directors welcomed the authorities' recent successes in improving tax administration. A credible medium term tax reform, to be implemented as the economy strengthens, would help finance needed social and public investment spending and put the public debt to GDP ratio on a firm downward trajectory.

Directors noted that recent inflationary pressures, while mostly temporary, pose a difficult balancing act amid still sizable slack. They recommended a gradual, data driven pace of policy normalization that carefully balances support for the recovery while keeping medium term inflation expectations well anchored. Continued efforts to enhance the central bank's communications would be helpful in this regard, while a strategic review of the monetary policy framework could be conducted at the appropriate time. The flexible exchange rate should continue to serve as an external shock absorber.

Directors recognized Mexico's early adoption of climate change mitigation policies and targets. They encouraged implementing a comprehensive strategy, which could consider the scope and level of carbon pricing as part of broader mitigation and adaptation actions and redistribution policies. They emphasized that leveraging Mexico's large and diverse renewable resource base can foster a cheaper, more sustainable, and competitive energy sector.

Directors encouraged the authorities to tackle impediments to productivity growth through well prioritized structural reforms. They highlighted the need to promote labor market formality, narrow gender gaps, foster financial inclusion, and improve governance. Directors also recommended calibrating minimum wage increases to productivity growth. Advancing AML/CFT reforms and addressing outstanding recommendations from the 2016 FSAP will be important.

It is expected that the next Article IV consultation with Mexico will be held on the standard 12 month cycle.

3

Mexico: Selected Economic Indicators, 2020–22

Population (millions, 2020):	127.8	GDP per capita (U.S. dollars, 2020)	8,403.6
Quota (SDR, millions):	8,912.7	Poverty headcount ratio (% of population, 2020) 1/	43.9

Main export products: cars and car parts, electronics, crude oil
Main import products: cars and car parts, electronics, refined petroleum
Key export markets: United States, EU and Canada
Key import markets: United States, China, EU

		Proj.	
	2020	2021	2022
Output			
Real GDP (% change)	-8.3	6.2	4.0
Employment			
Unemployment rate, period average (%)	4.4	4.1	3.7
Prices			
Consumer prices, end of period (%)	3.2	5.9	3.1
Consumer prices, period average (%)	3.4	5.4	3.8
General government finances 2/			
Revenue and grants (% GDP)	24.5	24.0	23.2
Expenditure (% GDP)	29.0	28.3	26.8
Overall fiscal balance (% GDP)	-4.5	-4.2	-3.5
Gross public sector debt (% GDP)	61.0	59.8	60.1
Monetary and credit			
Broad money (% change)	13.4	9.2	6.6
Credit to non-financial private sector (% change) 3/	1.5	3.3	5.9
1-month Treasury bill yield (in percent)	5.3	N.A.	N.A.
Balance of payments			
Current account balance (% GDP)	2.4	0.0	-0.3
Foreign direct investment (% GDP)	2.3	1.9	1.9
Gross international reserves (US$ billions)	199.1	211.8	221.5
In months of next year's imports of goods and services	4.6	4.8	4.8
Total external debt (% GDP)	43.1	36.8	36.4
Exchange rate			
REER (% change)	-7.6	...	...

Sources: World Bank Development Indicators, CONEVAL, National Institute of Statistics and Geography, National Council of Population, Bank of Mexico, Secretariat of Finance and Public Credit, and Fund staff estimates.
1/ CONEVAL uses a multi-dimensional approach to measuring poverty based on a "social deprivation index," which takes into account the level of income; education; access to health services; to social security; to food; and quality, size, and access to basic services in the dwelling.
2/ Data exclude state and local governments and include state-owned enterprises and public development banks.
3/ Includes domestic credit by banks, nonbank intermediaries, and social housing funds.

ANNEX 3: LETTER OF DEVELOPMENT POLICY

HACIENDA
SECRETARÍA DE HACIENDA Y CRÉDITO PÚBLICO

Subsecretaría de Hacienda y Crédito Público
Unidad de Crédito Público

Oficio No. 305.-110/2022

Ciudad de México, a 27 de abril de 2022

DAVID R. MALPASS
PRESIDENTE DEL GRUPO BANCO MUNDIAL
WASHINGTON D.C.
ESTADOS UNIDOS DE AMÉRICA
PRESENTE

El Gobierno de México, específicamente la Secretaría de Hacienda y Crédito Público (SHCP) y la Secretaría de Medio Ambiente y Recursos Naturales (SEMARNAT), han impulsado reformas, así como políticas y programas encaminadas a impulsar el crecimiento económico sostenible.

Para el ejercicio fiscal 2022, el Ejecutivo Federal propuso un conjunto de modificaciones al marco tributario que incentivan el cumplimiento y promueven la formalidad de los contribuyentes, disuaden conductas que erosionan la base recaudatoria y fomentan la competitividad y el crecimiento de los negocios. Estas propuestas fueron aprobadas por el Poder Legislativo, publicadas en el Diario Oficial de la Federación (DOF) el 12 de noviembre de 2021, con inicio de vigencia el 1 de enero de 2022.

Entre las medidas aprobadas está la creación, con relación al Impuesto sobre la Renta (ISR), de dos esquemas de tributación: a) el Régimen Simplificado de Confianza para las Personas Físicas con ingresos brutos anuales de hasta 3.5 millones de pesos (mdp) (RESICO PF); y b) el Régimen Simplificado de Confianza para las Personas Morales con ingresos brutos anuales de hasta 35 mdp (RESICO PM). Las disposiciones aplicables están previstas en la Ley del ISR, en los artículos 113-E a 113-J para el RESICO PF; y en los artículos 206 a 2015 para el RESICO PM.

Estos esquemas tributarios están dirigidos a los pequeños y medianos contribuyentes con el objetivo de que puedan cumplir con sus obligaciones de manera ágil y sencilla, sin enfrentar un marco tributario complicado y costoso.

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2022 Año de Ricardo Flores Magón

HACIENDA
SECRETARÍA DE HACIENDA Y CRÉDITO PÚBLICO

Subsecretaría de Hacienda y Crédito Público
Unidad de Crédito Público

Con respecto al sector financiero, desde 2021 la Secretaría ha redoblado esfuerzos por ampliar el acceso a productos y servicios financieros para la población, particularmente para grupos poblacionales y regiones tradicionalmente desatendidas. Asimismo, se han tenido importantes avances para incorporar un enfoque de sostenibilidad en el sector financiero.

En materia de inclusión financiera, destaca la emisión de reformas que promueven la ampliación de los puntos de acceso al sistema financiero, mediante la simplificación del proceso de autorización de figuras legales complementarias a los intermediarios tradicionales (i.e., corresponsales bancarios). Igualmente, se publicaron modificaciones regulatorias que facilitan la apertura de cuentas y el on-boarding remoto, mediante el uso de tecnologías digitales, en el sector de finanzas populares, que atiende principalmente a comunidades rurales. También, se emitieron distintas reformas regulatorias orientadas a reducir los costos e incentivar el otorgamiento de créditos a mujeres, al consumo, hipotecarios y a Pymes. Por último, el Gobierno de México ha sido particularmente activo en facilitar la apertura de cuentas entre los migrantes mexicanos que usan pasaportes y "matrículas consulares" a través de su producto "Debicuenta Expres"; estas cuentas se pueden abrir en línea o a través de sus sucursales en 11 consulados.

En cuanto a género, en marzo de 2021 se firmó con la Asociación de Bancos de México (ABM), una Carta compromiso para promover una mayor representación y participación de mujeres en puestos de toma de decisión en el sector financiero. En seguimiento a dicha carta, en marzo de 2022 se instaló el Comité Interinstitucional para la Igualdad de Género en las Entidades Financieras (CIIGEF), una instancia de coordinación donde se definirán, implementarán y dará seguimiento a acciones intersectoriales orientadas a promover la igualdad de género en el sistema financiero mexicano.

Por otro lado, en conjunto con las demás autoridades financieras, la Secretaría de Hacienda y Crédito Público implementó diversas iniciativas para la construcción de un sistema financiero más incluyente, sostenible y consciente de los retos del cambio climático.

Desde inicios de 2021, se trabaja en el desarrollo de una taxonomía sostenible para el sistema financiero mexicano. Esta actividad se implementa de la mano de todos los

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participantes del sector financiero, públicos y privados, así como de organismos internacionales, incluyendo al Banco Mundial. Esta taxonomía contribuirá al cumplimiento de las metas climáticas de México y al cierre de brechas sociales. Asimismo, dará mayor certidumbre a los mercados y mitigará el riesgo de lavado verde ("greenwashing"), social, sustentable o de género. La taxonomía en desarrollo está alineada con los Objetivos de Desarrollo Sostenible (ODS) de la Agenda 2030 de Naciones Unidas, y con las Contribuciones Nacionalmente Determinadas de México, derivadas del Acuerdo de París.

En temas de atención a daños por fenómenos naturales, como resultado del Decreto, publicado el 6 de noviembre de 2020, el instrumento financiero FONDEN transita de ser un fideicomiso a un esquema presupuestario, en aras de una mayor transparencia en el uso de los recursos públicos. Para garantizar una adecuada estructuración, la Unidad de Política y Control Presupuestario de la SHCP modernizó el reglamento del FONDEN, mediante la expedición de disposiciones específicas que establezcan los mecanismos presupuestarios para la ejecución de programas y proyectos para atender los daños ocasionados por fenómenos naturales. Ahora el gobierno federal tiene las bases para asistir a las poblaciones afectadas y, en especial, a los más vulnerables.

El 2022 es el primer año en que la atención de los daños causados por desastres naturales se regirá por las disposiciones específicas que establecen los mecanismos presupuestarios para ejecutar programas y proyectos para atender los daños por fenómenos naturales. Por lo tanto, se espera un uso más razonable y eficaz del presupuesto anual. Para lograrlo, se requiere la colaboración de las distintas Secretarías involucradas, de los gobiernos subnacionales y de la ciudadanía.

El Gobierno de la República tiene el compromiso de fortalecer la institucionalidad en materia de medio ambiente y recursos naturales, de conformidad con el Plan Nacional de Desarrollo 2019-2024, en su Eje II "Política Social", en el apartado de desarrollo sostenible, que lo señala como "un factor indispensable del bienestar" e indica que "el Ejecutivo Federal considerará en toda circunstancia los impactos que tendrán sus políticas y programas en el tejido social, en la ecología y en los horizontes políticos y económicos del país".

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La necesidad de proteger los recursos naturales y la biodiversidad del país, se reafirma en el Programa Sectorial de Medio Ambiente y Recursos Naturales 2020-2024 (PROMARNAT), publicado en el Diario Oficial de la Federación (DOF) el 7 de julio de 2020, en donde la Secretaría de Medio Ambiente y Recursos Naturales (SEMARNAT) y el sector ambiental, establecieron cinco objetivos prioritarios:

(i) Promover la conservación, protección, restauración y aprovechamiento sustentable de los ecosistemas y su biodiversidad con enfoque territorial y de derechos humano, considerando las regiones bioculturales, a fin de mantener ecosistemas funcionales que son la base del bienestar de la población;
(ii) Fortalecer la acción climática a fin de transitar hacia una economía baja en carbono, así como en una población, ecosistemas, sistemas productivos e infraestructura, estratégicos resilientes, con el apoyo de los conocimientos científicos, tradicionales y tecnológicos disponibles;
(iii) Promover el agua como pilar de bienestar, manejada por instituciones transparentes, confiables, eficientes y eficaces, que velen por un medio ambiente sano y donde una sociedad participativa se involucre en su gestión
(iv) Promover un entorno libre de contaminación de agua, aire y suelo, que contribuya al ejercicio pleno del derecho a un medio ambiente sano; y
(v) Fortalecer la gobernanza ambiental a través de la participación ciudadana libre, efectiva, significativa y corresponsable en las decisiones de política pública, asegurando el acceso a la justicia ambiental, con enfoque territorial y de derechos humanos, y promoviendo la educación ambiental.

Es importante resaltar que el Gobierno de México ha realizado diversas acciones de política pública encaminada a cumplir con esta finalidad, entre las que destacan:

A) Modificaciones a la Ley General de Desarrollo Forestal Sustentable, publicadas en el DOF el día 26 de abril de 2021, en donde se establece que la Secretaría de Medio Ambiente y Recursos Naturales:

    1) De acuerdo con el Art 93 "... solo podrá autorizar el cambio de uso de suelo en terrenos forestales por excepción, previa opinión técnica de los miembros del Consejo Estatal Forestal de que se trate y con base en los estudios técnicos justificativos cuyo contenido se establecerá en el Reglamento, los cuales demuestren que la biodiversidad de los ecosistemas

que se verán afectados se mantenga, y que la erosión de los suelos, la capacidad de almacenamiento de carbono, el deterioro de la calidad del agua o la disminución en su captación se mitiguen en las áreas afectadas por la remoción de la vegetación forestal" (...) "Tratándose de terrenos ubicados en territorios indígenas, la autorización de cambio de uso de suelo además deberá acompañarse de medidas de consulta previa, libre, informada, culturalmente adecuada y de buena fe, en los términos de la legislación aplicable. Para ello, la Secretaría (SEMARNAT) se coordinará con el Instituto Nacional de los Pueblos Indígenas" ;

2) De acuerdo con el Art 97 "No se podrá otorgar autorización de cambio de uso del suelo en terrenos forestales donde la pérdida de cubierta forestal fue ocasionada por incendio, tala o desmonte sin que hayan pasado 20 años y que se acredite a la Secretaría (SEMARNAT) que la vegetación forestal afectada se ha regenerado, mediante los mecanismos que, para tal efecto, se establezcan en el Reglamento de esta Ley".

B) Se declaró como Área Natural Protegida con el carácter de Área de Protección de Flora y Fauna, la zona conocida como Sierra de San Miguelito, en los municipios de Mexquitic de Carmona, San Luis Potosí, Villa de Arriaga y Villa de Reyes, en el Estado de San Luis Potosí, mediante Decreto publicado en el DOF el 13 de diciembre de 2021.

Con base en lo anterior, destaco a su atención que para la integración de la matriz de políticas que ha sido reconocida por el Banco Mundial para la conformación de un préstamo en apoyo al Programa "Crecimiento Económico Inclusivo y Sostenible de México", se han considerado las siguientes acciones prioritarias:

1) Reforma a la Ley del Impuesto sobre la Renta para: (a) fortalecer el marco tributario, cerrando las lagunas para la evasión y elusión fiscal, brindando a la autoridad fiscal nuevas herramientas para combatir dichas prácticas, en dquisiciones y reestructuraciones; y (b) introducción de nuevos regímenes simplificados para las empresas con ingresos de hasta un monto de 35 millones de pesos mexicanos, y trabajadores que laboran por su cuenta, reduciendo el número de procedimientos para declarar y pagar impuestos.
2) Modificación por parte de la Comisión Nacional Bancaria y de Valores (CNBV), de las disposiciones de carácter general aplicables a las instituciones de crédito, para facilitar la inclusión financiera de los migrantes mexicanos en los Estados

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Unidos y mejorar la seguridad y la asequibilidad de los flujos de remesas, al permitirles a dichos migrantes abrir remotamente cuentas con bancos comerciales y de desarrollo mexicanos, así como incluir credenciales adicionales para su uso como documentos válidos para acreditar su identidad.

3) Toma de medidas por parte de la CNBV y el Banco de México para promover la inclusión financiera digital mediante: (a) la emisión de regulaciones secundarias para las instituciones de pago electrónico bajo la Ley Fintech, que garanticen la protección adecuada del consumidor y la ciberseguridad de los servicios de pago digital; y (b) la actualización de la normativa bancaria de corresponsales minoristas, para facilitar los procesos de contratación, fortalecer los estándares de seguridad y establecer reglas claras para los contratos con administradores de redes de corresponsales.
4) Emisión de medidas por parte de la Unidad de Politica y Control Presupuestario de la Secretaría,para fortalecer su capacidad para movilizar rápidamente y destinar fondos ante la ocurrencia de desastres causados por fenómenos naturales, estableciendo disposiciones que detallen los mecanismos presupuestarios para financiar proyectos y programas de reconstrucción, así como la promoción del uso de mecanismos de transferencia de riesgo y financiamiento para complementar los mecanismos presupuestarios.
5) Reforma a la Ley General de Desarrollo Forestal Sustentable, para establecer que la SEMARNAT sólo podrá autorizar cambios de uso de suelo en terrenos forestales para proyectos que, entre otros, mitiguen la reducción de la capacidad de almacenamiento de carbono de los bosques.
6) Reforma a la Ley General de Desarrollo Forestal Sustentable, para mejorar la protección forestal al prohibir la emisión de autorizaciones de cambio de uso de suelo en tierras forestales que fueron deforestadas previamente.
7) Reforma a la Ley General de Desarrollo Forestal Sustentable, para introducir la consulta libre, previa e informada, para autorizar cambios de uso de suelo en terrenos forestales que se encuentren en territorios indígenas.
8) Declaración de una nueva área natural protegida en la Sierra de San Miguelito.

En virtud de lo anterior, agradecemos el reconocimiento del Banco Mundial a las acciones de políticas públicas mencionadas en el presente Oficio, implementadas por el Gobierno de México, que permiten un crecimiento económico sostenible.

Sin otro particular, hago propicia la ocasión para enviarle un cordial saludo.

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2022 Año de Ricardo Flores Magón
PRECURSOR DE LA REVOLUCIÓN MEXICANA

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ATENTAMENTE,
LA TITULAR DE LA UNIDAD

MARÍA DEL CARMEN BONILLA RODRÍGUEZ

C.C.P. Gabriel Yorio González.- Subsecretario de Hacienda y Crédito Público.- SHCP.- Para su conocimiento.
Manuel Alejandro Orrantia Bustos.- Director General en la Unidad de Asuntos Internacionales de Hacienda.- Por correo electrónico
Mónica Velasco Carrero.- Directora en la Unidad de Asuntos Internacionales de Hacienda.- SHCP.- Por correo electrónico.

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2022 Año de Ricardo Flores Magón
PRECURSOR DE LA REVOLUCIÓN MEXICANA

Unofficial translation of the Letter of Development Policy
LETTERHEAD – Ministry of Finance and Public Credit Office, Public Credit Unit
Official Letter No. 305.-XXX/2022

Mexico City, 27 April 2022

David R. Malpass
President of the World Bank Group
Washington D.C.
United States of America

The Government of Mexico, specifically the Secretariat of Finance and Public Credit [*Secretaría de Hacienda y Crédito Público* SHCP] and the Secretariat of Environment and Natural Resources [*Secretaría de Medio Ambiente y Recursos Naturales* SEMARNAT], have introduced reforms, as well as policies and programs geared toward promoting sustainable economic growth.
For fiscal year 2022, the Federal Executive proposed a set of amendments to the tax framework that encourage compliance and promote taxpayer formalization, discourage behaviors that erode the tax base, and promote competitiveness and business growth. These proposals were approved by the Legislative Branch, published in the Official Gazette of the Federation [*Diario Oficial de la Federación* DOF] on 12 November 2021, and became effective on 1 January 2022.

Among the measures approved is the creation of two taxation schemes under Income Tax (ISR): a) the Simplified Trust Regime for Individuals [*Regimén Simplificado de Confianza para las Personas Físicas*] with annual gross income of up to 3.5 million pesos (mdp) (RESICO PF); and b) the Simplified Trust Regime for Legal Entities [*Régimen Simplificado de Confianza para las Personas Morales*] with annual gross income of up to 35 million pesos (RESICO PM). The applicable provisions are set forth in articles 113-E to 113-J of the Income Tax Law for RESICO PF; and, in articles 206 to 2015 for RESICO PM.

These tax schemes are aimed at small and medium-sized taxpayers so that they can fulfil their obligations in a quick and simple manner, without encountering a complicated and costly tax framework.

With respect to the financial sector, since 2021 the Secretariat has redoubled its efforts to expand access to financial products and services for the population, particularly for traditionally underserved population groups and regions. Significant progress has also been made in incorporating a sustainability approach in the financial sector.

In terms of financial inclusion, the introduction of reforms that promote the increase in access points to the financial system, by simplifying the authorization process for legal entities that complement traditional intermediaries (i.e. banking correspondents) is noteworthy. Regulatory amendments were also published to facilitate the opening of accounts and remote on-boarding, through the use of digital technologies, in the 'popular finance' sector, which mainly serves rural communities. In addition, various regulatory reforms were issued to reduce costs and encourage the granting of loans to women, as well as for consumption, mortgages, and SMEs. Finally, the Government of Mexico has been very active in facilitating the opening of accounts by Mexican migrants who use passports and Mexican identification cards through its 'Debicuenta Expres' product. These accounts can be opened online or through branches in the 11 consulates.

In terms of gender, in March 2021, a Commitment Letter was signed with the Banking Association of Mexico [*Asociación de Bancos de México* ABM], to promote greater participation by and representation of women in decision-making positions in the financial sector. Subsequent to this letter, in March 2022, the Interinstitutional Committee for Gender Equality in Financial Entities [*Comité Interinstitucional para la Igualdad de Género en las Entidades Financieras* CIIGEF] was established, which is a coordinating entity that will define, implement, and follow up on intersectoral actions geared toward promoting gender equality in the Mexican financial system.

In addition, the Secretariat of Finance and Public Credit, along with other financial authorities, implemented several initiatives to build a more inclusive and sustainable financial system that is aware of the challenges of climate change.
Since the beginning of 2021, we have been working on the development of a sustainable taxonomy for the Mexican financial system. This activity is being implemented in collaboration with all participants in the financial sector, both public and private, as well as international organizations, including the World Bank. This taxonomy will contribute to the fulfillment of Mexico's climate goals and the closing of social gaps. It will also provide greater certainty to markets and mitigate the risk of green, social, sustainable, or gender washing. The taxonomy under development is aligned with the Sustainable Development Goals (SDGs) of the United Nations 2030 Agenda, and with Mexico's Nationally Determined Contributions, derived from the Paris Agreement.

In terms of attention to damage from natural phenomena, as a result of the Decree published on 6 November 2020, the financial instrument FONDEN is changing from a trust to a budgetary scheme, with a view to greater transparency in the use of public resources. To ensure proper structuring, the SHCP's Budgetary Policy and Control Unit modernized the FONDEN regulations by introducing specific provisions that establish budgetary mechanisms for executing programs and projects to address the damage caused by natural phenomena. The federal government now has the basis for assisting affected populations, especially the most vulnerable.

The year 2022 is the first one during which attention to the damage caused by natural disasters will be addressed through specific provisions that establish budgetary mechanisms for executing programs and projects to address the damage caused by natural phenomena. It is therefore expected that the annual budget will be used in a more reasonable and efficient manner. In order to achieve this, there will have to be collaboration among the various Secretariats involved, as well as subnational governments, and the citizenry.

The Government of the Republic is committed to strengthening the institutional framework in terms of the environment and natural resources, in conformity with Pillar II of the National Development Plan 2019-2024, on "Social Policy", in the section on sustainable development, which is described as "an essential factor for well-being." The Government has indicated that "the Federal Executive will in all circumstances consider the impacts that its policies and programs will have on the social fabric, the environment, and the country's political and economic prospects."

The need to protect natural resources and the country's biodiversity is reaffirmed in the Environmental and Natural Resources Sectoral Program [*Programa Sectorial de Medio Ambiente y Recursos Naturales* PROMARNAT] 2020-2024, published in the Official Gazette of the Federation (DOF) on 7 July 2020, wherein the Secretariat of Environment and Natural Resources (SEMARNAT) and the environmental sector established five priority objectives:

(i) Promote the conservation, protection, restoration, and sustainable use of ecosystems and their biodiversity with a territorial and human rights approach, taking biocultural regions into account, in order to maintain functional ecosystems that are the basis for the well-being of the population;
(ii) Strengthen climate action to move towards a low-carbon economy and a resilient population, ecosystems, production systems, and strategic infrastructure, supported by available scientific, traditional, and technological knowledge;
(iii) Promote water as a pillar of well-being, managed by transparent, reliable, efficient, and effective institutions that ensure a healthy environment and where a participatory society is involved in its management;

(iv) Promote an environment free of water, air, and soil pollution that contributes to the full exercise of the right to a healthy environment; and

(v) Strengthen environmental governance through free, effective, meaningful, and co-responsible citizen participation in public policy decisions, ensuring access to environmental justice with a territorial and human rights approach, and promoting environmental education.

It is important to note that the Government of Mexico has carried out various public policy actions aimed at achieving this goal, among which the following stand out:

A) Amendments were made to the General Law for Sustainable Forest Development [*Ley General de Desarrollo Forestal Sustentable*], published in the DOF on 26 April 2021, which establishes that the Secretariat of Environment and Natural Resources will be responsible for the following:

1) According to Art 93 "…. may only authorize land use change on forest lands exceptionally, subject to the technical opinion of the members of the State Forestry Council [*Consejo Estatal Forestal*] in question and based on the supporting technical studies whose content shall be established in the Regulations, which demonstrate that the biodiversity of the ecosystems that will be affected will be maintained, and that soil erosion, carbon sequestration capacity, deterioration of water quality or decrease in its uptake will be mitigated in the areas affected by the removal of forest vegetation" (…) " In the case of lands located in indigenous territories, the authorization of land use change must also be accompanied by prior, open, informed, culturally appropriate, and good faith consultation measures, under the terms of the applicable legislation. To this end, the Secretariat will coordinate with the National Institute of Indigenous Peoples;" and
2) According to Article 97, "No authorization may be granted for land use change on forest land where the loss of forest cover was caused by fire, logging, or clearing without 20 years having passed and without the Secretariat confirming that the affected forest vegetation has regenerated, through the mechanisms established for this purpose in the Regulations of this Law."

B) The area known as Sierra de San Miguelito, in the municipalities of Mexquitic de Carmona, San Luis Potosi, Villa de Arriaga, and Villa de Reyes, in the State of San Luis Potosi, was decreed a Protected Natural Area, as a Flora and Fauna Protection Area, and this was published in the DOF on 13 December 2021.

Based on the aforementioned, the following priority actions have been considered in relation to the integration of the policy matrix that has been recognized by the World Bank for the authorization of the loan "Mexico, Inclusive and Sustainable Economic Growth'':

1) Amendment of the Income Tax Law to: (a) strengthen the tax framework by closing the tax avoidance and evasion gaps, providing the tax authority with new tools to combat tax evasion, including in mergers, acquisitions, and restructurings; and (b) introduce new simplified regimes for enterprises with income of up to 35 million Mexican pesos, and self-employed workers, by reducing the number of procedures for declaring and paying taxes.
2) The National Banking and Securities Commission [*Comisión Nacional Bancaria y de Valores* CNBV] amended the provisions applicable to credit institutions to facilitate the financial inclusion of Mexican migrants in the United States and to improve the security, accessibility, and affordability of remittance flows by allowing them to remotely open transaction accounts with Mexican commercial and development banks, and including additional credentials to be used as valid documents to prove their identity.
3) The CNBV and the Bank of Mexico have taken measures to promote digital financial inclusion by: (a) Issuing secondary regulations for electronic payment institutions under the Fintech Law, to ensure adequate consumer protection and cybersecurity for digital payment services; and (b) updating retail banking regulations, to ease contracting processes, strengthen security standards, and establish clear rules for contracts with agent network administrators.
4) The Budgetary Policy and Control Unit [*Unidad de Política y Control Presupuestario*] introduced measures to strengthen its capacity to rapidly mobilize and allocate funds post-disaster by establishing provisions outlining budgetary mechanisms for financing projects and programs that respond to natural emergencies and disasters, as well as promoting the use of risk transfer and financing mechanisms to complement the budgetary mechanisms.
5) Amendment of the Forest Law to establish that only SEMARNAT can authorize land use changes on forest lands for projects that, among others, mitigate the loss of forests' carbon storage capacity.
6) Amendment of the Forest Law to enhance forest protection by forbbiding the issuance of authorizations for land use changes on forest lands that were previously deforested.
7) Amendment of the Forest Law, to introduce free, prior, and informed consultation to authorize land use changes on forest lands located in indigenous territories.

8) Declaration of a new protected natural area in the Sierra de San Miguelito to enhance protection of natural capital and climate change resilience, and foster sustainable development.

In witness of the foregoing, we thank the World Bank for its acknowledgement of public policy actions implemented by the Government of Mexico, which facilitate sustainable economic growth.
There being nothing further, please allow me to take this opportunity to extend to you warm regards.

SINCERELY,
THE HEAD OF THE UNIT
MARÍA DEL CARMEN BONILLA RODRÍGUEZ

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ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environmental effects	Significant poverty, social, or distributional effects, positive or negative
Operation Pillar 1: Inclusive economic growth		
Prior Action 1: The Borrower has enacted an amendment to the Income Tax Law to: (a) strengthen the tax framework by closing loopholes for tax evasion and avoidance, providing the tax authority with new tools to combat tax evasion and avoidance, including in mergers, acquisitions and restructurings, and (b) introduce new simplified regimes for enterprises with income up to an amount of 35 million Mexican Pesos and self-employed, reducing the number of procedures to declare and pay taxes, as evidenced, respectively, by the following provisions under the amendment to the Income Tax Law published in the Official Gazette on November 12, 2021: (i) amendments to Articles 24 and 161 of the Income Tax Law and (ii) introduction of articles 113-E to 113-J under Title IV, Chapter II, Section IV, called 'Simplified Trust Regime', and Articles 206 to 215 under Title VII, Chapter XII, called 'Simplified Trust Regime for legal persons' in the Income Tax Law.	No	Neutral impacts in the short and long term.
Prior Action 2: The Borrower's Securities and Banking Commission has amended provisions applicable to credit institutions to facilitate financial inclusion for Mexican migrants in the United States and improve the safety and affordability of remittances flows by enabling them to remotely open transaction accounts with Mexican development and commercial banks and including additional credentials to be used as valid documents to prove their identity, as evidenced by the resolution issued by the Borrower's Securities and Banking Commission amending general provisions applicable to credit institutions, published in the Official Gazette on May 21, 2021.	No	Positive impacts in the short and long term
Prior Action 3: The Borrower's Securities and Banking Commission and the Borrower's Central Bank, as applicable, have taken measures to promote digital financial inclusion by: (a) issuing secondary regulations for electronic payment institutions under the Fintech Law to ensure adequate consumer protections and cybersecurity of digital payment services, as evidenced by the provisions issued by the Borrower's Securities and Banking Commission and the Borrower's Central Bank applicable to electronic payment institutions referred to in Articles 48, second paragraph, 54, first paragraph, and 56, first and second paragraphs of the Fintech Law, published in the Official Gazette on January 28, 2021; and (b) updating retail agent banking regulations, to ease contracting processes, strengthen	No	Likely positive impacts in the short and long term

Prior Actions	Significant positive or negative environmental effects	Significant poverty, social, or distributional effects, positive or negative
security standards, and establish clear rules for contracts with agent network managers, as evidenced by the resolution issued by the Borrower's Securities and Banking Commission that modifies the general provisions applicable to credit institutions published in the Official Gazette on September 23, 2021.		
Operation Pillar 2: Sustainable economic growth		
Prior Action 4: The Borrower has taken measures to strengthen its capacity to rapidly mobilize and target funds post-disaster by establishing provisions detailing budgetary mechanisms for financing projects and programs to respond to natural emergencies and disasters, as well as promoting the use of financing and risk transfer mechanisms to complement budgetary mechanisms, as evidenced by the specific provisions that establish the budgetary mechanisms to execute programs and projects to address the damages from natural phenomena issued by the Head of the Policy and Budgetary Control Unit of the SHCP, published in the Official Gazette on November 23, 2021.	Yes Positive on climate change adaptation	Positive impacts in the short and long term
Prior Action 5: The Borrower has enacted an amendment to the Forest Law to establish that SEMARNAT can only authorize land use change in forest lands for projects that, among others, mitigate the loss of forests' carbon storage capacity, as evidenced by the amendment to the first paragraph of Article 93 of the Forest Law published in the Official Gazette on April 26, 2021.	Yes Positive on climate change mitigation and adaptation	Neutral impacts in the short run, long-term impacts are expected to be positive
Prior Action 6: The Borrower has enacted an amendment to the Forest Law to enhance forest protection by forbidding the issuance of land use change authorizations in forest lands that were previously deforested, as evidenced by the amendment to Article 97 of the Forest Law dated April 20, 2021, and published in the Official Gazette on April 26, 2021.	Positive on climate change mitigation and adaptation	Potentially negative short-term impacts for some vulnerable populations, but long-term impacts are expected to be positive
Prior Action 7: The Borrower has enacted an amendment to the Forest Law to introduce free, prior, and informed consultation for authorizing land use changes in forest lands that are located in indigenous territories, as evidenced by the amendment to the second paragraph of Article 93 of the Forest Law published in the Official Gazette on April 26, 2021.	Positive on climate change adaptation	Positive impact in the short and long term
Prior Action 8: The Borrower has declared a new natural protected area in the *Sierra of San Miguelito* to enhance protection of natural capital and climate change resilience, and foster sustainable development, as evidenced by the Presidential Decree published in the Official Gazette on December 13, 2021.	Positive on climate change mitigation and adaptation	Neutral impacts in the short run, long-term impacts are expected to be positive.

ANNEX 5: DETAILED POVERTY AND SOCIAL IMPACT ANALYSIS

1. **This PSIA is developed according to World Bank guidelines and designed to provide an analysis of the potential poverty and social impacts of the policy actions outlined in the Development Policy Loan (DPL).** The PSIA outlines the expected impacts from a gender-informed, social, and distributional perspective. The assessment is meant to analyze the policy actions with outcomes in the key objectives of this operation. Pursuant to the World Bank's policy on Development Policy Finance, this PSIA aims to: (a) identify whether the policies supported by the DPL are likely to have significant poverty and social consequences, especially on poor people and vulnerable groups; (b) analyze relevant analytical knowledge of these effects and of the country's systems (including legal and institutional framework) for reducing significant adverse effects and enhancing positive effects associated with the policies being supported; and (c) identify the actions that the GoM is undertaking or planning to undertake to address the identified gaps or shortcomings. Preliminary results of the PSIA indicate that this operation is not likely to have significant adverse social effects.

2. **The policy actions supported by the DPL are largely expected to have positive poverty and social impacts.** Amendments to the income tax law are expected to have neutral impacts over the short and long term. The actions aimed at promoting financial inclusion would provide greater access to finance to Mexican migrants abroad which are expected to have positive poverty and social impacts. Similarly, measures to ensure consumer protection and improved cybersecurity for payment initiation institutions are expected to benefit vulnerable groups as they often have less financial education and are more vulnerable to cyberattacks. Greater access to finance through agents could substantially open avenues for underserved areas. The approved guidelines to strengthen disaster risk response have the potential to reduce negative poverty and social impacts of natural disasters. Actions to amend the Forestry Law to limit land-use changes are expected to be positive in the long run. Still, they could have short-term negative impacts on populations currently living in previously deforested lands. In contrast, the introduction of prior consultation to IPs for land use changes is expected to have positive social impacts. Each of these issues is detailed in the following paragraphs. Finally, the declaration of a new natural protected area in the San Miguelito mountains is expected to have positive poverty and social impacts in the long run, with neutral effects in the short run. Each of these issues is detailed in the following paragraphs.

Prior Action 1: Reform of the Income Tax Law
The Borrower has enacted an amendment to the Income Tax Law to: (a) strengthen the tax framework by closing loopholes for tax evasion and avoidance, providing the tax authority with new tools to combat tax evasion and avoidance, including in mergers, acquisitions and restructurings, and (b) introduce new simplified regimes for enterprises with an income up to an amount of 35 million Mexican Pesos and self-employed, reducing the number of procedures to declare and pay taxes.

3. **The amended legislation will replace the previous regime for MSMEs to simplify tax filing while encouraging formalization.** The proposed legislation replaces the RIF which was previously introduced in January 2014 to reduce informality both on tax compliance and compliance with social security

contributions. Under the RIF, firms and self-employed individuals obtained a 100 percent discount on their corporate tax bill during the first year of enrollment. This discount decreased by ten percentage points each successive year. After ten years, firms and individuals were automatically moved into the general tax regime. Similarly, in the first year of enrollment, self-employed individuals received a discount of 50 percent in mandatory contributions to social security, with this discount decreasing by ten percentage points every two years. Business owners in Mexico were not required to contribute to their own social security, but the RIF offered the same subsidy if they chose to do so. In addition to these discounts for income taxes, RIF businesses also had discounts on their Value Added Tax and excise obligations. While the RIF taxed net income on an accrual basis, the new regime will be based on total revenue on a cash basis. Since the tax rates are lower in the new regime compared to the RIF, some MSMEs and self-employed workers will be facing a lower tax liability. However, taxpayers with small margins who previously benefited from deductions under the old regime could face higher liabilities. Taxpayers were given a choice to continue to file under the RIF through the end of January 2022; the default option is that all taxpayers will move to the new regime. Another important difference between the RIF and the new simplified regime is that self-employed professionals who were previously under the general regime are eligible to pay under the simplified regime, so long as their total revenue is below the eligibility threshold.

4. **The international literature has shown that simplified regimes typically can lower the barriers to the formalization of micro firms and broaden the tax base** (Bruhn 2011; Galiani, Meléndez, and Ahumada 2017; Kaplan, Piedra, and Seira, 2011; Fajnzylber, Maloney and Montes-Rojas 2011; Monteiro and Assunçao 2012). In the case of Mexico, the RIF regime was found to increase the number of small businesses paying the mandatory social security contributions on behalf of their employees (Kaplan and Silva-Porto 2017). However, the number of additional businesses contributing to the employees' social security was not large enough to have a noticeable impact on the share of informal employment, as wage workers not covered by social security in Mexico have remained relatively stable at around 45 percent. Moreover, some assessments of the RIF find that few taxpayers were aware of the benefits provided by the RIF, most required an accountant to comply, and formalization targets were unmet (Tejero Mena and Nic Pool 2017).

5. **Special regimes can also increase incentives for tax evasion and potentially lead to lower levels of aggregate productivity and GDP in the long run as firms have incentives to remain small.** While they encourage new contributors to enroll, they also reduce the tax rate on those small firms already registered and potentially incentivize large formal firms close to the regulatory threshold to under-report their true size to the tax authorities or limit their growth to avoid the additional tax burden. For instance, Azuara et al. (2019) find the bunching of firms around the eligibility threshold of various tax regimes in Peru. This can be due to misreporting to tax authorities or to firms limiting their size to enjoy the benefits of the special tax regime. Moreover, to the extent that formal firms have incentives to remain small, forgoing opportunities to innovate and grow, this leads to smaller and less productive firms on average in the economy, which is reflected in turn in a decrease in welfare or total productivity (Guner et al, 2008; Garicano et al, 2016; Almunia and Lopez-Rodriguez, 2018). In addition, workers' social security contributions in micro firms, as in the case of the RIF, the indirect pressure on federal budgets could be significant (Azuara et al. 2019). Finally, simplified regimes also potentially misallocate resources across

sectors and distort the incentive arrangements within firms. This is because simplified regimes allocate too little employment to more productive firms that (i) choose to be just below the regulatory threshold; or (ii) bear a higher tax. Moreover, to the extent that some of the tax burden in the general income tax regime falls on workers, equilibrium wages could be lower in firms subject to the general regime, encouraging too many agents with low managerial ability to become small entrepreneurs rather than working as employees for more productive firms (Garicano et al 2016). By focusing on firms with specific organizational structures (e.g., family-owned businesses, unincorporated firms), often in the least productive activities, these type-distortions could seriously affect total factor productivity (Busso et al, 2012).

6. **The poverty and social impacts of the income tax amendments are expected to be neutral in the short run.** The reform will simplify the administrative burden that individuals and small firms face in their income tax filing. However, it is not clear that this would be enough to ensure that firms formalize. Many other factors that will influence whether a firm decides to formalize, including the broader business environment, which includes access to credit, the extent of criminal activity and the potential for extortion, corruption and the cost of unofficial payments, the quality and efficiency of the legal system, and other regulatory costs. Moreover, while the reform was calibrated to be revenue-neutral in the short run, it is uncertain whether it will be the case as many more taxpayers are now eligible for the simplified regime compared to the past (including professional workers, those whose sole income is from rents, etc.). As such, the change in the tax regime is expected to have small or negligible impacts on poverty in the short run.

7. **The poverty and social impacts of the income tax amendments are also expected to be neutral in the long run given high degree of uncertainty over complementary policies**. While greater formalization could potentially lead to higher revenue, their impact on social outcomes will highly depend on how additional revenues are used. Similarly, while an increase in formalization could potentially lead to a larger number of workers covered by social security, it is possible that the reform could also exacerbate the incentives to remain small, potentially leading to lower productivity and growth thus leading to worse poverty and social outcomes. Nevertheless, these effects are likely to be small or insignificant, as the decisions of firms to expand and grow depend on a large host of factors and policies that are independent of the tax regime. Given the balance of opposing forces, the long run poverty and social impacts are expected to be neutral.

8. **Given the uncertainties, the team aims to empirically explore potential short-term impacts of the reform to inform its implementation.** The team will assess the short-term distributional impact of the reform and its potential impact on informality. Data from the 2019 Economic Census will be combined with other surveys to quantify the impact of the reform on the likelihood MSMEs' formalization, by assessing its costs and benefits. Following Dabla-Norris et al (2008), the probability of formalization will be estimated as a function of tax liabilities, state-level regulatory costs, the cost of unofficial payments, and the quality and efficiency of the legal system. Then, firm profits will be estimated under each regime, along with likely changes in dividends, employment, and wages. The resulting changes will be averaged for each municipality, sector of economic activity, and firm size. These impacts will then be matched to workers in the household survey by sector, firm size, and municipality to assess the short-term

distributional impact of the tax reform on formal employment and wages. The work will seek to assess the net household benefits from changes in formalization, and, therefore, changes in access to social security benefits and through wages for workers in firms for whom profitability changed with the tax reform.

Prior Action 2: Financial inclusion for Mexican migrants

The Borrower's Securities and Banking Commission has amended provisions applicable to credit institutions to facilitate financial inclusion for Mexican migrants in the United States and improve the safety and affordability of remittances flows by enabling them to remotely open transaction accounts with Mexican development and commercial banks and including additional credentials to be used as valid documents to prove their identity.

9. **Migrants without access to formal bank accounts face a less competitive remittance market.** If migrants cannot access formal bank accounts, they cannot access the most competitive, convenient, and formal remittance channels; instead, they must trust less formal and more expensive mechanisms (Isaacs et al. 2018). This implies that migrants face more risk and higher remittances fees, which on average, reduce the remittances that they send (Aycinena, Martinez, and Yang 2010). When fees are reduced, the increase in remittances occurs through increases in the frequency of transactions, and not in funds sent per transaction (Aycinena, Martinez, and Yang 2010). These results suggest that reforms that lead to a reduction in migrant remittance fees can have larger impacts on remittance flows. Such reforms include increased competition in money transmission markets or improvements in information for migrants on the relative costs of different money transmission services.

10. **The most vulnerable Mexican families rely relatively more on remittances.** Although the quantities received by households in the middle and top of the distribution are higher than those received by poorer households, remittance income represents 6.5 percent of the total income in the first income decile but just 1.9 percent in the tenth (table 5.1). This relative importance decreases as the income is higher.

11. **Valid ID documentation is one of the main barriers to opening bank accounts for migrants.** Undocumented migrants frequently lack valid or formal ID documentation. This situation is highlighted as one of the most important barriers to migrants having bank accounts (Isaacs et al., 2018). Undocumented migrants are also more likely to come from more vulnerable households. Increasing the types of documents migrants can use as proof of identity will increase migrants' probability of opening a bank account (Chin, Karkoviata, and Wilcox 2011).

12. **Moreover, access to bank accounts could have long-term benefits, as access to bank accounts increases migrants' savings, particularly those of the low-income population.** The evidence shows that access to bank accounts allows migrants to increase both their savings and the remittances that they effectively send (Amuedo-Dorantes and Bansak 2006; Ashraf et al. 2015; Chin, Karkoviata, and Wilcox 2011). However, if the bank account is opened in the destination country, it may also reduce the remittances used for consumption, as savings increase in the destination country (Ashraf et al. 2015).

Table 5.1. Remittances Received by Pre-fiscal Income Deciles

Income Decile	Average Remittance (MXN)	Remittances (% of Income)
1	47.0	6.5
2	80.5	5.6
3	108.6	5.7
4	106.9	4.5
5	123.3	4.3
6	156.9	4.6
7	153.5	3.8
8	235.1	4.7
9	195.3	2.9
10	266.7	1.9
Total	148.6	4.4

Source: World Bank using ENIGH 2020.

13. **Enabling Mexican migrants in the United States to remotely open transaction accounts with Mexican development and commercial banks and facilitating ID requirements are expected to have positive poverty and social impacts.** Given the evidence on remittance flows' barriers noted above, and the evidence on the impact of remittance income on household incomes, the proposed reform will likely positively impact the bottom of the distribution. Moreover, given women's dependency on remittances, higher and more frequent flows will likely benefit them. Remittance-receiving households have an average of 2.53 women, compared to 2.29 women in non-remittance-receiving households, and women receive 27 percent more remittances than men (ENIGH 2020).

Prior Action 3: Consumer protections and cybersecurity of digital payment services.

The Borrower's Securities and Banking Commission and the Borrower's Central Bank, as applicable, have taken measures to promote digital financial inclusion by: (a) issuing secondary regulations for electronic payment institutions under the Fintech Law to ensure adequate consumer protections and cybersecurity of digital payment services; and (b) updating retail agent banking regulations, to ease contracting processes, strengthen security standards, and establish clear rules for contracts with agent network managers.

14. **Financial inclusion is important for poverty reduction.** The literature has found that when people are part of the financial system, they are better able to start a business, invest in health and education, or absorb unexpected financial shocks.[72] The empirical evidence for Mexico shows that the expansion in the supply of financial services has proven to positively affect the economic opportunities for the poor. For instance, in 2002, a new bank (Banco Azteca) that targets low-income households and least populated municipalities led to a massive increase in banking services in Mexico, enabling the poorest to smooth consumption and accumulate more durable goods (Ruiz 2013). The increase in financial services positively affected labor market activity and income levels with impacts more pronounced for individuals below median income levels (Bruhn and Love 2011). A similar regulation introduced in 2007—which authorized

[72] See Burgess and Pande 2005; Brune et al. 2016; Dupas and Robinson 2013; Karlan and Zinman 2010; Kast and Pomeranz 2014.

five more banks that targeted low-income households—also affected employment outcomes and entrepreneurial activities, particularly for informal business owners.

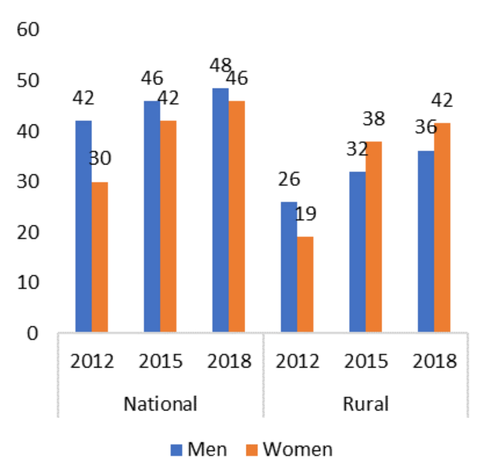
15. **Although access to finance has been increasing in Mexico, it continues to be low relative to peer countries, particularly at the bottom of the distribution.** A larger share of the population had a bank account in 2018 compared to 2012. However, account ownership continues to be low compared to other regional and upper-middle-income countries, particularly in rural areas (29.3 versus 72.9 percent, figure 5.1). Moreover, less than 4 percent of people in the bottom 40 percent and only 7 percent in rural areas saved at a formal financial institution in 2017 (table 5.2).

Table 5.2. Account Ownership (% of people ages 15+) by Individual Characteristics, Findex, 2017

	Mexico	LAC	UMIC
Total	36.9	54.4	73.1
Male	41.1	57.8	77.0
Female	33.3	51.3	69.3
Older adults (ages 25+)	38.3	59.5	74.6
In labor force	42.9	59.5	78.4
Out of labor force	26.0	43.3	61.6
Primary education or less	24.5	43.9	65.6
Secondary education or more	43.8	60.1	80.2
Income, poorest 40%	25.8	41.9	62.4
Income, richest 60%	44.0	62.7	80.3
Rural	29.3	52.6	72.9

Source: Global Findex (Global Financial Inclusion Database), https://globalfindex.worldbank.org/

Figure 5.1. Percentage of Adults with a Bank Account, ENIF, 2018



Source: ENIF, INEGI 2018.

16. **Access to finance is also key for women's access to economic opportunities.** Closing gender gaps in financial inclusion has positive effects on smoothing consumption, providing security, increasing saving and investment rates, and managing economic risk. The evidence shows that having access to and use of a range of financial services enhances the contribution of female-owned businesses to growth, contributes to women's empowerment, allows for better use of resources, and reduces the vulnerability of their households and businesses.[73] Therefore, closing the gender gap in access to finance can enable economic growth, inequality reduction, and social inclusion. Between 2015 and 2018, the proportion of men and women with at least one financial product remained unchanged, and so did the gender gap. In rural areas, the percentage of women with at least one financial product marginally decreased from 57 percent in 2015 to 56 percent in 2018. In 2018, the number of women reporting having at least one financial product with a formal institution continued to be lower than that of men (65 percent compared to 72 percent).

[73] See Aker et al. 2015; Ashraf et al. 2010; Delavallade et al. 2015; and Dupas and Robinson 2013.

17. **Most transactions in Mexico have traditionally been done in cash.** This is true for large transactions and regular payments, including taxes, fees, and public and private services (table 5.3). In 2017, 31.7 percent of adults (ages 15+) made or received digital payments, representing a smaller share compared to the LAC region and the average UMIC (table 5.4). Moreover, while 39 percent of individuals in the top 60 percent of the distribution had made payments, the same was true for only 20 percent of the bottom 40 percent of the distribution. Similarly, electronic payments were more common among men compared to women, among those with higher education, and among people in the labor force.

Table 5.3. Mexico: Forms of Payment Used

	For payments of MX500+			Form of payment used by type of transaction				
	National	Urban	Rural	Rent	Taxes or fines	Utilities: electricity, water, other	Private services: phone, cable, internet, other	Public transport
Cash	87.5%	83.5%	95.0%	89.8%	92.3%	95.2%	91.5%	97.6%
Debit card	9.3%	12.4%	3.3%	3.3%	4.0%	2.4%	4.2%	0.4%
Credit card	2.6%	3.3%	1.3%	0.3%	1.3%	0.6%	1.5%	0.2%
Electronic transfer	0.4%	0.5%	0.1%	3.6%	1.7%	1.3%	1.5%	0.1%
Check	0.1%	0.1%	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%
Prepaid card	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	1.6%
Automatic debit to account/card	0.0%	0.0%	0.0%	1.5%	0.3%	0.4%	1.1%	0.1%
Other	0.2%	0.1%	0.2%	1.3%	0.3%	0.1%	0.1%	0.1%

Source: ENIF, INEGI 2018

18. **Electronic payments can lower transaction costs, potentially fostering financial inclusion.** Increases in electronic payments and the ability for third-party participants to offer electronic payment options are expected to lower indirect transaction costs by facilitating access to money and reducing the cost of checking balances. Evidence has shown that digital payments increase the security, privacy, and control over the funds received, especially for women (Docquier, Lowell, and Marfouk 2009; Duflo 2012; Dupas and Robinson 2009; Morawczynski and Pickens 2009). Fintech simplifies operational processes and allows more detailed, less costly analytics that enhance transparency while also maintaining the personal privacy and security of the financial activity. In addition, fintech has changed cross-border and remittance payment services, offering better and cheaper services while lowering the cost of complying with regulations.

Table 5.4. Made Digital Payments in the Past Year (% age 15+) by Individual Characteristics, 2014–2017

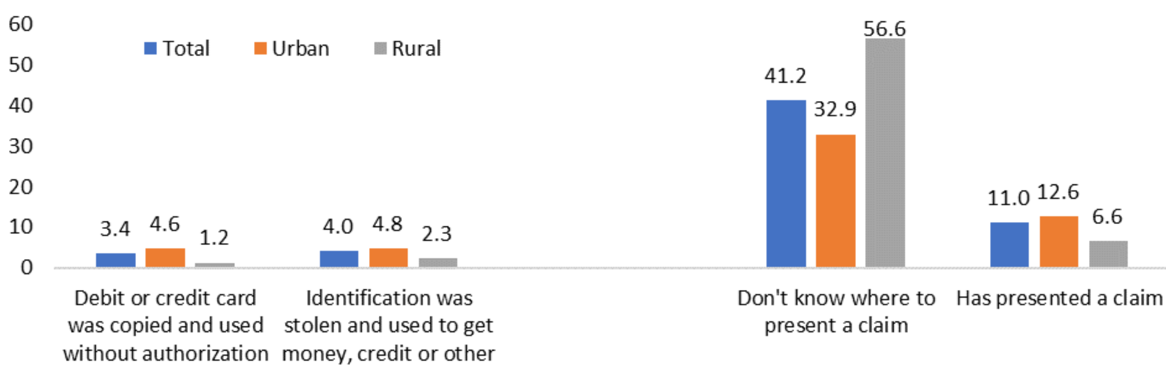
	Mexico		LAC		UMICs	
	2014	**2017**	**2014**	**2017**	**2014**	**2017**
Total	29.4	31.7	37.7	45.1	44.4	62.3
Male	31.7	35.8	43.3	47.7	47.3	65.9
Female	27.3	28.2	32.3	42.6	41.6	58.7
Young adults (% age 15–24)	26.2	29.7	29.1	33.4	46.4	59.8
Older adults (% age 25+)	30.6	32.4	40.6	49.0	43.9	62.8
In labor force	39.2	38.7	46.7	51.1	49.5	68.7
Out of labor force	14.2	19.0	23.1	32.0	32.6	48.3
Primary education or less	17.0	19.6	23.6	32.1	28.1	50.5
Secondary education or more	38.8	38.3	46.7	52.0	62.2	73.4

Poorest 40%	17.2	20.2	24.2	32.4	29.4	48.5
Richest 60%	37.5	39.1	46.6	53.4	54.1	71.6
Rural areas	22.9	23.7	32.0	42.5	36.9	60.4

Source: Global Findex (Global Financial Inclusion Database), World Bank, Washington, DC, https://globalfindex.worldbank.org/.
Note: People who report using mobile money service in the past 12 months.

19. **However, the expansion of electronic payments also presents a risk; therefore, regulations that support services and cybersecurity will protect new technology users and the previously unbanked population.** In 2018, 3.4 percent of the adult population had their debit or credit card numbers copied and used without authorization, while 4 percent had their identities stolen and used to get money, credit, or other financial services (ENIF 2018). Moreover, only 59 percent of the customers in the financial system in Mexico in 2018 knew where to present a claim if they needed to and, in rural areas, almost 57 percent of the customers did not know where to go. As electronic payments and access to financial services to populations who were previously unbanked expand, there is also a growing concern that new technology users are especially vulnerable to cybercrimes if targeted. Poor password management or simple phishing techniques make the digital financial illiterate easy victims if they are unaware of the risks. Women are less financially literate than men on average and are less familiar with banking and financial terminology (OECD 2013). As financial products become more broadly available, financial capability is crucial in accelerating women's financial inclusion.[74] The new regulations that support the authorization and operationalization of agents to support cybersecurity rules will provide important protection to vulnerable groups.

Figure 5.2. Customers Who Have Faced Financial Crimes and Knowledge about Available Recourse, 2018



Source: ENIF, INEGI 2018.

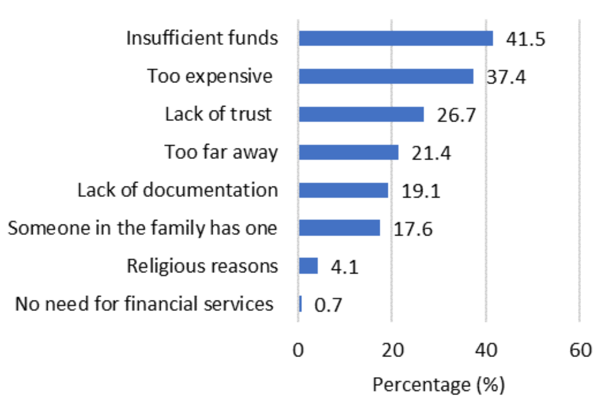
20. **In addition to cybersecurity, new technologies raise concerns regarding data collection and data privacy that could harm financial inclusion efforts.** Fintech companies collect large amounts of data about their customers, including personal information and financial records. Moreover, many fintech firms harvest data by collecting information about customers' online spending behavior and social media patterns. If customers fear their privacy is being violated and their personal information may be used

[74] Financial capability is understood as the ability of consumers to make sound financial decisions and use financial products effectively and responsibly, as defined by Reddy, Bruhn, and Tan (2013).

inappropriately, they may be less likely to use formal financial services. Moreover, to the extent that firms become more visible through technology, this could pose a disincentive for microentrepreneurs to enter the financial sector, as there is a strong bias toward informality to avoid taxes.

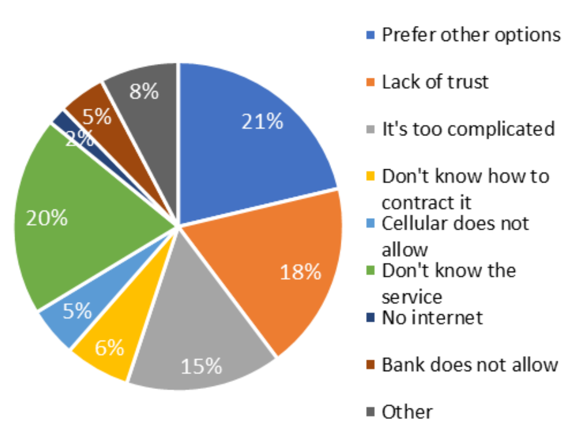
21. **Therefore, secondary regulations aiming to ensure adequate consumer protection and cybersecurity of digital payment services provide an opportunity to create trust in the financial sector and foster financial inclusion.** In 2017, 26.7 percent of the unbanked population (ages 15+) declared that the lack of trust in financial institutions was a barrier to owning an account in Mexico. Moreover, out of the 23.2 million adults with a savings account who have not contracted mobile banking services, 18 percent declared it was because they lack trust, according to the ENIF 2018. The use of technology to disburse payments rather than cash has been proven to increase transparency and reduce corruption (Muralidharan et al. 2016). A secure payment infrastructure is an investment that could improve financial inclusion and help improve the implementation of social programs.

Figure 5.3. Barriers for Owning an Account, Findex 2017



Source: Findex, World Bank, 2017.

Figure 5.4. Reasons for Not Using Mobile Banking Services among Account Holders, ENIF 2018



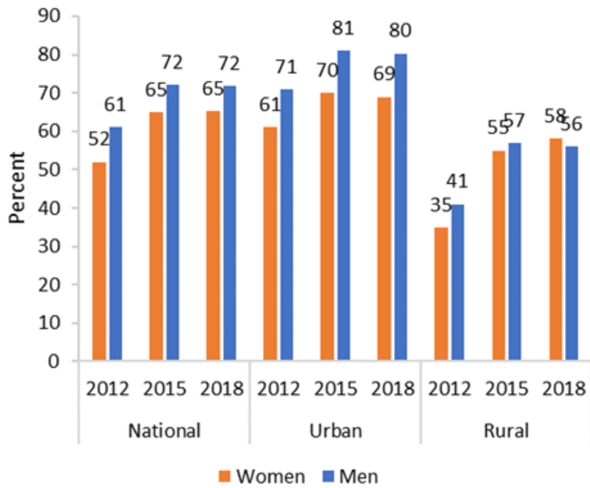
Source: ENIF, INEGI 2018.

22. **In terms of improving access to finance in hard-to-reach areas, despite recent improvements, a larger percentage of rural women still use bank branches more than other channels.** In the past decade, the financial landscape in Mexico has been altered by a sharp expansion of the financial infrastructure and the availability of products and services.[75] New legislation increased the accessibility and convenience of financial services with point-of-service (POS) stores and ATMs. However, in 2018, a larger percentage of rural women (30 percent) continued to use bank branches more than other channels (28 percent for POS stores and 22 percent for ATMs) (figure 5.6). In contrast, ATMs were the most common channel used by urban women: 52 percent reported using one over the past year. Thus, so far, channels designed to

[75] Since 2002, Mexican banking authorities have supported legal changes to permit specialized banks, such as Banco Azteca and Banco Walmart, to operate from stores that have a strong physical presence throughout the country. Furthermore, in 2009, legislation was passed to provide an enabling framework for third parties (such as stores or pharmacies) to deliver banking services. See the law at *http://dof.gob.mx/nota_detalle.php?codigo=5306829&fecha=16/07/2013.*

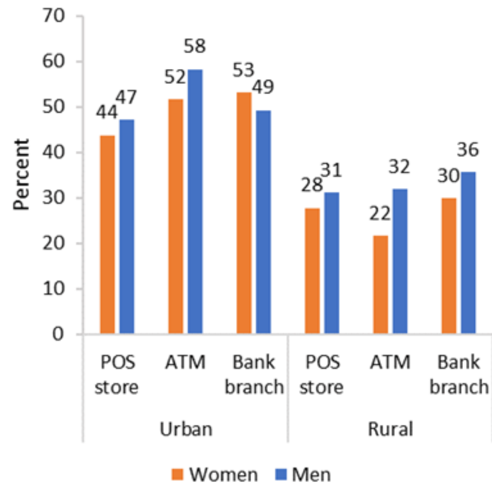
increase financial access have been primarily beneficial to those with greater financial knowledge and capability, mostly in urban areas (Reddy, Bruhn, and Tan 2013).

Figure 5.5. Adult population with at least one financial product



Source: ENIF, INEGI 2018

Figure 5.6. Use of the financial infrastructure by gender over the last year, 2018



Source: ENIF, INEGI 2018

23. **Updating retail agent banking regulations will promote the financial inclusion of households and firms that traditional banks do not serve well.** Lack of physical access to financial institutions has historically been a key driver of financial exclusion, particularly among poor rural communities which are not well served by traditional financial infrastructure. In fact, commercial lending is concentrated in urban areas, while development banks and non-bank financial institutions, such as credit unions and cooperatives, are key in servicing the rural sector. However, these financial institutions often lack economies of scale and tend to be constrained by poor governance, low technical capacity, and limited funding sources (Branch and Evans 1999). In turn, these constraints are passed on to the borrower in the form of higher interest rates and credit rationing.

24. **Technology can enable banks and their customers to interact remotely in a trusted way through existing local retail outlets.** Agent-based models, in which retailers act on behalf of a financial institution to facilitate basic financial transactions, allow financial institutions to leverage existing retail infrastructure and serve consumers at significantly lower cost than through brick-and-mortar branches or ATMs. Thus, this reform has the potential to open access to a range of financial services and providers in most rural areas. For instance, in the case of Peru, Mas and Siedek (2008) find that 55 percent of districts with agents in 2007, corresponding to 24 percent of the population, had no bank branches, suggesting that banks deliberately targeted underserved areas to a significant degree. In the case of Mexico, 26 percent of municipalities remain unserved by retail agents.

25. **Updating retail agent banking regulations will promote financial inclusion of households and firms that are not well served by traditional banks.** Lack of physical access to financial institutions has historically been a key driver of financial exclusion, particularly among poor rural communities which are

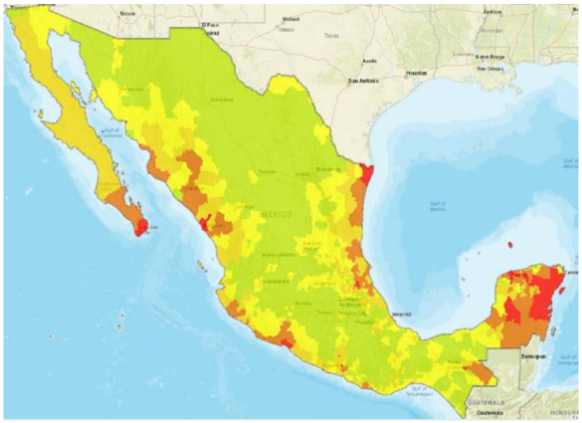
not well served by traditional financial infrastructure. In fact, commercial lending is concentrated in urban areas, while development banks and non-bank financial institutions, such as credit unions and cooperatives, are key in servicing the rural sector. However, these financial institutions often lack economies of scale and tend to be constrained by poor governance, low technical capacity, and limited funding sources (Branch and Evans 1999). These constraints are in turn passed on to the borrower in the form of higher interest rates and credit rationing.

Prior Action 4: Disaster risk mobilization capacity
The Borrower has taken measures to strengthen its capacity to rapidly mobilize and target funds post-disaster by establishing provisions detailing budgetary mechanisms for financing projects and programs to respond to natural emergencies and disasters, as well as promoting the use of financing and risk transfer mechanisms to complement budgetary mechanisms.

26. **Natural disasters can push people into poverty in the short term and limit long-term poverty reduction.** Natural disasters have consistently been a key factor responsible for pushing vulnerable households into poverty and keeping households poor (Krishna 2006; Sen 2003). Just as importantly, the exposure to natural hazards may reduce incentives to invest and save, since the possibility of losing a home due to a flood or livestock and crops due to a drought makes these investments less attractive (Cole et al. 2013; Elbers, Gunning, and Kinsey 2007). Poor people are more vulnerable to disaster events (Carter et al. 2007; Patankar and Patwardhan 2016). In addition to losing more, poor households have a relatively lower capacity to deal with shocks than non-poor households due to lower access to savings, borrowing, or social protection (Highfield et al. 2014; Kundzewicz and Kaczmarek 2000; Masozera, Bailey, and Kerchner 2007). As a result, poor populations could end up using their few assets which could plunge them further into persistent deprivation. The vulnerability of poor people to natural disaster risk is particularly worrying in the context of climate change, which may increase the frequency, intensity, and spatial distribution of heavy precipitation, floods, and droughts (IPCC 2012).

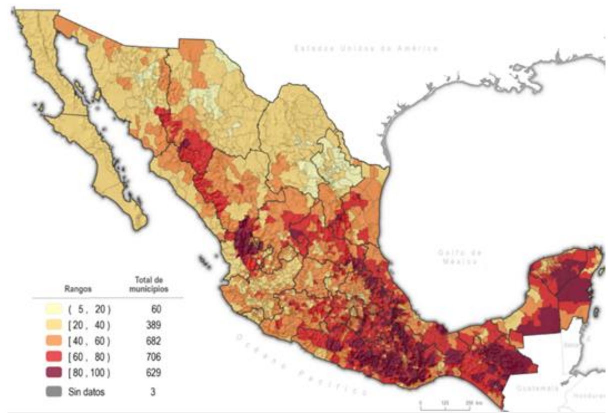
27. **Some of the most disaster-prone areas in Mexico are also home to poor and vulnerable populations.** Mexico's location and geographic characteristics make it prone to hydrometeorological events (DOF 2014) and its socioeconomic characteristics make it highly vulnerable to the negative effects of extreme weather events and climate change (Hunter et al. 2013; SEMARNAT 2009). A large share of poor and extreme poor households resides in risk-prone areas. As much as 38 percent of households in extreme poverty and 33 percent of households in moderate poverty reside in municipalities with high risk of hurricanes (Figures 5.7 and 5.8). Similarly, 50 percent of households in extreme poverty and 37 percent of households in moderate poverty reside in municipalities with high risk of earthquakes. Women are typically disproportionately affected by disasters across several outcomes, including life expectancy, unemployment, labor force re-entry, and relative asset losses (Erman et al. 2021).

Figure 5.7. Risk of Hurricanes



Source: World Bank based on CENAPRED 2021.
Note: Darker colors denote higher risk.

Figure 5.8. Incidence of Poverty, by Municipality



Source: Coneval 2021.

28. **Mexico has experienced several natural disasters with important consequences for the poor.** For instance, Rodriguez-Oreggia et al. (2013) found significant and adverse effects of natural disasters between 2000 and 2005 on both human development and poverty. Their causal analysis finds that extreme poverty increased by 3.7 percent due to natural disasters during that period. Similarly, the effect on the Human Development Index was equivalent to losing on average two years in human development gains in affected municipalities over the sample period. Floods and droughts had the most adverse effects compared to other hazards. With respect to vulnerable groups, de Janvry et al. (2006) find that girls' school enrollment decreased by 5 percent in Mexico after their locality was affected by an earthquake, hurricane, flood, or plague. They find no effect for boys. After a natural disaster, the likelihood of engaging in child labor also increased for both girls and boys.

29. **The strengthened guidelines for disaster risk response have the potential to reduce negative poverty and social impacts of natural disasters.** The approved guidelines will help mitigate the impacts of a natural disaster by providing clarity for line ministries on how to request resources following the declaration of a natural disaster, potentially saving lives and providing relief to the worst affected households in a timely and effective manner. Moreover, clarity on how the government will procure insurance and risk transfer instruments for damage caused by natural phenomena could also ensure that the most affected and most vulnerable populations have help when the crisis hits. Insurance programs have been shown to have high returns in Mexico. For instance, state-level drought insurance for farmers has been shown to induce positive risk management responses as observed through higher yields where coverage is available (Fuchs and Wolff 2011).

Prior Action 5: Land use change authorizations require mitigation of the forest's carbon storage capacity

The Borrower has enacted an amendment to the Forest Law to establish that SEMARNAT can only authorize land use change in forest lands for projects that, among others, mitigate the loss of forests' carbon storage capacity.

30. **Forests can improve water quality, reduce the emergence of new diseases, and protect against natural disasters, all of which could positively impact the poor and vulnerable over the long run.** Higher upstream tree cover can improve downstream water quality, reducing the probability of diarrheal disease (Herrera et al. 2017). Mexico's forests contribute to the overall economy by providing critical ecosystem services that sustain key sectors and rural and urban areas such as mitigating soil erosion, maintaining soil fertility, supporting water infiltration, and providing raw material for productive sectors and natural habitats for biodiversity. With one of the largest areas of community-managed forest lands in the world, sustainable forest management has the potential to generate jobs for Mexico's forest dwellers. It is estimated that forests are home to 12 million people in Mexico, who are among the poorest and most marginalized segments of the population.

31. **Given the long-run benefits of forests, the amendments requiring mitigation of the forest's carbon storage capacity will likely positively impact the poor and vulnerable in the long run.** Preventing deforestation through land use changes can have important welfare impacts, especially if they contribute to reducing global carbon emissions. While land use changes accounted for 3.2 percent of Mexico's GHG emissions, preserving forests and ensuring that they continue to act as a carbon sink is a critical part of Mexico's efforts to reduce the nation's contributions to global warming. The poor and vulnerable are most at risk of climate change; therefore, any effort to reduce global carbon emissions can have positive poverty and social impacts in the long term. For instance, results for Mexico show that the reduction of GHG can have significant co-benefits. Crawford-Brown et al. (2012) find that almost 3,000 premature deaths and more than 400,000 nonfatal diseases can be avoided each year if, by 2050, Mexico reduces its CO_2 emissions by 77 percent. Moreover, land-use changes can alter human-wildlife interactions, creating the potential for zoonotic infections to move from animal to human populations; roughly 75 percent of emerging infectious diseases are zoonoses (Myers et al., 2013). Furthermore, converting natural habitats to managed or disturbed habitats tends to increase disease prevalence (Dunn 2010). In addition, when hurricanes or cyclones hit coastal areas, mangrove forests can significantly reduce inundations areas and human and economic losses (Das and Vincent 2009; Zhang et al. 2012).

32. **The proposed amendments are also not expected to have negative impacts on the poor and vulnerable in the short run.** With the proposed prior action, projects seeking land use change authorization must demonstrate that they will mitigate their impacts on the loss of carbon stocks of forests. Most land use change authorization requests in Mexico are associated with activities in mining, electricity, energy, transport, infrastructure, and tourism. While in theory some high-productivity and high-employment projects could suffer from having to comply with the new regulation in the short run, in practice the new requirement is not expected to reject any new project. These projects typically have high rates of return, so they will likely be able to find a way to implement mitigation measures to obtain land use authorization and proceed anyway. Therefore, it is unlikely that there is an opportunity cost for the poor and vulnerable. Moreover, to the extent that projects employ local communities with forest emission reduction projects to mitigate their emissions, forest dwellers and other vulnerable groups may benefit.

Prior Action 6: Forbidding the issuance of land use change authorizations in lands that were deforested previously

The Borrower has enacted an amendment to the Forest Law to enhance forest protection by forbidding the issuance of land use change authorizations in forest lands that were previously deforested.

33. **Agriculture and livestock expansion is largely responsible for deforestation, but typically this sector does not request land use authorizations.** Expansion of agriculture, livestock and grazing drives around 90 percent of deforestation in South America and around 70 percent in North and Central America (FAO, 2020). In Mexico, it is mainly driven by high price agro-industrial products such as avocado, agave, cattle, soy, and African palm. In line with the expansion in the agro-industrial sector, labor productivity in the primary sector has grown by 23 percent between 2010 and 2020 (INEGI).[76] However, deforestation for agricultural purposes is done with no land use change authorization requests from the agricultural sector. For instance, as an extreme case, Aguilar-Tomasini, Escalante, and Farfán. (2020) find that natural protected areas in Mexico have not been effective in containing land use and land cover change in the Trans-Mexican Volcanic Belt.

34. **To the extent that agricultural growth depends on factor accumulation as opposed to productivity growth, this will continue to lead to deforestation, as stagnating productivity poses a threat to livelihoods.** An outsized share of employment in Mexico works in agriculture, particularly among the poor. While 15 percent of the working population were employed in agriculture, hunting, and forestry in 2020, households with agricultural workers make up 39 percent of those living under the US$5.5 a day poverty line and 53 percent of workers in the bottom 10 percent of the income distribution[77]. To the extent that low productivity in the non-primary sectors fails to offer better opportunities through higher value-added and capital-intensive jobs, there will be continued pressure to expand land use. For instance, recent evidence confirms that deforestation in the Amazon is highly correlated with productivity growth in both rural and urban areas (World Bank, 2022, *forthcoming*).

35. **The proposed amendments to eliminate perverse incentives for deforestation are expected to have positive long-term impacts on the poor and vulnerable.** The introduction of amendments that would limit land use change authorizations on previously deforested areas will limit deforestation by requiring landowners to use the legal channels before developing any project. While this action will not limit illegal deforestation for small agricultural production, it will serve as an incentive to ensure that larger projects go through legal channels. In the long run, these incentives will ensure that mitigation measures are put in place, which will ultimately contribute to reducing the climate change impacts on the poor over the long term.

[76] Mexico's agricultural economy is characterized by dualism, with a small number of highly concentrated, vertically integrated large farms juxtaposed against a majority (81 percent) of lower-productivity and subsistence-oriented farms smaller than 5 ha. About 52 percent of farms are smaller than 2 ha. Of more than 5.3 million rural production units, 73 percent are characterized by subsistence or limited market links. These farms suffer organizational problems, use outdated technologies, lack access to finance, suffer from low productivity and limited value addition, and generate reduced income.

[77] World Bank estimates based on ENIGH 2020.

36. **However, the new legislation could negatively impact some vulnerable populations currently living in and around previously deforested lands in the short run.** The new amendment will prevent new deforestation from being carried out prior to submitting a change in land use authorization. Any new project on that land would have to go through the legal channels to request land use changes and ensure appropriate mitigation measures as detailed in Prior Action 5. Based on this, no expected poverty and social impacts are expected in the short run. However, for already deforested areas, any project with high employment and wage opportunities would now be turned down. For local populations living in those areas, some of which may be vulnerable, the new guidelines could have a negative poverty and social impacts in the short run, as those potential employment opportunities would no longer be there. This would be particularly true if projects with a high economic return, high employment generation, and high wages were turned down.

Prior Action 7: Informed consultation for land use in Indigenous territories
The Borrower has enacted an amendment to the Forest Law to introduce free, prior, and informed consultation for authorizing land use changes in forest lands that are located in indigenous territories.

37. **IPs lag non-indigenous populations in multidimensional measures of well-being.** IPs represent 21.5 percent of Mexico's population (25.7 million) according to the 2020 Census question on self-declared identification by culture. About half live in rural areas with fewer than 2,500 inhabitants (Cuesta et al., 2021). There is a well-established consensus that IPs are one of the most disadvantaged groups regarding living standards in Mexico. Some 73.2 percent of IPs lived in poverty in 2020, compared to 47.1 percent of the non-indigenous population. Poverty is also more severe among IPs, with 29.2 percent of IPs experiencing extreme poverty compared to 6.4 percent for non-IPs in 2020 (CONEVAL 2022). Moreover, poverty reduction among IPs has been disappointing. Between 2008 and 2018, multidimensional poverty minimally declined by 1.6 percentage points among IPs compared to 2.2 percentage points among non-IPs (CONEVAL 2021). When looking at nonmonetary dimensions of poverty, including education, health care, social security, basic services (water, sanitation, electricity, and cooking material), quality housing, and nutritious food, IPs averaged 3 deprivations in 2020, while non-IPs averaged 2.3 deprivations. In fact, IPs were three times more likely to be deprived in terms of access to quality housing and basic services than non-IPs (CONEVAL 2022).

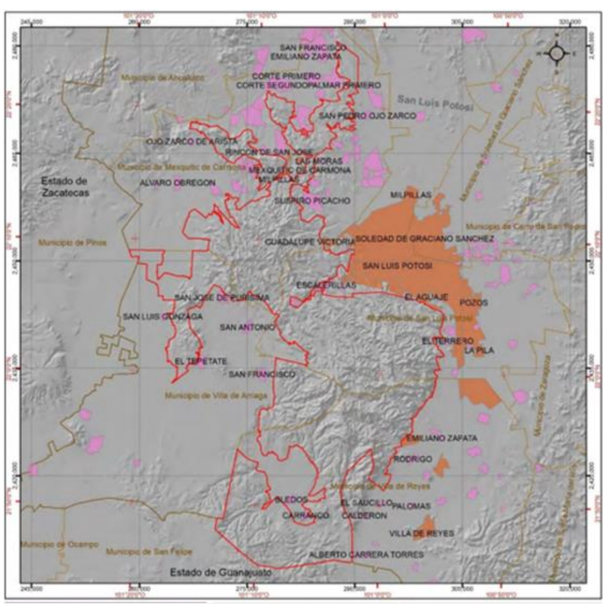
38. **This reform constitutes a commitment by the Mexican State to grant IPs voice, control, and decision-making on the activities to be implemented in their territories.** The new legislation would establish the right of IPs to be consulted and to a free, prior, and informed consent for land use changes in forest lands. This will be aligned with the ILO Convention 169 on Indigenous and Tribal Peoples in Independent Countries, the UN Declaration on the Rights of Indigenous Peoples, and in other international legal instruments. To the extent that the consultations will be binding, the new law will move toward effective implementation. The reform would also be in line with the proposed new General Law for the Consultation of IPs and Afro-Mexican communities (*Ley General de Consulta de Pueblos y Comunidades Indigenas y Afro-Mexicanas*), which was approved by the Chamber of Deputies in April 2021 and is pending approval by the Senate.

39. **The poverty and social impact of the reform is likely to be positive, especially if operationalized based on lessons learned from previous consultation processes.** Mexico has a strong framework for conducting consultations with IPs. While the Government has conducted over 100 consultations with IPs in the last decade,[78] these have been conducted with various degrees of success. Several deficiencies have been highlighted regarding the process—for example, the information is presented in overly technical language and is not offered in local languages (Gasparello 2020; Gutierrez Rivas and Pozo Martinez 2019; and Leyva Hernandez et al. 2018).

Prior Action 8: Declaration of a new natural protected area in the Sierra of San Miguelito
The Borrower has declared a new natural protected area in the Sierra of San Miguelito to enhance protection of natural capital and climate change resilience, and foster sustainable development.

40. **The Sierra San Miguelito (SSM) is in the driest region in the country.** Droughts have dampened agricultural and livestock activities, while their use has led to soil degradation. It has historically been at the limit of agricultural activity, as the population favored the lower flat lands for cultivation and livestock (CONANP, 2021). Forests cover nearly 39 percent of the region, while the area used for agricultural activity has been steadily declining. Characterized by sharp peaks, the forested area has not held large population settlements other than Mexquitic and Escalerillas. The area declared as the new natural protected area covers 111,160 ha across four municipalities of the state of San Luis Potosi, which was home to 1,024,044 people in 2020.[79] Bordering the town of San Luis Potosi (Figure 5.9), it is home to agriculture, livestock, forestry, mining, manufacturing, and tourism activities.

Figure 5.9. Human Settlements around Natural Protected Area



Source: CONANP, 2021.
Note: Urban areas in orange, rural settlements in pink.

[78] See https://www.inegi.org.mx/app/scitel/Default?ev=9.
[79] 2020 Census data for the municipalities of Mexquitic de Carmona, San Luis Potosi, Villa de Arriaga, and Villa de Reyes.

41. **The SSM region has high rates of poverty outside of its urban center.** Outside of urban San Luis Potosi, multidimensional poverty rates in the region are higher than the national average. The municipality of San Luis Potosi, where the capital of the state resides, has a poverty rate of 20.3 percent, compared to 43.9 nationally. However, the three other municipalities that are home to the SSM natural protected area, have poverty rates above 46 percent, with about 60 percent of the population having incomes below the national monetary poverty line (Table 5.5). These poorer municipalities are characterized by a higher share of households that have multiple deprivations, including in terms of education, access to social security, access to basic services and higher levels of food insecurity. As much as 80 percent of the region is communally owned as an ejido or as an agrarian community (CONANP, 2021), and only about 1.1 percent of the population is Indigenous (2020 Census).

Table 5.5. Multidimensional poverty rates (share of population), 2020

	Multi-dimensional Poverty	Extreme Poverty	Share of population by type of deprivation						Income below monetary poverty line	Income below extreme monetary poverty line
			Education lags	Health	Social security	Housing	Basic Services	Food		
National	43.9	8.5	19.2	28.2	52.0	9.3	17.9	22.5	52.8	17.2
State of San Luis Potosi	42.8	8.8	19.2	19.8	51.6	9.3	25.0	18.7	51.5	17.8
SSM municipalities										
Mexquitic de Carmona	54.6	8.0	19.2	22.5	70.3	7.4	30.5	17.1	60.7	26.5
San Luis Potosí	20.3	1.6	9.9	20.8	37.9	3.5	2.3	12.5	30.0	6.8
Villa de Arriaga	58.6	7.8	26.8	18.6	81.8	5.1	34.8	19.1	62.0	24.1
Villa de Reyes	46.7	5.3	24.1	13.8	52.2	8.3	17.0	17.8	60.3	23.5

Source: World Bank calculations based on Coneval small area estimation of multidimensional poverty rates using ENIGH 2020 and population census 2020. See https://www.coneval.org.mx/Medicion/Paginas/Pobreza-municipio-2010-2020.aspx

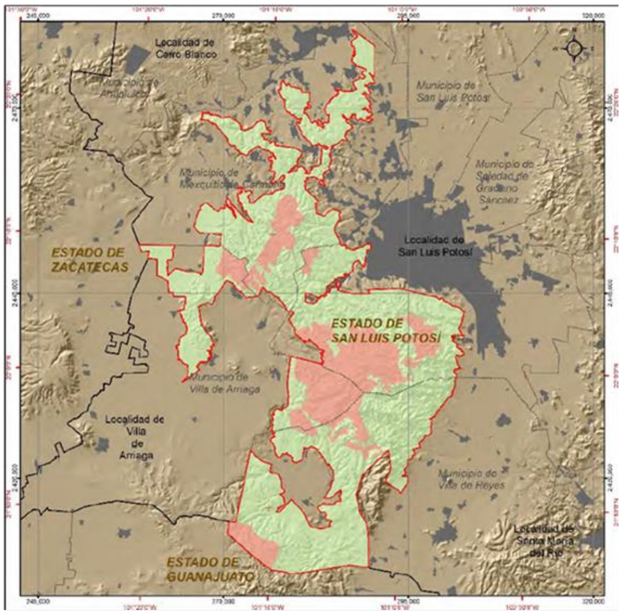
42. **Local communities will face both positive and negative impacts from the designation of a natural protected area**. In theory, protected areas can provide economic benefits to the local population by spurring tourism, attracting infrastructure investments, and ensuring the continued provision of valuable forest ecosystem services (Ferraro, 2008; Ferraro & Hanauer, 2011; Robalino, 2007). The Millennium Ecosystem Assessment divides the contribution of protected areas to poverty reduction into four categories: (a) *provisioning services*: provision of natural products such as food, fresh water, fuelwood, and herbal medicines that have direct use-value to rural communities; (b) *regulating services*: benefits from ecosystem services such as climate regulation, watershed protection, coastal protection, water purification, carbon sequestration, and pollination; (c) *cultural service*s: benefits from religious values, tourism, education, and cultural heritage; and (d) *supporting services*: benefits from soil formation, nutrient cycling, and primary production (IUCN, 2004). However, in the short term natural protected areas could also impose economic costs on local communities by limiting their ability to use forested land for agriculture, logging, and hunting. In the case of SSM, the set of economic activities undertaken in and around the region also include livestock, mining, and some manufacturing. The SSM declaration explicitly allows for many of these activities, including conservation agriculture and non-timber management, enabling local communities to actively engage in natural resource management and income-generating activities within the natural protected area.

43. **The empirical literature shows inconclusive evidence on the net poverty and social impact of new natural protected areas, highlighting the importance of how these areas are managed.** The net impact of establishing a natural protected area has been shown to vary widely across different countries. Focusing only on quasi-experimental studies that control for the fact that natural protected areas are not randomly located, the evidence is mixed. On the one hand some studies find that protected areas lead to poverty reduction. For instance, Andam et al. (2010) find that protected areas reduced poverty by 1.27 percentage points in Costa Rica and 7.9 percentage points in Thailand. Robalino and Villalobos (2010) find that nonagricultural wages earned close to parks in Costa Rica are higher, but only for people living near tourist entrances, implying increases in inequality. On the other hand, some studies find negative effects when there are strict restrictions on converting cropland to conservation land (Ma et al, 2019), while others find no effects when the local populations are not dependent on natural resources (Miranda et al., 2016). In the case of Mexico, Robalino, Villalobos, Blackman, and Pfaff (2012) find that protected areas led to higher levels of economic marginalization in both the short and the long run. The literature concludes that the management of protected areas is critical in determining the net poverty and social impacts, particularly the extent to which local populations can undertake complementary and sustainable economic activities.

44. **To the extent that the proposed area includes multiple zones, the short-run poverty and social impacts are expected to be neutral.** The Sierra San Miguelito protected area will be governed by a management plan that, in line with the zoning established in the Presidential decree of December 13, 2021, includes nuclear zones, aimed at natural resource protection and of restricted use, along with a buffer zone aimed at ensuring sustainable management of economic activity (Figure 5.10). These buffer zones allow for the use of land for productive activities that include traditional uses, sustainable use of natural resources and ecosystems, and sustainable human settlement. The multiple-zone administration of natural protected areas has been shown to outperform strict administration in terms of forest conservation since the effectiveness of strict programs depends on the ability to enforce restrictions (Blackman, 2015). Moreover, strict administration has the potential to create conflict (Nepal and Weber, 1995). Mixed-use protection seeks to strengthen local communities' capacities and incentives for forest conservation (Wells and Brandon, 1992; McNeely, 1995). In addition, no involuntary displacement or resettlement took place for establishing this protected area and there has been extensive consultation with local communities. To the extent that the administration of the new natural protected area can balance the needs of the communities living in the buffer regions with conservation efforts, any negative poverty and social impacts is expected to be mitigated.

45. **In the long term, the natural protected area is expected to have positive poverty and social impacts by reducing climate change impacts, including reductions in the risk of forest fires and flooding that could be devastating to populated areas**. The SSM region is highly vulnerable to climate change, given its high exposure to droughts, frosts and floods affecting agricultural and livestock activities with limited resources to confront these risks. Recurrent forest fires have had negative impacts on biodiversity and in terms of the welfare of the surrounding populations. The proposed natural protected area would provide environmental services that benefit the surrounding populations including carbon sequestration, a water recharge and infiltration zone, climate regulation, soil retention, flood prevention, and environmental research and education.

Figure 5.10. Sierra San Miguelito Natural Protected Area: Proposed Nuclear and Buffer zones



Source: CONANP, 2021.
Note: Nuclear zones in pink.

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