BBVA Bancomer

Serie Propuestas

Ten Actions to Boost
Productivity and Well-being

SPECIAL EDITION

Ten Actions to Boost Productivity and Well-being

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Foreword

Today we can build a better future in Mexico. One in which every man and woman has greater opportunities to generate income and create family savings. A future in which retirement from the workplace can be comfortably enjoyed, in which poverty affects an increasingly smaller number of families, and in which children and youth can enjoy quality health care, education and many other such services. In other words, today we can establish the bases for Mexico to become a developed country in the next 20 years, and where its people can have a higher standard of living with a better distribution of income.

If we are to learn anything from international experience it is that economic development cannot be considered a given nor can it be viewed as the exclusive privilege of a few nations. Rather, from numerous examples evidence shows that in each nation economic development is essentially the result of individual and collective efforts to obtain sustained gains in productivity. Certainly, this becomes easier within an institutional framework that offers the appropriate conditions and incentives for generating physical and human capital, which in turn enhance the rapid expansion of individual productive activity within an environment of competition and fair opportunities.

How to create the most appropriate conditions and incentives to strengthen Mexico's growth and economic development has been the main subject discussed in our *Serie Propuestas (Proposal Series)* since 1999. Based on this previous work, I am pleased to present this Special Edition in English of the *Serie Propuestas*. The aim of this issue is mainly to compile in a single publication the more relevant points in our analyses regarding how to achieve greater development in Mexico, and to present for public opinion and debate *ten strategic actions to boost productivity and well-being*.

We hope this work will contribute to the free exchange of ideas that Mexico requires to define the most appropriate actions that will allow the country to build a better future. In this context, we believe that a comprehensive overview of the main economic issues that must be resolved and their clear interrelation can help the public to understand better the need to introduce numerous changes in the Mexican institutional framework. It also offers an opportunity to explain to society that the short-term costs that such a process of improvement might impose can be reduced and compensated by appropriate strategic planning and preparation and that, viewed from a medium- and long-term standpoint, the social gains derived for Mexico from greater economic development will ultimately exceed the costs.

It is therefore time for everyone to provide ideas, reach agreements, and carry them out as soon as possible.

Hector Rangel Domene

Editorial

The aim of any public policy is to improve the well-being of the people. Just for this, it is imperative to involve society in its design, particularly regarding a democracy. But, there are practical reasons for this as well. One is that actions taken to improve social well-being should be long term and consequently should extend beyond the customary electoral periods. Social support is thus necessary for their continuity. The other is that although the underlying aim of public policy is to improve social well-being, some decisions can be costly for some population groups, which tends to result in their dissatisfaction. For this situation not to become an obstacle to the application of such policies and prevent improvement in the living conditions of broad sectors of the population, it is necessary for society to know and value them.

The time is now right for Mexico to enter into a debate on how to improve social well-being, not only because of the upcoming elections, but because even though the long term always appears distant, it is in fact, increasingly closer. An international environment characterized by intense competition and globalization is here and increases the costs for the country of assuming an indifferent attitude and not advancing decisively toward improving productivity, which is the only road to enhancing social well-being. Thus, this special issue of the *Serie Propuestas (Proposal Series)*, while recognizing that considerable progress has been made to improve living standards in Mexico, also notes that much still remains to be done.

It is not the aim of this publication to propose an absolute and simple formula, which rarely exists, but to provide what we consider to be the key elements to increase productivity and social well-being. To this end, the document proposes ten actions. Maintaining macroeconomic stability and strengthening the country's fiscal position (including pensions) are undeniably of crucial importance, since this would provide confidence regarding the direction of the economy and would free resources to increase public spending in areas of high social benefit. Also, it is necessary to improve efficiency in allocating resources, assuring the supply of energy and making the labor market more flexible, as well as strengthening competition and access to markets, and not deviate from reinforcing respect for the law.

We do not believe that there is only one way to lead Mexico to greater wealth and a better distribution of income. We are certain that our analyses may find agreement among some, and inspire healthy disagreement from many others, but we also think it is important to offer a comprehensive view and to participate in the debate with alternatives that can lead to positive conclusions. The steps we are proposing are found in an initial article that serves as an umbrella for specific policies and explains the reasons why we believe that the quest for higher living standards in Mexico should be based on improving productivity and reinforcing the role of the state. This in order to guarantee that the mechanisms of a market economy operate properly and that the basic function of providing adequate public goods and improving the distribution of income are met. Moreover, conscious of the fact that, in the end, a debate on development must take place in a specific political context, we are closing this issue with the opinion of an independent collaborator, who offers a political view on how to achieve new institutional improvements in Mexico. We invite you to read on.

Chart 1
Selected Indicators

	1980	2004
Health		
• Basic vaccination program for preschool children (%)	nd	98.2
• Infant mortality rate for each 1,000 births	40.2	16.5
• Life expectancy at birth (years)	67.1	75.2
Education		
• Terminal efficiency		
• Primary	63.0	89.7
• Secondary	75.5	78.8
• Illiteracy (%)	17.0	8.3
• Average schooling (grades)	4.6	8.2

Source: Appendix to 2005 State of the Nation report

Chart 2
Characteristics of Poverty in Mexico
Percentage of poor

	1992	2002	2004
Asset poverty[1]			
National	52.6	51.7	47.0
Urban	44.0	42.0	41.0
Rural	65.0	67.5	56.9
Capacities poverty[2]			
National	28.0	26.5	24.6
Urban	18.4	16.0	17.8
Rural	41.8	43.8	35.7
Nutritional poverty[3]			
National	22.5	20.3	17.3
Urban	13.5	11.4	11.0
Rural	35.6	34.8	27.6

1 People who cannot cover nutritional needs and basic consumption on the level of clothing, footwear, housing, and public transportation
2 People in nutritional poverty plus those with limited access to health-care and educational services
3 People who cannot cover nutritional needs
Source: Appendix to 2005 State of the Nation report

Chart 3
Average Growth Rates
Percentages

	Population	Real GDP	Per capita GDP
1981-1985	2.2	2.1	-0.1
1986-1990	2.0	1.7	-0.3
1991-1995	1.8	1.6	-0.2
1996-2000	1.4	5.5	4.1
2001-2004	1.6	1.6	0.0

Source: BBVA Bancomer with INEGI and IMF data

In the past 25 years, the state in Mexico has taken numerous steps to improve the welfare of the population.[1] This is reflected, for example, in concrete advances registered in some health and education indicators. National vaccination campaigns have eradicated illnesses such as poliomyelitis, diphtheria, and cholera, and the incorporation of new technologies and medications in the National Health System has reduced mortality rates and increased life expectancy. In education, the coverage of basic schooling is almost universal and the percentage of students who conclude basic education studies (pre-school, primary and secondary school) has increased. Thus, between 1980 and 2004, illiteracy in the population has decreased from 17% to 8.3% and the average number of school years completed has increased from 4.6 to 8.2 (See Chart 1).

Nevertheless, the disparities in the country are still enormous. In rural areas, a great number of homes do not have electricity and drinking water and in the urban areas, public works for street lighting, sewer systems, and street paving are still pending. In addition, the country faces a shortage of jobs in the formal sector, there is a housing deficit of slightly more than four million homes, and 43% of the population does not have health insurance and social security coverage. These conditions are even more adverse for some social groups due to their poverty. Official figures for 2004 indicate that on a national level, 47% of the population does not have enough income to cover minimum basic needs (food, clothing, footwear, health care, education, housing, and transportation) and 17.3% cannot even pay for food. The situation becomes more serious in rural areas, where those percentages rise to 56.9% and 27.6%, respectively (see Chart 2).

The key lies in improving productivity

The lack of resources is not the main cause of the underdevelopment and poverty that the country faces. Mexico has a young population and has substantial natural resources. In terms of territorial extension, Mexico is the 14th largest country in the world and among its assets are extensive coastlines, seas and rivers; deserts, woodlands and tropical rainforests; plains, mountains and valleys. It is also an important producer of oil, gold and silver; iron and zinc; a major exporter of meat, vegetables and lumber, and a leading tourist attraction. Moreover, due to its geographical location, Mexico is in a strategic position to establish business relations with North America and, possibly, to serve as a link between North America and Europe and Asia.

Mexico's low productive capacity is the main barrier to its development. Price instability and the financial crises of the past had a negative effect on the country's productive capacity because they were obstacles to physical and human capital formation and ultimately economic strength. As a result, real growth in per capita income has been very low (see Chart 3). This decline in living standards has been more pronounced in the rural areas due to the number of inhabitants involved (25.4% of the country's total population), low productivity, and the small share of agriculture in gross domestic product.

1 The state encompasses the executive, legislative, and judicial branches on the three levels of government: federal, state, and municipal.

There is little doubt regarding the need to increase the economy's productive capacity in order to achieve greater social well-being. Evidence indicates that an increase in the production of goods and services and their free exchange in the markets create greater employment opportunities and higher income for the population (see Sala-i-Martin (2000)). Furthermore, various studies show that when a country's per capita income increases, its social welfare indicators improve, especially for those living in poverty. More specifically, Dollar and Kraay (2000) demonstrated that as per capita GDP increases, the income of the population living in poverty also rises in the same proportion (see Graph 1).

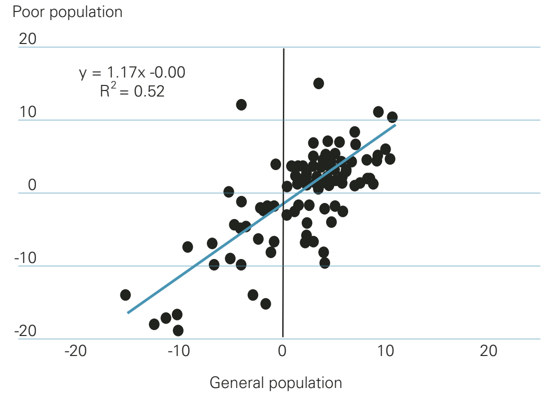
The availability of resources and the productivity with which they are used determine economic growth. Although Mexico has the advantage of having substantial resources, it is in productivity where it faces serious challenges. Faal (2005) revealed that since 1980 the country's productivity has been negative, only improving after its trade opening and other economic measures were adopted (see Chart 4). This is cause for concern because the countries with greater growth and higher social welfare indicators are those that register greater increases in productivity and the reason for this is simple: while natural resources are limited, human creativity is not, and therefore, the possibilities of improving production due to increases in efficiency or technological innovations are significant.

Boosting productivity and improving the well-being of the population requires strengthening the institutional framework

Many researchers point out that the conditions and incentives to achieve gains in productivity depend on each country's institutional setting. North and Thomas (1973) note that countries with norms and institutions that encourage and protect private economic activity see innovation and the efficient use of resources flourish. They thus obtain gains in productivity that later materialize in greater production and employment. In contrast, in nations where the institutional framework does not protect, but rather hinders private productive activities, the general result is a waste of resources, economic stagnation, and poverty.

It is clear, then, that Mexico should strengthen its institutional framework. This is a task in which the state has a key responsibility since it is in charge of establishing the institutions and setting the norms that regulate both its own and private participation in the economy. Fortunately, in Mexico, the state does not have to begin from zero in undertaking such efforts in favor of greater productivity and economic growth. Not only major advances in this regard have already been made, but considering the challenge the country faces, the experience at the international level offers numerous cases of nations that boosted their development in this manner. Chile in Latin America, Spain and Ireland in Europe, Singapore in Asia, and Australia and New Zealand in Oceania are examples of countries that 25 years ago had per capita income similar to that of Mexico and that today have at least doubled or tripled such income levels partly due to the strengthening of their institutions. Their higher per capita income has allowed these countries to reduce poverty and approach the levels of economic welfare enjoyed by the United States (see Graph 2).

Graph 1
Per Capita GDP
Growth rates



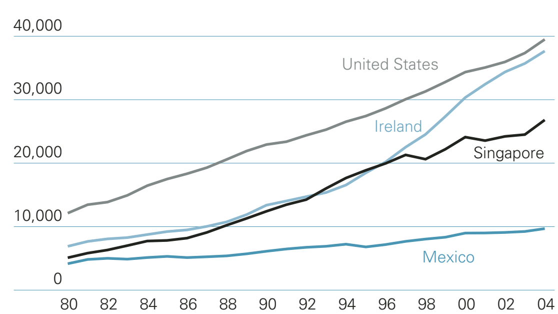
Source: Dollar and Kraay (2000)

Chart 4
Sources of Economic Growth in Mexico, 1965 - 2003
Contribution to GDP growth, percentage points

	1965-1979	1980-2003	1996-2003
Production factors			
Labor	2.4	2.0	1.6
Capital	2.0	1.1	1.2
Productivity	2.1	-0.5	0.7
Real GDP growth	6.5	2.6	3.5

Source: Faal (2005)

Graph 2
Per Capita Income
Dollars, adjusted by purchasing power parity

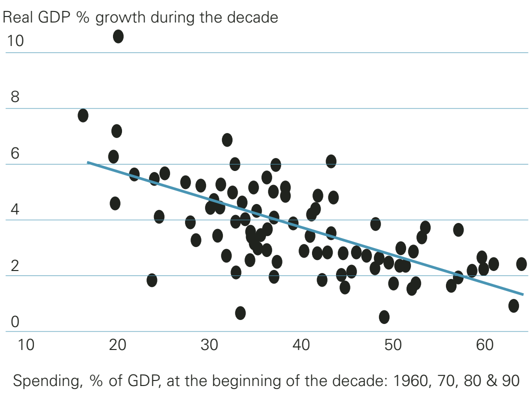


Source: BBVA Bancomer with International Monetary Fund (IMF) data

Graph 3
Per Capita GDP and Property Rights

Source: BBVA Bancomer with World Bank and Fraser Institute data

Graph 4
Government Spending and Economic Growth
OECD countries



Source: Gwartney (1998)

Chart 5
Economic Freedom Index
Scale of 1 to 5 (best to worst)

	1995	2000	2005	Position*
Hong Kong	1.51	1.40	1.35	1
Singapore	1.68	1.59	1.60	2
Ireland	2.15	1.81	1.70	5
New Zealand	nd	1.75	1.70	5
Chile	2.60	2.04	1.81	11
United States	1.99	1.88	1.85	12
Mexico	3.10	3.09	2.89	63

* 2005 position in the world
Source: Heritage Foundation

The national agenda should be centered on three issues: providing public goods, the efficiency of the state, and greater economic freedom

The international experience indicates that the process of strengthening society's institutions for productivity and social well-being should invariably encompass three areas: the sufficient supply of public goods by the state, the efficient operation of the public sector, and the expansion of opportunities for production or economic freedom for private enterprise.

Public goods such as security, the administration of justice, macroeconomic stability, and the creation of basic infrastructure are essential for development, because they allow respect and peaceful coexistence among individuals. They protect people's life, property and other rights; they reduce the costs of trade in the markets; they offer certainty to individuals for the accumulation of physical and human capital, and they facilitate technological development. Their existence represents a net social benefit, and it is efficient that the state guarantee and/or supply them, since contrary to private goods and services, no one can be excluded from their use or consumption. It should come as no surprise, then, that the countries that strengthen the position of the state as a regulator and often as a producer of public goods improve the opportunities of economic growth and equity for the population (see Graph 3).

Nevertheless, the international experience also indicates that when government spending exceeds expenditures earmarked for providing public goods and is not applied efficiently, it can hinder productive activity (see Graph 4). Gwartney (1998) offered four reasons to explain this hypothesis: 1) uncontrolled growth in public spending reduces economic activity because it can potentially impose a higher tax burden on the population to finance such expenditures, 2) as public spending shifts away from the production of public goods, its productivity decreases; that is, resources are increasingly earmarked for items with less social benefit, 3) a direct participation of the state in the production of private goods and services can displace private productive activity, and 4) as the state grows, its resources become an objective for interest groups for their redistribution and their social profitability declines. Estimates by Gwartney indicate that for each 10-percentage point increase in the ratio of public spending to GDP, annual economic growth decreases by one percentage point. Therefore, control over public spending and the efficient application of such expenditures are essential to improving productivity.

At the same time, in the international agenda for institutional strengthening, a special emphasis is placed on expanding productive opportunities for individuals, because it is widely recognized that they create a nation's wealth. Thus, economic freedom—understood as free choice and the facility to participate in the markets—has been a key factor in explaining the differences in the progress registered by different countries. In this regard, Alvarez and Vega (2003) argued that when the markets do not operate freely or when they are ignored, the benefits of specialization and trade are not taken advantage of, to the detriment of economic growth. It should come as no surprise then that countries with important advances in productivity and social well-being such as Singapore, New Zealand, Ireland, and Chile, also occupy first places on a worldwide level in terms of economic freedom (see Chart 5).

Mexico can increase its productivity and social well-being

In Mexico, the state has already led some important institutional transformations to increase the productive capacity of the economy. In the 1980s, it began a process of macroeconomic stabilization to combat inflation and then in the 1990s launched an economic opening and control over public spending to reduce the government's excessive intervention.

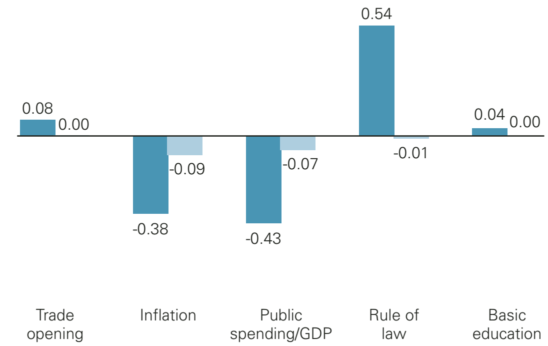
Measures such as control of the fiscal deficit and the elimination of monetary financing, the autonomy of the central bank with the mandate to guarantee price stability, the adoption of a flexible exchange rate, the deregulation of domestic markets, and the incorporation of the country's economy into international trade and investment, have established the bases for Mexico to have more appropriate conditions and incentives for greater mobility of the productive factors, lower price distortions and, of course, gains in efficiency and productivity. Over time, their impact on the social well-being of the population will be increasingly positive. Indeed, Dollar and Kraay (2000) have found long-term evidence that lower inflation, more efficient public spending, and respect for the law have an important positive effect on a country's per capita income and especially in the case of the poorest strata of its population (see Graph 5).

However, this is only a first step, because the obstacles to productivity are not static and can assume different forms. In Mexico, such obstacles range from protective measures for certain industries to prohibitions on private sector participation in different fields of economic activity, passing through price controls, taxes that generate major distortions, complex and bureaucratic paperwork procedures, and excessive federal and local regulations. In response to these obstacles, the state should resume its central role in development and strengthen its institutions to guarantee individuals equality of conditions to produce and compete in the formal economy. This would create appropriate incentives for greater production, investment, and employment, but would also open up new opportunities and would generate resources so that the state can attend more efficiently to the needs of the population and especially its poorest strata.

Fortunately the evidence indicates that it is possible to increase a country's social well-being levels. Doing so does not depend on miraculous formulas but on an institutional framework that promotes productivity and the capacity of the economy to generate employment. In order to strengthen this institutional framework in Mexico, we are presenting an agenda consisting of ten strategic actions in relation to the direction that the country can take, and proposing, in this regard, some general guidelines and specific policies. Nevertheless, the recommendations do not presume to be exhaustive and certainly they do not represent the only alternatives. In this document we are only presenting those proposals that might be efficient from economic and technological standpoints in achieving the objectives set forth, and viable in terms of their application in accordance with different national and international experiences. The ten strategic actions are required to strengthen economic growth. In this context, any advances made, if in the right direction and regardless of how modest they might be, represent gains in terms of social well-being.

Graph 5

Effects of Selected Variables on Per Capita Income*



■ Effect on growth in income
■ Effect on distribution of income
* Quantifying the effect on per capita income of the population living in poverty after increasing the selected variable in a standard deviation

Source: Dollar and Kraay (2000)

Ten Actions to Boost Productivity and Well-being

What must be done?

1. Consolidate Macroeconomic Stability

We must do it, because . . .

Budgetary control and reducing inflation generate certainty for economic activity and confidence for investment. In recent decades, greater control over government spending, a responsible handling of the public debt, and the autonomy of the central bank have allowed a significant reduction in the public deficit and inflation rates in Mexico. (See Graph 1). All this has led to a condition of stable prices, reduced country risk perception and lower interest rates, all of which have facilitated better investment planning and have extended consumption opportunities for the population.

Nevertheless, to achieve higher and, above all, sustained growth rates in the Mexican economy, certainty is required in terms of long-term macroeconomic conditions. This can be achieved by consolidating and advancing in resolving challenges such as strengthening public finances and guaranteeing the financing of various contingent liabilities.

How can we do it?

• By reinforcing fiscal discipline

With fiscal discipline, excessive indebtedness can be avoided, the risks of an economic crisis can be reduced, and price instability curtailed. In addition, with interest rate stability, spaces are opened for private enterprise to develop greater economic activity in a framework of certainty. While authorities have scored significant progress in this regard, it would be worthwhile to reinforce some important factors so as to ensure that such advances be permanent and that they be strengthened.

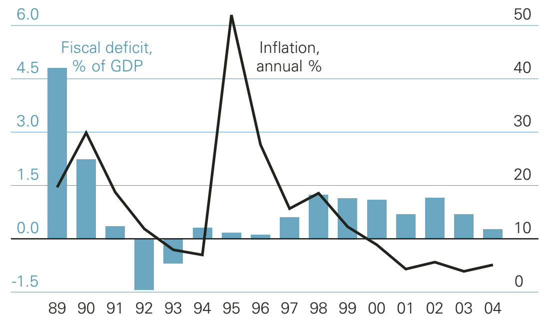
√ By guaranteeing a balanced budget

In Mexico, the evolution of balanced public sector finances has been favorable. Between 1989 and 2004, the fiscal deficit as a percentage of GDP, declined from 4.8 to 0.3, as a result of significant control over spending. If financial costs are excluded from the balance sheet, the "primary balance" would register a surplus, which on average was 3.4% of GDP between 1990 and 2004. However, the figures also reveal a decreasing fiscal effort, since in 1990 the primary surplus was 7.2% of GDP, while in 2004 it had dropped to 2.5%. This shows how, within the primary structure of spending and revenues, there are increasingly fewer funds available to attend to financial costs, without even considering expenditures on guaranteed and contingent liabilities.

In the future, will the present primary surplus be sufficient? The response to this question should be formulated in terms of whether the primary surplus reduces the balance of the public debt or keeps it constant over time. The details of this estimate, based on the accounting data available on the uses and sources of government financing, can be found in BBVA Bancomer Serie Propuestas (*Proposal Series) No. 23*. Here, only the results of two debt scenarios will be discussed: a) 40% of GDP in relation to the country's traditional debt in addition

Graph 1

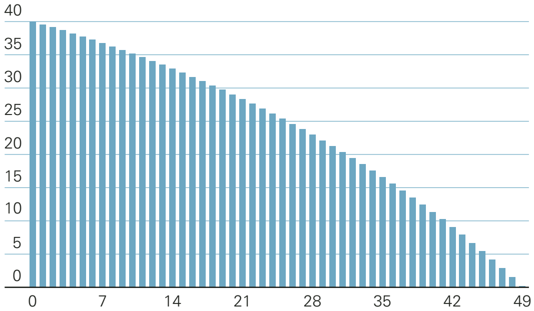
Fiscal Deficit and Inflation



Source: BBVA Bancomer with Banco de México data

Graph 2

Performance of 40% of GDP Debt with a Constant Primary Surplus of 1.4% of GDP*

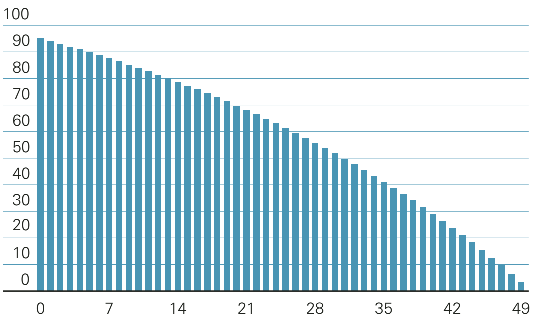


* Assumes an economic growth rate of 3.5% and a real interest rate of 6.0%, both constant

Source: BBVA Bancomer

Graph 3

Performance of 95% of GDP Debt with a Constant Primary Surplus of 3.3% of GDP*



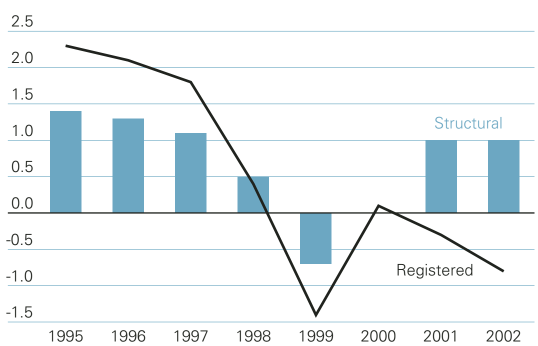
* Assumes an economic growth rate of 3.5% and a real interest rate of 6.0%, both constant

Source: BBVA Bancomer

Graph 4

Chile: Fiscal Balance

% of GDP



Source: Marshall (2003)

to the federal government's guaranteed liabilities and b) 95% of GDP, taking into account the contingent liabilities due to the main public pension systems. (See Chart 2).

Based on the assumption of constant GDP growth rates (3.5%) and real interest rates (6%), the primary surplus required to keep debt constant at the equivalent to 40% of GDP would be 1.0%; and to reduce it to zero in 50 years would be 1.4%. (See Graph 2). Meanwhile, in order to maintain debt at 95% of GDP, the primary surplus would have to be 2.3% and to eliminate it in 50 years, the corresponding figure would have to be 3.3%. (See Graph 3). This does not mean that the debt must be brought to zero in 50 years; it only indicates that if current fiscal efforts remain constant or increase, there would be no problem in paying the traditional or guaranteed liabilities, and substantial funds could even be freed for other social priorities. In the case of contingent liabilities, fiscal efforts should be greater so as not to have to face solvency risks.

In order to ensure constant fiscal efforts that would allow the federal government to meet the liabilities that it is facing in the medium and long terms, it would be important to approve steps that, codified into law, would establish the rule of having a balanced budget or a constant primary surplus in a multi-year period (6 years). Moreover, in order to allow the application of a counter-cyclical fiscal policy, the rule could be defined with respect to "structural" balance, as is the case in Chile.

In Chile, "structural balance" is defined as the revenue level minus government expenditures if economic activity, measured by GDP, were to grow at its potential rate and if the price of copper were the same as its medium-term trend. The fiscal policy rule adopted by the Chilean government consists in setting public spending in the budget at such a level that the structural balance will register a surplus of 1% of GDP every year. This rule allows the economic balance to be lower than 1% of GDP when cyclical conditions are unfavorable and higher than 1% when they are favorable. (See Graph 4).

To provide transparency in the structural balance estimate, the Chilean government consults with External Expert Committees regarding long-term copper prices and the economy's potential production level that must be included in its estimate. The details can be found in the Internet page of the Chilean Finance Ministry, www.hacienda.gov.cl and in Marshall (2003). In Mexico, the proposal for balanced public finances should be related to oil prices.

√ By establishing financing rules for the new legislation

In Mexico's various legal dispositions one frequently finds a clear contrast in which there are ample social benefits in the form of free or highly subsidized services for the population, but there are no legal long-term provisions that would assure government financing of these services. This is serious because, within a context where the state sets its budget annually and with variable allocation criteria for its outlays, it is impossible to guarantee financing of public programs or institutions in charge of providing the rights promised to society. An insufficient and/or low-quality provisioning of various services provided by the state is proof of this frequent reality.

To prevent the legal framework from being a source of unfulfilled promises to society, despite its good intentions, the proposal, from now on, is all bills, particularly those with a high impact on the federal budget, should contain regulatory provisions (articles, sections, clauses, etc.) that would adequately provide for long-term financing for all state expenditures. Strict rules should also be established for exercising public expenditures: a) there should not be any government programs with incomplete financing that can later turn into liabilities for the state, and b) all additional expenditures should be offset with cutbacks of equal magnitude in the expenditures of other already budgeted projects or programs, although of lower priority, or should be backed by new public revenue.

• By strengthening public sector revenue

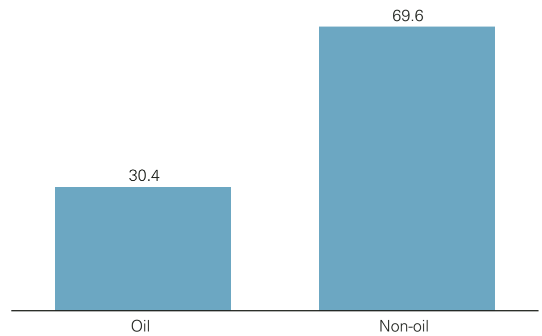
Strengthening public sector revenue provides viability for the state's social activity, without causing pressure on the budget and/or the public debt. In Mexico, the main sources for public sector funds are revenue from taxes and oil. In this section, proposals will be offered for strengthening oil revenue due to its importance in budgetary revenue. (See Graph 5). In the following section —"Improving efficiency in tax collection"— proposals will be presented to increase tax revenue.

√ By optimizing oil revenue

In Mexico, Petroleos Mexicanos (Pemex) is responsible for maximizing the economic value of the country's oil reserves so that, subsequently, the state can transform these non-renewable resources into productive assets, goods and services for the nation. Within this context, Pemex's fiscal regime should ensure the greatest amount of funds possible for the government, allowing the expansion in the productive capacity of the state-run oil company. Through 2005, the fiscal regime ensures that by means of a combination of duties and taxes, the state-owned oil company will turn over to the state 60.8% of its total sales of hydrocarbons and petrochemical products and any additional funds, whenever oil prices exceed the limit established in the Revenue Law. While the rates for duties and taxes applied to Pemex are comparable to those of other oil producing countries, its fiscal regime discourages productive expansion (which reduces the generation of revenue for the state in the medium term) because in the duty on oil extraction, the costs including investment cannot surpass the amount authorized *a priori* by the Finance Ministry for effects of estimating the taxable base (revenue minus costs).

In July 2005, the Chamber of Deputies modified the Pemex fiscal regime so that the state-owned oil company would have more funds for the development of its activities. The reform consisted in replacing three duties by other new fees with lower tax rates and in reducing its taxable base. (See Chart 1). This was done by defining the concept of revenue, eliminating *a priori* limits in costs, and setting periods and deductible amounts for investment. Also taken into account was a four-year transition period for deductions for costs, expenditures, and investments that do not exceed a fixed quota of the volume of the extracted hydrocarbons. (See Pemex 2005).

Graph 5
Public Sector Budgeted Revenue, 1990-2004
% of total



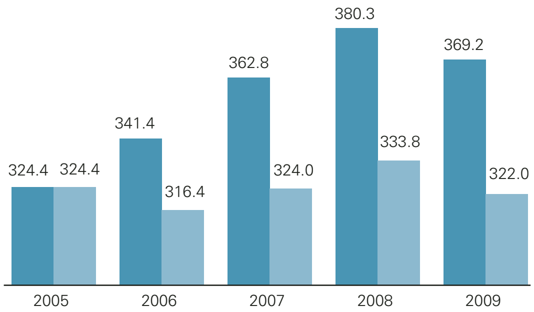
Source: BBVA Bancomer with Finance Ministry data

Chart 1

Pemex Fiscal Regime	Congressional Deputies (July 2005)
• Duty on oil extraction	• Ordinary duty on hydrocarbons
• Extraordinary duty on oil extraction	• Extraordinary duty on crude oil exports
• Additional duty on oil extraction	• Duty on hydrocarbons for stabilization fund
• Duty on hydrocarbons	• Repealed
• Tax on oil yields	• In force
• Special tax on production and services (IEPS)	• In force
• Value Added Tax (VAT)	• In force
• Duties	• In force
• Taxes on merchandise imports	• In force
• Gains/benefits from surplus yields	• In force

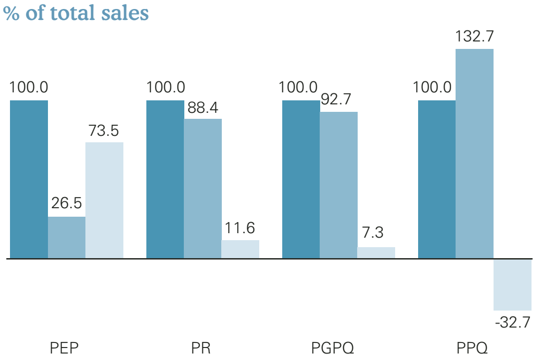
Source: BBVA Bancomer

Graph 6
Tax Collection from Pemex Fiscal Regime
Billions of pesos



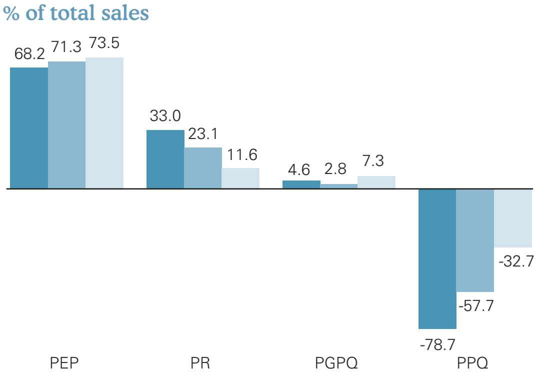
In force
Congressional deputies (July 2005)
Source: BBVA Bancomer with Finance Ministry data

Graph 7
Pemex: Operating Performance before Taxes*, 2004
% of total sales



Sales
Costs and expenditures
Operating performance
* Excludes financing costs
Source: BBVA Bancomcer with Pemex data

Graph 8
Pemex: Operating Performance before Taxes*
% of total sales



2002
2003
2004
* Excludes financing costs
Source: BBVA Bancomer with Pemex data

The fiscal regime approved in July 2005 would grant P$25 billion in resources to Pemex in 2006 and an accumulated total of P$160 billion through 2009. (See Graph 6). Nevertheless, the corresponding bill was returned to the lower chamber of the legislature by the executive branch with a series of observations. Once most of these were included, and an expansion of the amortization period for investments and a differentiated treatment for natural gas to stimulate its production were considered, the congressional deputies approved a motion on a new fiscal regime for the company in October 2005, which was later sent to the Senate for its consideration and approval. Under the new tax plan, in 2006 Pemex would receive US$23 billion, based on an average price of the Mexican mix of US$31.5 per barrel and considering an exchange rate of P$11.40 per dollar.

However, these steps should be reinforced with measures leading to a more efficient operation of the state-owned oil company in order to ensure that the economic value of Mexico's hydrocarbons is maximized. For example, the figures of Pemex's operating performance (sales minus costs and expenditures, excluding taxes and financial costs) indicate that, with the exception of Pemex Exploration and Production (PEP)—the company that absorbs the greater part of the tax burden—all the subsidiary bodies of the state-owned enterprise are facing high costs. (See Graphs 7 and 8). Thus, without improvements in efficiency, there is the risk that the additional revenue from a new fiscal framework in Pemex will only have a transitory effect on improving production capacity.

Greater productivity in Pemex is therefore essential not only to guarantee the company's competitiveness, but also to reduce high social costs for the country, since all inefficiency in the state-owned company inevitably diverts funds that could be used in combating poverty and/or providing public goods and services. With this in mind, one alternative would be to correct the decree approved in October 2005 by the Chamber of Deputies, so that the deductions for costs and expenditures, excluding investment, will be indefinitely maintained at a costcap of the value of the hydrocarbons extracted and not only during a transitional period. This simple correction would allow Pemex to develop its investments, and at the same time would protect the state's taxable base from inefficiencies in production. Nevertheless, the costcap could be reviewed every four years so that Pemex and its subsidiary divisions can meet their operating efficiency goals, previously agreed to with the Finance Ministry in categories such as percentages of utilized capacity, warehousing and distribution costs, repair times for facilities, etc.

- **By strengthening the responsible management of the public debt**

The public debt affects the solvency of government finances, the effectiveness of monetary policy, and unquestionably, the well-being of future generations. Therefore, any advance made toward better management of the debt represents a net social benefit.

√ **By setting stricter rules for public indebtedness**

In Mexico, the constitutional framework allows for a judicious management of the public debt by the executive branch of government, since the latter must present Congress with a proposal on the net indebtedness required to finance each year's budget. However, this does not guarantee a limit, since the legislation in force also provides for authorization from the executive branch in order to exercise or approve additional amounts of financing, when, in its opinion, there exist "extraordinary" circumstances. Under such "extraordinary" circumstances, undefined by the law, the executive branch must only inform Congress of the use of the previously mentioned authorization.

Within this context, the proposal is to remove the executive branch's authority to exercise additional debt under "extraordinary" circumstances. Rather, in response to "adverse economic shocks"—a term amply known among economic specialists—the executive branch should submit a new debt proposal for authorization by Congress. This is the case because in response to a change in the usual conditions of the economy, there is great uncertainty regarding its future performance and, as a result, there is considerable room for errors in estimates. Considering that the management of the public debt affects the solvency of long-term public finances, it would be worthwhile to hold an extensive debate on the advisability of increasing the debt in response to short-term shocks and undertake an evaluation of its potential costs, alternative scenarios, and the necessary mechanisms to reduce such liabilities. The Mexican experience in the 1970s and 1980s in 1) the oil boom, 2) foreign debt, 3) the drop in crude oil prices and 4) the foreign debt crisis, illustrates the costly errors that can be made under the legislation currently in effect.

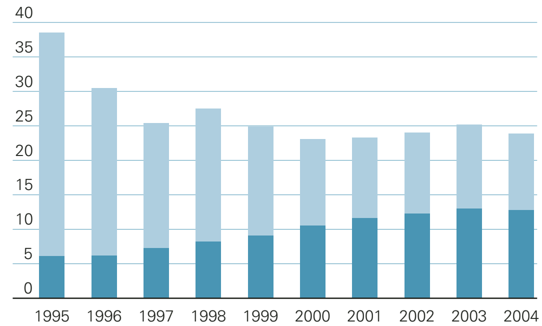
√ By expanding the administrative faculties of the Finance Ministry in managing the public debt

The public debt is comprised of the liability obligations of: I) the federal executive branch and its departments and divisions, II) the Federal District (Mexico City) government, III) decentralized agencies, IV) companies with majority state control, V) development banks, national insurance and bonding companies, and VI) trusts in which the federal government or any of the previously mentioned entities participate. It is up to the executive branch, through the Finance Ministry, to authorize federal public sector departments and state-owned enterprises (SOEs) to obtain financing in foreign markets. To this end, the departments and SOEs must provide all the information that is required. For domestic financing, however, the departments and SOEs only need the authorization of their respective board governing bodies and inform the Finance Ministry.

A responsible management of public finances has allowed debt as a percentage of GDP to be reduced significantly and to reach levels not registered since the mid-1970s. Similarly, efforts to reduce the vulnerability of the economy to external shocks, have led to orienting indebtedness more toward domestic financing sources. (See Graph 9). Within this context, the absence of legal deadlines and terms for federal public sector entities to inform the Finance Ministry of their financing requirements in the domestic markets opens up considerable room for an inefficient supervision of the public debt.

Also the lack of effective coordination in placements of government bonds can have significant financing costs for the public and private sectors. With this in mind, the proposal is to expand the adminis-

Graph 9
Traditional Public Debt
% of GDP



Domestic
Foreign
Source: BBVA Bancomer with Finance Ministry data

Chart 2
Expanded Balance of the Public Sector by Type of Liability

	% of GDP
Traditional	**23.9**
Net Foreign Debt	11.1
Net Domestic Debt	12.8
Guaranteed liabilities	**12.7**
IPAB	8.1
Pidiregas	0.8
Development banks, funds and trusts*	3.3
Debtor support	0.5
Contingent liabilities	**58.2**
IMSS**	25.3
ISSTE**	32.4
INFONAVIT**	0.5
State and municipality debt	n.d
Total	**94.8**

*	Includes Farac
**	For IMSS and ISSTE, own estimate based on a 50-year horizon, and for INFONAVIT, the value of its past-due loan portfolio in 2004 is considered
Note:	2004 GDP is equal to P$7.6 billion
Source:	BBVA Bancomer with Finance Ministry data

trative faculties of the Finance Ministry regarding the public debt. Specifically, that all federal public sector departments and SOEs submit any financing requirement that constitutes public debt to its authorization, independently of the origin of the funds (domestic or external). With improved information regarding the public debt, the Finance Ministry will be better able to program the placement of the different government bonds. This step coincides with the efforts of many countries that are seeking increasingly to centralize the management of all their public debt in a single government agency. See IMF and World Bank (2003).

√ By recognizing the federal government's guaranteed and contingent liabilities as public debt

In 2004, the public debt was equivalent to 23.9% of GDP. This debt, considered as "traditional", includes the federal government, state agencies and SOEs and government financial intermediaries, without considering the loans that they have granted to the private sector as an asset. However, if various liabilities (Pidiregas, IPAB, Farac, etc.) that are not considered public debt but which are guaranteed by the federal government are added to this total, the historic balance of the Financial Requirements of the Public Sector (RFSP for its Spanish initials) is obtained, which would bring the level of indebtedness to 36.6% of GDP.

In addition, in total liabilities of the federal government, it would also be necessary to consider others from contingent developments which include the costs of the transition to the new pension system in the Mexican Social Security Institute (IMSS for its Spanish initials) and the actuarial imbalances of the pension system of the State Workers Social Security and Services Institute (ISSSTE for its Spanish initials). Similarly, the past-due loan portfolios of the public housing agencies and the debt of states and municipalities would have to be considered. Taking into account the contingent liabilities, the balance of the public sector financial requirements would be close to 100% of GDP. Thus, the liabilities recognized as public debt represent less than half of the total. (See Chart 2).

The proposal is to recognize both the guaranteed and the contingent liabilities of the federal government as public debt. This recognition would facilitate legally providing the necessary funds for servicing the debt and could reduce its financing costs, given that for example public debt pays lower interest rates compared to the yields paid on bonds issued by the Bank Savings Protection Institute (IPAB for its Spanish initials). In addition, the consolidation of the debt would allow establishing more appropriate long-term fiscal goals for the real financial needs of the public sector, thus benefiting an improved programming of public spending and coordination with monetary policy.

What must be done?
2. Improve Efficiency in Tax Collection

We must do it, because . . .

Low tax collection levels prevent the state from having the necessary funds to meet its essential functions. Increasing the efficiency in tax collection is, therefore, an indispensable task for improving social well-being in Mexico.

In Mexico, the federal government, the states and the municipalities have the authority to determine taxes. Nevertheless, the most important in this regard are federal taxes due to their scope and the amount collected. Federal tax collection basically involves three taxes, namely, income tax (ISR for its Spanish initials), which is applied to individuals and companies' revenue; the value-added tax (VAT), which is levied on the consumption of goods and services; and a special tax on production and services (IEPS for its Spanish initials), which is levied on the sale or import of some goods and services. (See Chart 1).

Efficiency in the collection of federal taxes is relatively low, in particular in the case of the VAT. While in Mexico, revenue from income tax and VAT represented 4.7% and 3.5% of GDP in 2000, in Latin America the average was 3.9% and 5.5%. Mexico's low collection levels are even more notable when compared to that of the developed nations. For example, in the OECD countries, average revenue from taxes on income and consumption represented 13.6% and 6.9% of GDP in 2000. Denmark and New Zealand illustrate the high collection potential for both taxes. (See Chart 2).

How can we do it?

• By using taxes mainly for collection purposes

The most important obstacle to effectiveness in taxes lies in not using them for collection. Any other use, independently of the purpose, results in fiscal revenue losses that must be evaluated.

√ By eliminating fiscal subsidies

The intended use of taxes as a means of redistribution of income in Mexico has given rise to a situation in which the country's fiscal legislation contains various dispositions regarding special treatment to grant subsidies. For example, in income tax (ISR for its Spanish initials), different tax regimes are taken into account for taxpayers, depending on their economic activity. In the case of the VAT, the rates are applied differentially, by type of product, service and geographical region, including numerous exemptions. (See Charts 3 and 4). These subsidies result in significant fiscal revenue losses, which in 2005 will represent 6.6% of GDP, an amount equivalent to 66% of 2004 tax revenue.

In view of the significant fiscal losses, the state has increased its collection pressure on taxpayers outside the special regimes. This situation generates inequity and new losses in tax collection levels by encouraging more individuals or businesses to transfer part or all of their economic activity to the preferential regimes or even to the informal economy. Considering that recent estimates reveal high evasion levels for the ISR and VAT (almost 40%) and that the value of

Chart 1
Public Sector: Budgetary Revenue
Average 1995-2004

	% of GDP	% of total
Total	**22.2**	**100.0**
Federal Government	**15.6**	**70.4**
Taxes	10.5	47.3
ISR	4.5	20.5
VAT	3.3	14.9
IEPS	1.7	7.6
Imports	0.5	2.4
Other	0.4	1.9
Non-Tax	5.2	23.1
Agencies and companies	**6.6**	**29.6**
Informational items		
Oil revenue	**4.5**	**28.7**
Non-oil revenue	**11.1**	**71.3**

Source: Finance Ministry and INEGI

Chart 2
OECD: Tax Revenue
% of GDP, 2000

	ISR*			VAT**
	Total	Companies	Persons	Total
Denmark	28.7	2.4	25.7	9.5
New Zealand	20.8	4.1	15.0	8.7
Canada	17.5	4.0	13.2	5.2
United States	15.1	2.5	12.6	2.2
Ireland	13.3	3.8	9.6	6.7
Spain	9.8	3.0	6.6	6.2
Japan	9.2	3.6	5.6	2.4
South Korea	7.5	3.7	3.8	4.4
Mexico	**4.7**	**nd**	**nd**	**3.5**
OECD average	**13.6**	**3.6**	**10.0**	**6.9**

* Taxes on income and business profits
** Value-added and sales taxes
Source: Banco de Mexico (2003)

Chart 3
Fiscal Regimes in Income Tax

Companies
- General*
- Fiscal consolidation
- Simplified (primary sector and auto transportation)
- Non-profit organizations

Individuals
- General**
- Professional and business activities
  - Intermediate
  - Small taxpayers
- Residents abroad

Preferential * and multinational companies**

* Includes sections for financial institutions
** Includes sections by source of income: wages and salaries, leasing, sale or acquisition of goods, interests, premiums, dividends and others
*** Income taxed abroad with an income tax lower than the 75% that would correspond to it in Mexico
Source: LISR (Income Tax Law) 2005

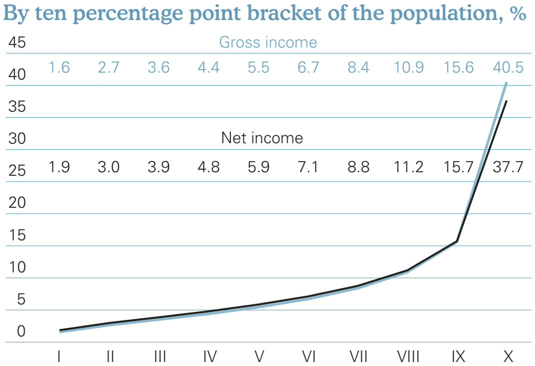
Chart 4
Fiscal Regimes in the Value-Added Tax

General with a 15% rate
Border with a 10% rate
Special with a 0% rate
- Non-industrialized foods
- Food products
- Patented medicines
- Inputs & services for agroindustry
- Exports of goods and services

Special exemption
- Sale of: homes, books, newspapers, magazines, games of chance, lottery tickets, land, currency, others
- Services: teaching, medicine, public overland and maritime transportation, public shows, copyright, others
- Temporary use of goods: farms and ranches, goods of residents abroad, others
- Imports: donated goods, works of art, gold and vehicles of foreign governments, others
- Exports: sales to residents abroad, others

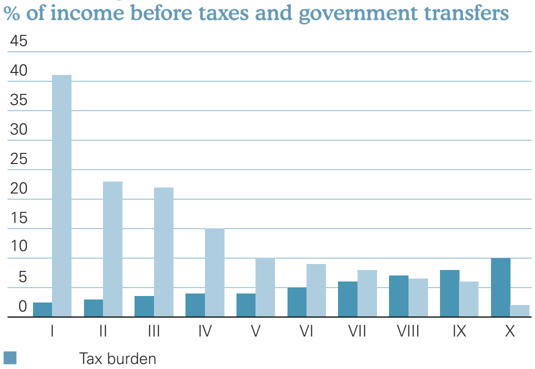
Source: LIVA (Value Added Tax Law) 2005

Graph 1
Income Distribution in Mexico Before and After Taxes
By ten percentage point bracket of the population, %



Source: Martinez Vazquez (2001)

Graph 2
Tax Burden and Public Spending by Ten Percentage Point Bracket of the Population
% of income before taxes and government transfers



Source: Finance Ministry (SHCP 2005)

the informal economy has been estimated at between 12% and 30% of GDP, the elimination of subsidies in fiscal legislation is a feasible alternative for increasing equitable treatment among taxpayers and discouraging the growth of the informal sector. Given the high fiscal losses to date, it is unquestionable that any advance in this direction has great potential for strengthening tax collection levels.

√ By using public spending to generate income opportunities

Because low tax revenue today represents fewer public goods and services tomorrow, it is worth considering whether the special tax treatments really improve income distribution and, with it offset their high opportunity costs. Evidence reveals that this is not the case. For example, Martinez-Vazquez (2001) shows that income distribution in Mexico among ten percentage point brackets of the population does not change significantly when revenue is compared before and after taxes, excluding government budgetary transfers. (See Graph 1). In other countries, the same results have been found. (See Engel, 1998 for Chile case).

On the contrary, public spending can have better results not only in income distribution, but also in its creation. In the first place, it improves income distribution because spending can be directed proportionally to benefit low-income individuals the most. (See Graph 2). In the second place, it creates income opportunities because public spending, for example in health and education, increases individuals' productive capacity, and this increases their possibilities for obtaining new or higher income. In contrast, with tax subsidies, it is difficult to direct them toward specific groups. Furthermore, their effect is practically nil on individuals' productive capacity and they only prolong their dependence on additional subsidies.

• By strengthening the Federal Taxpayer Registry

The Federal Taxpayer Registry (RFC for its Spanish initials) is the backbone of the federal tax system, because it contains the information to identify and specify individuals' fiscal obligations. However, the registry contains only 46% of the potential number of individual taxpayers. To strengthen the RFC, it is necessary for all taxpayers to have their registry number. This can be achieved in two ways: through the timely affiliation of potential taxpayers and encouraging their voluntary incorporation.

√ By affiliating potential taxpayers in a timely manner

In order to affiliate potential taxpayers in a timely manner, one option would be for the RFC number to be assigned as one more piece of data prior to individuals' entry into economic activity; for example, on their birth certificate, and for such effects establishing coordination agreements between the Tax Administration System (SAT for its Spanish initials) and the Bureau of Vital Statistics offices in each state. The number thus assigned, would remain inactive until the individual in question legally comes of age, at which time it would be activated and he or she would be required to provide a fiscal address, perhaps different from that of the parents', and to file annual declarations indicating no income was received while the person was not engaged in a paid activity.

√ By incorporating benefits to the registry

In order to encourage voluntary registration in the RFC, the proposal is to include benefits in the registry. This can be done by linking not only tax obligations to the RFC but other transactions as well, such as military service records, obtaining a passport, academic transcripts, etc., and government budgetary transfers (funds for combating poverty, scholarships, subsidies for leveling income, tax refunds, etc.). To this end, the proposal is to expand the SAT "Virtual Office" at www.sat.gob.mx and to create a fiscal information system in which each individual has an account with two sub-accounts: benefits and taxes. With this system, the taxpayer and the authorities could achieve better follow-up in terms of their rights and obligations.

This system would also represent an opportunity for establishing a transparent and efficient mechanism of government budgetary transfers to the population, an instrument that undoubtedly would do away with the costly use of taxes as a supposed means for the redistribution of income. For example, individuals registered in the rolls of programs such as "Opportunities" and "Popular Insurance" should be among the main groups incorporated in the system in order to be identified and to receive any additional benefit the state might grant.

• By expanding the tax collection base

To move toward higher federal tax collection levels requires combating tax evasion and, in particular, reducing fiscal losses or expenditures due to subsidies contemplated in the corresponding legislation. (See Chart 5). This can be achieved by eliminating special treatment policies in the ISR and with a low number of rates and exemptions in the VAT, which would allow increasing the taxpayer base.

√ By eliminating special fiscal regimes in income tax (ISR)

The proposal is to incorporate companies with consolidated and simplified fiscal treatment into the general company category and, in the case of individuals, to simplify the business activity regime, eliminating the intermediate and small taxpayer schemas. Although the simplified regime was created to provide administrative facilities to the primary and auto transportation sectors, its elimination is justified by the fact that it will encourage taxpayers in the general regime in these activities to transfer operations to the simplified schemas. This will occur because in the simplified regime, ISR payments are reduced by 42.86% (46.67% in 2005) and because, among other benefits, investments in land and fixed assets can be deducted in advance.

The fiscal consolidation regime should be eliminated because it does not significantly reduce the costs of compliance for the taxpayers and leaves the door open to the possibility of tax evasion through accounting manipulation. This explains the growing controls and restrictions in the legislation, so that companies can adhere to the policy. For example, in 2005, the requirement of a consolidatable share of the holding companies was increased from 60% to 100% and the obligation was added for the holding company to present in its consolidation declaration all the information that will allow its tax result to be determined as if it were not consolidated.

Chart 5

Fiscal Revenue Losses

Preferential treatment, administrative facilities, deductions and fiscal incentives

	2005		2006e	
	MP	% GDP	MP	% GDP
Total	**528,874**	**6.7**	**617,285**	**7.2**
ISR	336,842	4.2	413,154	4.9
Companies	214,676	2.7	94,489	1.1
Individuals	122,166	1.5	318,665	3.7
VAT	158,625	2.0	170,245	2.0
Special taxes*	14,445	0.2	15,510	0.2
Fiscal incentives**	18,962	0.2	18,375	0.2

e estimated
MP Millions of Pesos
* Includes IEPS, taxes on new cars (ISAN) & car ownership tax
** Mainly includes tax accreditation, tolls & research expenditures
Source: Finance Ministry (SHCP 2005a)

Chart 6

Fiscal Revenue Losses

Preferential treatment, administrative facilities deductions and fiscal incentives

	2005		2006e	
	MP	% GDP	MP	% GDP
ISR companies	**214,676**	**2.7**	**94,489**	**1.1**
Special treatment	23,802	0.3	29,344	0.3
Fiscal consolidation	-993	-0.0	4,248	0.0
Transportation subsidy	4,197	0.1	4,360	0.1
Primary subsidy*	20,487	0.3	20,736	0.2
Book publishing	111	0.0	—	—
Administrative facilities	5,514	0.1	5,603	0.1
Transportation subsidy	2,841	0.0	2,836	0.0
Primary subsidy	2,674	0.0	2,768	0.0
Authorized deductions	145,261	1.8	39,249	0.5
Others	40,099	0.5	20,293	0.2

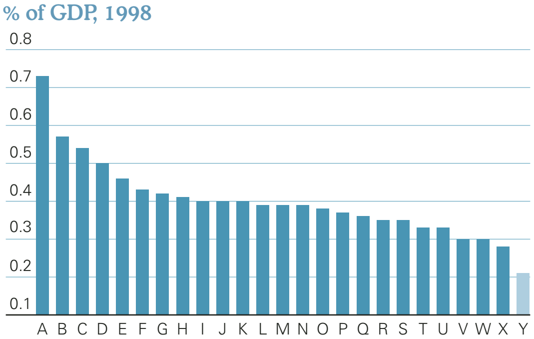
e estimated
* Agriculture, livestock, fishing, forestry
Source: Finance Ministry (SHCP 2005a)

Chart 7
Fiscal Revenue Losses
Prefer. treat., admin. facilities, deduc. & fiscal incent.

	2005 MP	2005 % GDP	2006e MP	2006e % GDP
ISR Individuals	**122,166**	**1.5**	**318,665**	**3.7**
Special treatments	13,550	0.2	9,682	0.1
Primary subsidy	1,833	0.0	1,584	0.0
Intermediate regime	—	—	—	—
Small taxpayers rgm.	6,697	0.1	2,708	0.0
Interest income*	5,021	0.1	5,390	0.1
ISR of salaried workers	58,938	0.7	—	—
Exempt income	40,085	0.5	57,115	0.7
Others	349	0.0	242,280	2.8
Personal deductions	9,244	0.1	9,589	0.1

e estimated
* Agriculture, livestock, fishing, forestry
Source: Finance Ministry (SHCP 2005a)

Graph 3
OECD: Tax Collection for each Point of VAT Rate
% of GDP, 1998



A New Zealand
B Turkey
C Switzerland
D Japan
E Portugal
F Greece
G Austria
H Germany
I Denmark
J Iceland
K Norway
L Finland
M The Netherlands
N United Kingdom
O France
P Luxembourg
Q Hungary
R Korea
S Spain
T Belgium
U Ireland
V Italy
W Czech Rep.
X Sweden
Y Mexico

Source: Banco de Mexico (2003)

Chart 8
Fiscal Revenue Losses
Prefer. treat., admin. facilities, deduc. & fiscal incent.

	2005 MP	2005 % GDP	2006e MP	2006e % GDP
VAT	**158,625**	**2.0**	**170,245**	**2.0**
0% rate	115,858	1.5	124,345	1.5
Foods	96,324	1.2	103,380	1.2
Medicines	7,776	0.1	8,345	0.1
Books, news., magaz.	5,554	0.1	5,961	0.1
Water	4,205	0.1	4,513	0.1
Others	2,000	0.0	2,145	0.0
Exempt	32,531	0.4	34,914	0.4
Health services	1,904	0.0	2,044	0.0
Teaching services	12,774	0.2	13,710	0.2
Public transportation	8,411	0.1	9,027	0.1
Public shows	714	0.0	766	0.0
Housing	8,728	0.1	9,367	0.1
10% border rate	10,235	0.1	10,985	0.1

e estimated
Source: Finance Ministry (SHCP 2005a)

The intermediate and small taxpayer regimes also negatively affect tax collection levels, without generating any benefits that would justify them. These regimes were created to incorporate independent workers and those employed in the informal sector into the RFC under a simple taxpaying policy. Nevertheless, it is clear that with 23% of the population employed informally, these regimes have lagged behind in meeting their objectives. On the contrary, they generate opportunities for those already registered in the RFC to use these regimes and this results in fiscal revenue losses. For example, fiscal spending based on revenue from the small taxpayers regime is estimated at 6.6 billion pesos or 0.03% of GDP for 2005. By eliminating special ISR regimes, these types of losses can be reduced and the tax collection base can be significantly expanded. (See Charts 6 and 7).

√ By standardizing the general and border VAT rates

The co-existence of two VAT rates, 10% for the border area and 15% for the rest of the country, creates opportunities for tax evasion, because it makes it possible to falsely attribute the sale of a product at a lower rate than what should in fact be applied. Standardizing VAT rates would allow simplifying application of the tax and would eliminate incentives for any accounting manipulation. Applying the 15% rate would allow eliminating tax losses estimated at 0.12% of GDP for 2005, while a 10% rate would increase such losses in the short term, although they should then decrease when tax evasion drops.

√ By eliminating exemptions

An extensive list of exemptions and of products and services taxed at a 0% rate reduces sales that could be taxed with the VAT by almost 50%. Thus, the effectiveness of the VAT in collecting tax revenue for each point in its rate is 21% in Mexico, while in OECD member countries the average is 40%, due to its broader collection base. (See Graph 3).

Between goods taxed at a 0% rate and those that are exempt, the former have a higher fiscal cost and the latter a greater social cost. This is because the VAT that cannot be transferred to the final consumer is returned to the producers in the first case, while for products and services that are exempt the reimbursement is partial because it has to be credited as an expense in calculating the ISR. Nevertheless, the accounting of exempt goods encourages producers to hide the tax in the price, to transfer it to consumers, and to partially recover it again with the ISR.

With this in mind, the proposal is to limit the exemption only to services provided to the public without charge; to the sale of goods that are not consumed (land, national or foreign currency, social outlays, documents pending collection, and negotiable instruments); to imports of personal household furnishings, donated goods, works of art, gold, vehicles of foreign governments; and insurance and financial instruments that serve as vehicles for providing social services and savings and that, therefore, do not represent forms of consumption. (See Chart 8).

√ By applying the 0% VAT exclusively to exports and transitorily to a basket of medicines and foods

The proposal is to apply the 0% rate exclusively to export sales so that the exporter can recover the tax that is being transferred and it will not affect its competitiveness. As regards medicines and foods, application of the 0% rate should be transitory and restricted only to a basket of staple products of popular consumption, which can be reduced gradually as more efficient mechanisms for transfers or compensation to the population through public spending are developed. Thus, if initially applying a general VAT rate on products such as coffee and canned chili peppers might affect the consumption of some low-income sectors, the state could more than offset this adverse effect with higher social spending and budgetary transfers. This is because, by applying a general VAT rate to a greater number of products in the economy, the tax collection base increases and more funds can be obtained from the consumption of high-income individuals. This would generate additional funds both for social spending and, if necessary, to cover monetary transfers to low-income sectors that, in principle, might be affected by a higher VAT rate. All this would be facilitated by the system of individualized fiscal information.

An alternative for determining the basket of medicines and foods would be to include patented medicines with active components equivalent to those of the basic list compiled by the Health Ministry, and in the case of foods, to consider non-processed and only a few processed products.

√ By setting low tax rates

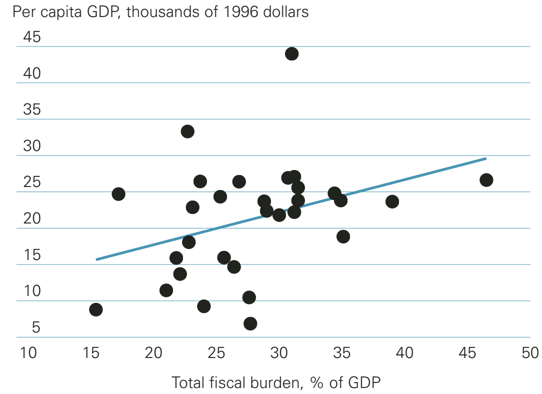
Tax collection levels bear a positive correlation to levels of development. (See Graph 4). This is because public spending financed by tax revenue strengthens the population's productive capacity and income. Nevertheless, there are limits to the tax burden, because as it grows, individuals and companies have fewer incentives and funds for their productive activities. Thus, from a tax standpoint, the best way to promote well-being is through a broader tax collection base and not high tax rates, which encourage tax evasion, generate fewer funds, and finance fewer public services, to the detriment of economic growth. (See Graph 5).

√ By initiating a virtuous circle between tax collection levels and growth

In Mexico, important efforts have been made to reduce tax rates and to simplify their application. For example, between 1990 and 2005, the highest income tax (ISR) rates were reduced from 42% to 30% for companies and from 50% to 30% for individuals. Meanwhile, in 2004, Congress approved an additional reduction in the highest ISR rate to 28% in 2007. It also approved simplifying the calculation of the ISR for individuals as of 2006, thereby setting a new rate in two sections, instead of 50 rates with multiple sections. However, international trends reveal a lag in the reduction of tax rates. Mexico registers higher business ISR rates than those applied in countries that, 25 years ago, had a similar level of development as Mexico, and which today have a per capita income that is three or four times higher, such as Ireland (25%) and Singapore (20%).

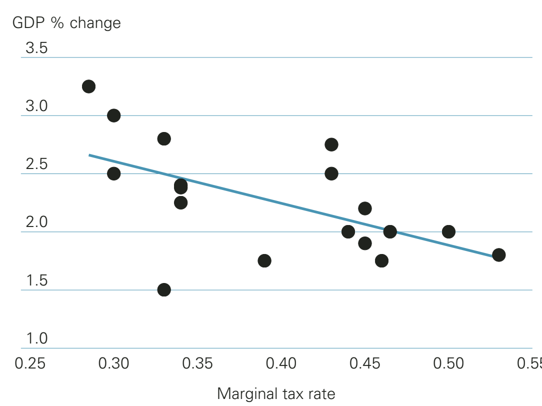
Continuing the tax rate reduction once again imposes the need to expand the tax collection base, since if this is not done, the financial feasibility of the state's social activity would be put at risk. Therefore, it is important to start the virtuous circle between tax collection and economic growth.

Graph 4
Per Capita GDP & Total Fiscal Burden
2000



Source: Banco de Mexico (2003)

Graph 5
OECD: Marginal Income Tax Rate and Economic Growth



Source: Leibfritz (1997)

The combination of a broad tax collection base with low tax rates allows the creation of this virtuous circle between tax collection and economic growth. Indeed, when taxes do not excessively withdraw funds from society, they strengthen economic growth through public spending and, in the process, higher income, consumption, and tax collection levels are generated. This is compatible with the experience previously referred to of developed OECD member countries. However, the combination of high tax rates and a narrow tax collection base has contrary effects since it increases upward pressure on tax rates, encourages non-compliance, and hurts economic growth, income, consumption, and tax collection, which, in turn, demands once again increasing the tax rates or reducing public spending.

- **By making the fiscal framework permanent**

In Mexico, there have been numerous and constant modifications to federal tax policies during the past two decades: 1978-1980, 1983, 1985, 1986, 1988, 1989, 1990-1991, 1993, 1994, 1995-1997, 1998, 2002 and 2004. However, increasing efficiency in tax collection requires a stable fiscal framework that offers taxpayers certainty and legal security.

√ **By not introducing new taxes**

The proposal is to not introduce new taxes. A permanent application of the current taxes and not creating new ones, many of which have recently been declared unconstitutional by the Supreme Court, would allow a better knowledge of fiscal obligations and a decrease in the compliance costs for the taxpayer. Companies and individuals could, as a result, better plan their economic activities in the long term, improving efficiency in resources, economic growth and social well-being.

√ **By replacing the use of the Miscellaneous Fiscal Resolution with a review of fiscal policies in the middle of each six-year presidential administration.**

The Miscellaneous Fiscal Resolution is the legal instrument used by the SAT (Spanish initials for Tax Administration Service) so that every year it may incorporate or modify the rules and general procedures for tax payment. While these changes seek to clarify and update tax dispositions, the constant reforms while they are in effect, generate high costs for the taxpayers. Taxpayers have to constantly monitor the changes and incorporate them in their obligations, since the application of the Miscellaneous Fiscal Resolution is obligatory, provided that it does not generate greater fiscal requirements than those contained in the law that regulates it and is not contrary to such legislation.

In order to reduce the compliance cost, the proposal is that the Miscellaneous Fiscal Resolution be replaced by a single review of the fiscal rules and procedures in the middle of each six-year presidential administration. This would promote better planning and reduce the complexity of the tax system. In this way, the costs in activities that do not generate added value for individuals, corporations or the economy would be reduced, thereby benefiting tax collection levels and economic growth.

What must be done?
3. Offer Economic Viability to Pensions

We must do it, because...

In Mexico most of the public pension plans post an actuarial deficit, given that in present value their expenditures are greater than their revenues (see Graph 1). The most serious case is that of the State Employees Social Security and Services Institute (ISSSTE for its Spanish initials). ISSSTE pension plans already register an imbalance between current revenue and expenditures that the federal government must cover with growing budget transfers so as to not interrupt the ISSSTE's operation.[1] In the long term, to continue pension plans of this type puts the solvency of public finances at risk.

However, in the short term, the lack of financial viability of public pensions also imposes a high cost. This is because the funds diverted from the budget to finance their operation could be better used to fight poverty or expand the supply of public goods and services to society. Furthermore, the lack of economic viability of such plans prevents expanding their coverage.

How can we do it?

- **By closing defined benefit pension plans**

As is the case in many countries, most government agencies in Mexico operate their pension plans based on a defined benefit plan. Namely, the pension is defined at the beginning of the plan as a percentage of the wage (replacement rate) and to obtain it, the worker must complete minimum requirements of age and the length of time he or she contributes into the system. The pension is financed with the fees paid by active workers to a fund managed by the respective government division or agency.

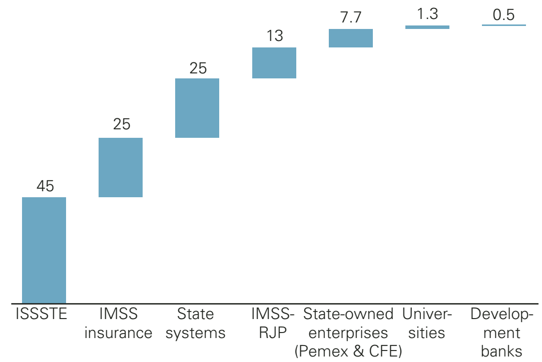
Most of the public pension plans in Mexico have the following common characteristics: non-individualized fees, low contribution rates, and high replacement rates. Over the long term, these conditions have generated imbalances between expenditures and revenues. In addition, the ratio of active workers to retirees makes financing the pension plans vulnerable to demographic factors. For example, a higher life expectancy increases the expenditures by resulting in pensions being paid over a longer period of time. Such pensions should be made financially solvent with adjustments in contribution rates or in the required time period for paying into the system. However, this rarely occurs in Mexico.

√ **By providing a "recognition bond"**

In Mexico, over the next 50 years demographic factors will exacerbate the imbalance between revenues and expenditures of the defined benefit pension plans. The aging of the population and lower birth rates will continue reducing the ratio of active workers to retirees, while a higher life expectancy of the population will extend the length of time during which pensions are paid out in relation to the time that workers have been paying the corresponding fees (see Graph 2). Therefore, it is imperative to end the operation of defined benefit pension plans and move toward a more viable plan.

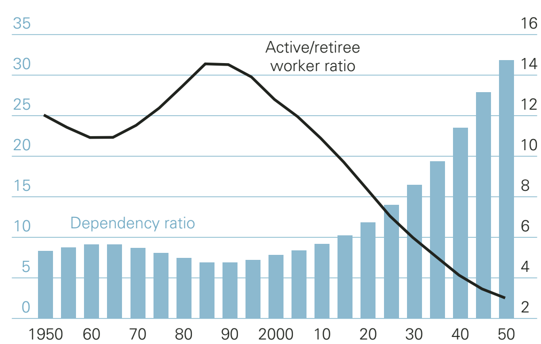
1 For further details on the IMSS financial situation, see BBVA Bancomer Serie Propuestas No. 31.

Graph 1
Pension Liabilities in Mexico*
% of GDP, 2003



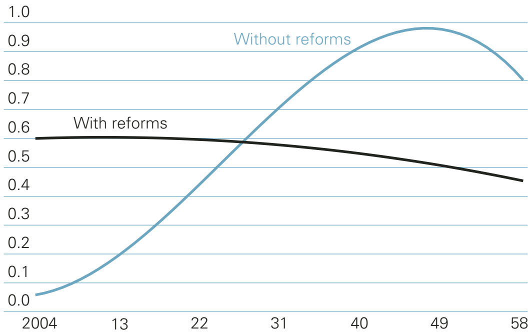
* The figures are indicative. They cannot be combined due to different calculation methodologies
Source: IMSS, ISSSTE, SHCP and CNH 2004

Graph 2
Population Dynamics in Mexico
1950-2050



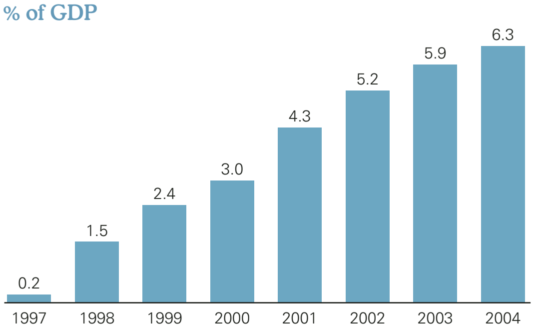
Dependency ratio: adults over the age of 65 as a percentage of the population between 15 and 65 years of age
Active to retiree worker ratio: number of people between 15 and 65 years of age for each person above the age of 65
Source: UN

Graph 3
IMSS Pensions
Annual fiscal cost, % of GDP



Source: BBVA Bancomer with Consar data

Graph 4
Balance in Retirement Savings Funds Deposited in Siefores
% of GDP



Source: Consar

Closing the operation of defined benefit pension plans requires a mechanism that allows the rights of the workers under such pension programs to be recognized and then transferred to another plan. A "recognition bond" issued by the state is an alternative that has been successfully employed in many countries that have reformed their pension systems. This bond translates the amount of time a worker has paid fees under a defined benefit pension plan into money, pays a fixed real annual interest rate and is provided to the employee at the moment of his or her retirement together with the corresponding benefits under the new pension plan.

Mexico could take advantage of the international experience and use the recognition bond to close defined benefit pension plans through the application of three rules: 1. The pensions of workers that are already retired would not be modified (their pensions would continue to be the responsibility of the corresponding government division or agency) 2. Under the new plan, all those who pay into a pension system must do so from the beginning on the basis of the new policies, 3. Those who are paying fees under a defined benefit pension plan should have the option of remaining in this system or changing over to the new defined contribution pension plan with their rights acknowledged with a recognition bond.

• By using defined contribution pension plans

In defined contribution pension plans, the worker pays a defined fee into an individual capitalization account that generates interest. The balance in the account determines the amount of the worker's pension at the moment of his or her retirement, either under the form of scheduled retirements or by allowing the employee to buy a life annuity with an insurance company. In the long term, the viability of the defined fee plan is assured because the worker obtains the amount of his or her fees plus interest as a benefit. Thus, the defined fee pension plans do not depend on the ratio of active workers to retirees and always show a correspondence between rights and obligations.

√ By extending the Retirement Savings System (SAR)

In 1997 the Mexican Social Security Institute (IMSS for its Spanish initials) substituted its defined benefit pension plans with those based on defined fees for workers employed in the private sector. The adoption of the new defined contribution pension plans had the following advantages: 1. It offered workers an instrument to exercise control over their pensions through the administration of their fees, 2. It opened the possibility for employees to retire before the legal retirement age if they have enough funds in their accounts and 3. It assured the economic viability of the pensions, freeing up resources for society and reducing pressure on the national budget (see Graph 3).

In addition, the IMSS reform separated the operation of the retirement pensions from the administration of their financing. The operation of the pensions was in the hands of the IMSS, but the administration of their financing was entrusted to private companies known as Retirement Fund Administrators (AFORES). From the time it was first established, the Retirement Savings System (SAR) has successfully operated with these private management companies. Between 1997 and 2004, the balance accumulated in individual accounts rose from 0.2% to 6.3% of the country's GDP (see Graph 4). The use of the defined contribution pension plans thus represents a major advance in establishing viable pension systems and long-term savings mechanisms.

An alternative for extending defined contribution pension plans to other public sector divisions and agencies would be to use the previously proposed recognition bond. This would allow the rights acquired under the defined benefit pension plans to translate into a monetary value and for this to then be able to be transferred to the new defined fee plans. This operation, in allowing the full transfer of benefits between pension plans, also facilitates the worker's job mobility between the public and private sector, thus benefiting his or her professional career.

- **By strengthening the profitability of the individual accounts system**

Given that with a defined contribution pension system, the amount of the pension depends on the accumulation of funds in an individual account, it is essential to establish conditions that facilitate the greatest possible accumulation of such funds. In Mexico, the opportunities to increase the real profitability of retirement savings funds are still considerable if the Latin American experience is used as reference (see Graph 5).

√ **By making investment policies more flexible**

Recently Mexico has taken firm steps toward adopting more flexible investment policies for retirement savings in the individual account systems. Since December 2004, the corresponding resources can be assigned to new investment instruments (international securities and protected capital bonds tied to stock market indexes) and placed, in accordance with the decision of the individual involved and with some age-related restrictions, in one of two types of mutual funds, one corresponding to fixed income and the other to fixed and variable income securities. This replaces the basic fund that operated since 1997 with only fixed-income instruments and that concentrated most of the pension portfolio in government securities. Such advances will undoubtedly allow an improvement in the yield paid on retirement funds and expand the risk-return options.

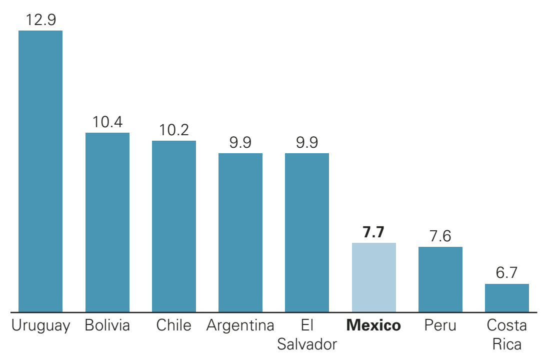
Nevertheless, the experience of other nations with savings systems similar to Mexico's but with higher average returns, such as Chile and Uruguay, indicates that the investment policies for their mutual funds are more flexible than those in our country (see Chart 1). This is because non-government instruments account for a greater share of the total in the investment portfolios of retirement funds, which increases the yield options for each level of risk.

Increasing the share of non-government instruments in Mexico would allow improving the yield possibilities for retirement savings funds and reducing risks, beginning with those associated with a limited diversification of the portfolios. An alternative for advancing toward these more flexible and at the same time safe investment policies would involve strengthening the regulation of risk management in items such as limits on value at risk (VAR) and the minimum ratings for the instruments. This would allow opening up spaces so that long-term investments could obtain higher yields and, at the same time, their exposure to risk could be more efficiently limited than by establishing maximum ceilings *a priori* on allocations in international securities or stock, as is currently the case.

Graph 5

Real Gross Profitability of Pension Funds

Historical through December 2004, annual %



Source: AIOS

Chart 1

Portfolio of Managed Funds

December 2004, % of fund total

	Gov't debt	Financial institutions	Non-finan. institutions	Other*
Mexico	**85.5**	**4.9**	**9.6**	**0.0**
El Salvador	83.5	10.5	5.8	0.2
Costa Rica	73.1	14.2	7.9	4.8
Argentina	62.0	6.6	2.0	29.5
Bolivia	67.5	5.6	16.9	10.1
Uruguay	57.9	36.9	4.2	1.0
Chile	18.7	28.5	7.1	45.8
Peru	24.2	11.4	11.5	52.7
Average	**55.3**	**16.2**	**7.9**	**20.6**

* Includes shares, mutual and investment funds, foreign issuers
Source: AIOS

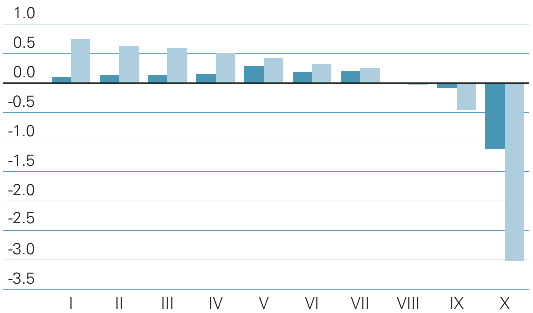
What must be done?
4. Increase the Effectiveness of Public Spending

We must do it, because . . .

After economic regulation, public spending is the state's main instrument for promoting development. Thus, for example, construction of highways, bridges and ports by the government promotes greater economic activity by facilitating communication, the expansion of trade and investment flows, and the mobility of persons.

Furthermore, public spending is the most effective means for combating poverty and improving income distribution. Expenditures in health and education have a significant effect on the development of individuals' productive capacity, on their opportunities for employment, income, and social mobility. Moreover, some studies indicate that public spending has a positive impact, almost six times greater than that of income taxes on the poorest 30 per cent of the population (See Graph 1). Because of this and given that public sector resources in Mexico are extremely reserved and limited, the only way in which the state can comply with its social function effectively and responsibly is by increasing the efficiency and quality of public spending.

Graph 1
Taxes vs. Public Spending
Increase in autonomous income by ten percent income brackets*, %



* 10% population brackets in order of per capita spending
Taxes
Spending
Source: Finance Ministry (2005)

How can we do it?

- **By concentrating public spending on the production of goods with high social gains**

There is no activity with greater social gains for the state than efforts focused on the production of "public goods". This is because in the case of such goods, there is no individual cost to enjoy their advantages and it is impossible to exclude anyone from consuming them. Therefore, the production of these goods benefits all sectors of the population at the same cost. Examples of public goods include national defense, law enforcement, the administration of justice, and the creation of basic infrastructure. At the same time, the production of "private" goods and services—whose costs vary in accordance with the quantity produced and where it is possible to exclude those who do not pay for their consumption—has more limited social gains depending on the efficiency with which the state can provide them. Some examples of "private" goods and services provided by the public sector in Mexico are electric power and health and education services.

√ **By evaluating the social gains of public projects**

In Mexico, most public spending is concentrated on the production of "private" goods and services rather than "public" goods. Essential functions of the state such as the administration of justice, provision supply, and social assistance have a low weight in government spending, while the production of "private" goods and services such as energy has greater importance (See Chart 1). It is not surprising then that, for example, respect for the law is fragile and the administration of justice deficient. Because of this, it is imperative to evaluate the social benefit of public spending and to reallocate funds in order to provide greater weight to spending on goods and services with greater social gains.

Chart 1
Programmable Spending in Functional Classification
% of total

	1990	2000	2002
Total	**100.0**	**100.0**	**100.0**
Social development functions	**38.2**	**60.7**	**59.6**
Education	15.6	24.2	24.1
Social security	0.6	14.4	14.8
Health	17.4	14.3	12.3
Regional & urban development	3.7	6.2	6.8
Others[1]	1.0	1.6	1.6
Productive functions	**52.3**	**25.8**	**29.4**
Energy	33.6	19.0	17.9
Agriculture & fishing develop.	11.1	3.5	7.9
Communications & transport.	5.5	2.8	2.8
Other serv. & economic activ.	2.1	0.5	0.8
Gov't. management functions	**9.4**	**13.5**	**11.1**
Gov´t & national terr. sovereignty	8.3	9.1	6.5
Law enform´t & admin. of justice	0.8	1.8	2.4
Legislation	0.2	0.4	0.5
Others[2]	0.3	2.6	2.2

1 Supply and social assistance
2 Environment, natural resources, human rights
Source: Appendix Fifth State of the Nation Report 2005

In light of these considerations, an alternative would be that, together with the proposed expenditures budget decree, the executive branch could submit a study to Congress, with a 10-year performance projection, on the economic and financial impact of the main activities of the state in providing "private" goods and services. This would allow legislators to have a better-informed and more long-term opinion of the social gains of public resources at the moment in which budgetary items are allocated. To carry out the suggested studies, the executive branch could seek support from the various institutions of the federal public administration, which have ample experience in the social evaluation of projects and cost-benefit type analysis, such as Banobras, Nafinsa, and the Finance Ministry itself.

- **By strengthening public spending in rural areas and on the poor population**

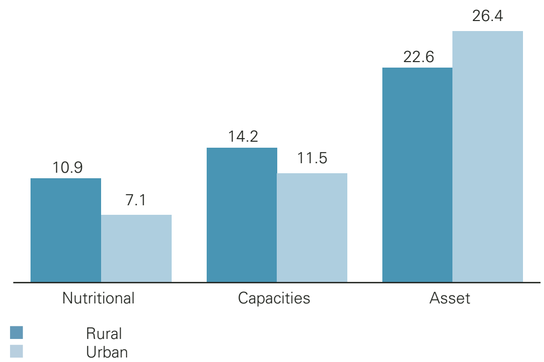
In Mexico, poverty is relatively concentrated more in the rural areas. In 2004, six of every 10 individuals in a situation of nutritional poverty and 5.5 in poverty of capacities lived in rural areas (See Graph 2). Nevertheless, most public spending with a social or re-distributional purpose is earmarked for urban areas. While a high demographic concentration in cities serves to explain this distribution of spending, it does not necessarily justify it, since the most vulnerable segments of the population do not benefit in all cases from this spending.

√ **By increasing spending on basic education and rural areas**

Most public spending on education is earmarked for urban areas (78%), as is also the case with such expenditures for basic education (69%) and middle and higher education (93%). However, while spending on basic education (pre-school, primary and secondary) mostly benefits, relatively speaking, the lower 50 per cent of the population with the lowest consumption capacity, middle and higher education mainly favors the upper 40 per cent (See Graph 3).

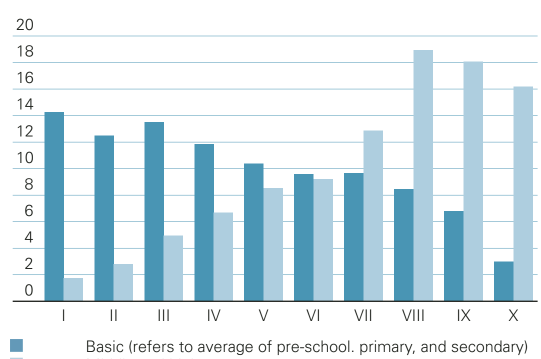
To increase the social gains of public spending not only should more resources be channeled toward basic education, but the rural areas should also be especially attended to. Therefore, although a direct allocation of funds would be ideal, in view of the country's obvious budgetary restrictions, one can only trust that economic policy measures would be accelerated that would allow freeing the state of its non-essential spending and generate savings in the basic education system in accordance with demographic changes and their impact on the urban areas. For example, when due to demographic factors, the size of the children's population decreases the demand for basic education services, the schools that do not cover demand for two shifts, should stop operating and their few students should have the option of choosing another alternative on the level of public education. The budgetary funds thus freed could then be reallocated to rural schools. By the same token, to transfer resources from activities with lesser to greater social gains, a possible alternative would be for the state to promote voluntary contribution systems for users of upper-middle and higher public education systems, which would supplement public financing. In addition, the state could substitute all its scholarships on these educational levels with loans.

Graph 2
Types of Poverty in Mexico, 2004
Millions of persons



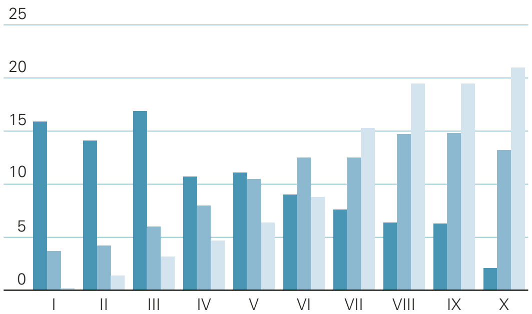
Source: Technical Committee for Measuring Poverty (2005)

Graph 3
Distribution of Public Spending on Education, 2002
% of total



Note: 10% population brackets in order of per capita spending
Source: BBVA Bancomer with Finance Ministry data (2005)

Graph 4
Distribution of Public Spending on Health
% of total, 2002



SSA
IMSS
ISSSTE
Note: 10% population brackets in order of per capita spending
Source: BBVA Bancomer with Finance Ministry data (2005)

√ By increasing spending on health services for the uninsured population

In health services, 70.9% of public spending is earmarked for urban areas, while its benefits vary according to the institution that provides such care. The subsidy to the uninsured population through the Health Ministry (SSA for its Spanish initials) mostly benefits, relatively speaking, those with lower consumption levels, in both rural and urban areas. However, the health services of the main social security institutions mostly benefit the upper 50 per cent of the population with greater consumption capacity and concentrate 85% of their spending, on average, on the urban areas (See Graph 4).

To increase the social gains of public spending on health care requires an increase in financing for services earmarked for the uninsured population. An important advance in improving health care services for this sector of the population is through the Popular Insurance program. Nevertheless, its financing could be reinforced, for example by freeing funds allocated for social security institutions that most benefit sectors with a greater consumption capacity. An ideal alternative here would be previously or simultaneously to close those institutions' defined benefit pension funds and stop the growing transfers of budgetary funds that resolve their financial imbalances. Other possible measures could be gradually to reduce federal government contributions to health insurance and, in order to finance such programs, to establish a progressive system of fees in accordance with the income level of the workers affiliated to the IMSS and the ISSSTE. In addition, fees should begin to be charged to workers who up to now were exempt from such payments in some state-owned enterprises, a situation that has resulted in the total cost of their medical services being transferred to the state.

• By earmarking subsidies to demand for goods or services

In general, the state should not grant subsidies or assume expenditures of sectors that can pay for their benefits, because this generates considerable distortions. For example, a generalized subsidy for water or electricity consumption can lead to a greater use or the waste of such resources by making them less expensive and/or generate savings for those who otherwise would have paid for these services. Furthermore, in order to prevent consumers from turning into captive customers of suppliers of low-quality services that are financed with public funds, it is important to subsidize the demand, rather than the supply of such services.

√ By establishing a national system of public budgetary transfers

An alternative in order to have an efficient system of subsidies in Mexico would be to create a national system of public budgetary transfers with the support of the system of individualized tax accounts, discussed in the section "Improving Efficiency in Tax Collection". This national system would allow: 1) fully defining and identifying the neediest strata of the population, which, in principle, would be those enrolled in the Popular Insurance and the Opportunities programs, 2) granting subsidies as monetary transfers to individual accounts for greater transparency, 3) granting assistance by income or socio-economic level, and never by source of income or economic activity, so as not to break with horizontal equity.

What must be done?
5. Ensure the Supply of Energy

We must do it, because . . .

Energy plays a fundamental role in economic development. Insufficient or unreliable energy supply reduces social well-being, not only because it limits the use of different items that satisfy the demands of daily life, but also because it hinders the operation of the country's productive plant, the application of technologies, the growth of productivity and, ultimately, per capita income. For these reasons, a large number of nations with varying degrees of development are boosting the efficiency of their energy sectors. Within the industry, the private sector is increasingly playing a greater role, because of its capacity to provide capital as well as experience in the development and application of new technologies.

In Mexico, important measures have been introduced to increase the efficiency and productivity of the energy sector. In the past two decades, the first steps were taken to reintroduce private participation in the generation of electricity (self-consumption) and in the transportation, storage, and distribution of natural gas. Nevertheless, these advances are not sufficient. The delay in investments by the public sector for the development of the country's reserves of natural gas, the main input for generating electricity and for the generation and transmission of electric power as such, places at risk the sufficient and reliable supply of electricity that Mexico will demand in the future (see Graph 1). To advance in overcoming these obstacles is a task that cannot be postponed if we are to ensure the supply of energy (see Graph 2).

How can we do it?

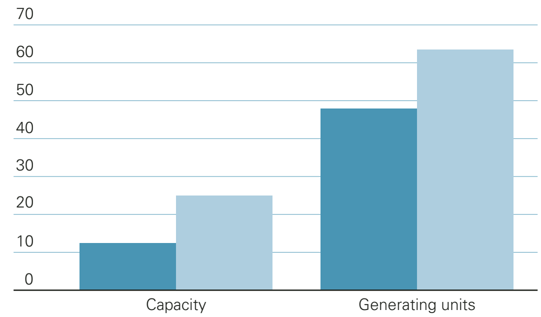
- **By developing a market for electric power**

Despite the actions undertaken for the modernization of the electricity sector, the public supply of such services is still affected by major deficiencies. The supply of electricity is not reliable because it is highly variable in its voltage and suffers from many interruptions. In addition, its cost is higher for the commercial and industrial sectors than in the case of Mexico's main trading partners (see Graph 3).

If at the present time, such situations are serious, the problem will worsen in the next few years. According to the Energy Regulatory Commission (CRE), the demand for electric power will increase at an annual average rate of 5.6% between 2003 and 2012, and therefore it will be necessary to increase the generation capacity by around 60%.[1] To ensure that the necessary investments in the energy sector are available and that from now on its infrastructure can respond to demand in a timely manner, the proposal is to establish an electric energy market. Among those participating in this market would be generators (public and private) that would sell their electricity wholesale to an electricity exchange, and subsequently the distributor and supplier companies would acquire electricity from this exchange for its retail sale and would compete for clients (see Diagram 1).

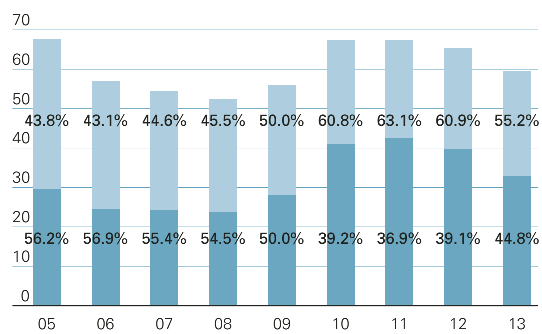
1 In BBVA Bancomer Serie Propuestas No. 21 the reader can find a broader analysis of the advances and challenges of the electricity sector in Mexico.

Graph 1
Electricity Infrastructure Built More than 30 Years Ago
Percentage



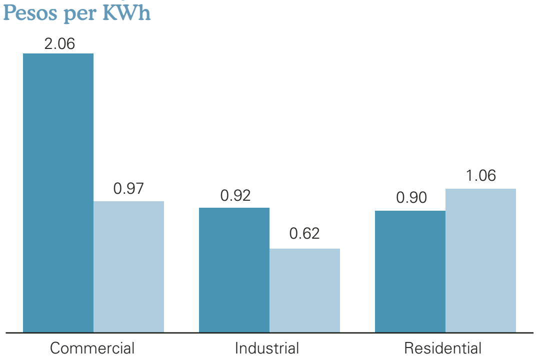
2002
2011
Source: Ministry of Energy

Graph 2
Electricity Sector: Investment Requirements
Billions of 2004 pesos



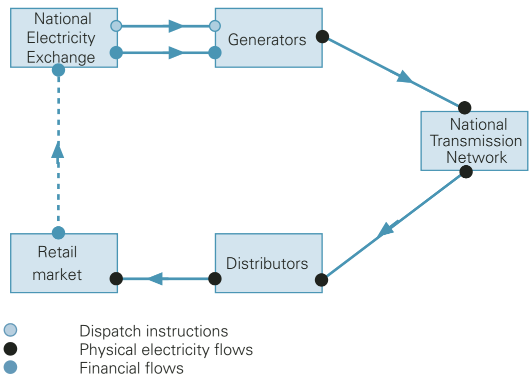
Budgetary
Private, participation anticipated under the system of financed public works
Source: Ministry of Energy

Graph 3
Electricity Rates, 2005
Pesos per KWh



Mexico
United States
Source: CFE, Energy Information Administration (EIA)

Diagram 1
Energy Market



√ By expanding private participation in electricity generation and extending it to distribution

The prevailing legal framework defines the public supply of electric power as an activity exclusively reserved to the state in terms of its generation, transmission, and distribution. Nevertheless, in 1992, in response to the growing demand for electricity and the shortage of public resources, private participation was allowed in the categories of co-generation, self-supply, independent producer (PIE), exports and imports. However, given that self-suppliers and co-generators did not have clear rules regulating the sale of their surpluses and since the Federal Electricity Commission (CFE) was the only authorized agency to purchase electric power for purposes of providing a public service, these private investment modes have not prospered. Most such efforts have been concentrated in the PIE category, based on long-term agreements for the sale of electric power exclusively to the CFE.

Given the need to advance toward a reliable supply of energy, the proposals are to allow public and private participation in electric power generation; for establishing an electricity exchange in charge of purchasing electric power from the generators and the instructions for its use (the exchange would be independent of the CFE, regulated by the state but managed jointly by the public and private generators); and for allowing private sector participation in the distribution of electricity through open access to the networks of the public sector companies and the construction of new networks. Private participation in electricity generation will allow expanding the industry's generation capacity, while in distribution it would create incentives for providing better service to users.

Electricity is an ideal product for trading in an electricity exchange due to two characteristics: it cannot be stored and no unit of electricity can be distinguished from another, which makes it impossible to know which generator produces the current. In different electric power markets, the electricity exchanges are in charge of distribution through computerized systems that allow a balance to be maintained between supply and demand and determine reserve capacity and prices.[2]

√ By creating an independent public agency in charge of the administration of the national electricity transmission network

To guarantee security conditions in the national transmission network, but also open access to all the generators and distributors, the proposal is to create a new public agency in charge of the overall operation of the network. The assets of this agency would be the national electricity transmission network and its expansion and maintenance would be financed by interconnection charges to be paid by generators and distributors. Its operation would be coordinated with the electricity exchange, but its administration would be independent of the exchange to avoid conflicts of interest.

√ By allowing consumers free choice in selecting their distributor

In any market, in order to improve the quality of services it is indispensable that users be able to select the supplier of their choice. The national energy market should not be the exception.

2 For the case of NEMMCO in Australia see http://www.nemmco.com.au / and for PJM in the United States see in http://www.pjm.com/about/glance.html

Australia, Chile, Norway, and some states within the United States have successfully restructured their electricity sectors with private participation and, above all, by guaranteeing that consumers can choose their supplier. It is precisely this freedom to choose and therefore the ability to use demand to "reward" and/or "punish" that creates incentives for competition and quality in electricity services. To reinforce competition in the electricity market in these countries, the possibilities of vertical integration between generators and distributors have been limited.

• By strengthening the production of natural gas

On a worldwide level, the consumption of natural gas has increased considerably. Its wide variety of applications, high efficiency as a fuel, and low level of polluting emissions explain the high demand for natural gas in the residential, transportation, and industrial sectors, especially in the electric power industry. Mexico is not exempt from these trends and faces the challenge of ensuring domestic supply of this important energy product in the next few years (see Graph 4).

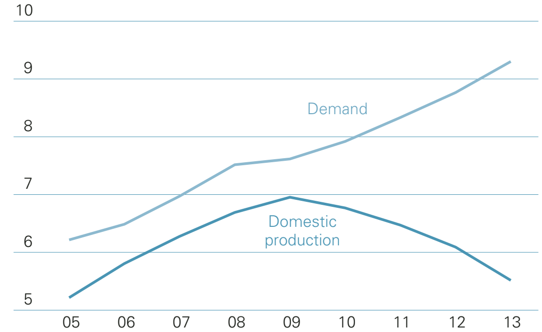
However, the strategy of the state of maintaining a public monopoly on natural gas production has shown that it is not able to ensure that the necessary budgetary resources will be available to carry out the required investments or that they can be efficiently undertaken. On the one hand, natural gas production is capital intensive and requires the continuous introduction of modern technologies to reduce costs and exploit new deposits; on the other, the production decisions adopted by the state monopoly do not respond to market price trends. Within Pemex, the subsidiary division PEP determines exploration and production decisions for both gas and oil. Due to the greater profitability of crude oil as compared to natural gas, the production of the latter responds more to PEP's *a priori* goals than to signs of prices, which are regulated. Thus, the challenge is in advancing toward a structure in the industry that ensures supply and production efficiency.[3]

√ By formalizing private participation in the production of natural gas not associated with oil

In 1995, the industry segments corresponding to the transportation, storage, and distribution of natural gas were opened up to private participation. This has allowed progress to be made in creating infrastructure and establishing a more competitive market structure in the industry. Nevertheless, the effort to deregulate and open up the industry is incomplete because production remains monopolized by the state. This, however, does not limit the private sector's contribution to the development of the industry since, in response to the lack of financial resources, the federal government has sought the assistance of private capital in carrying out infrastructure projects through the Pidiregas (Productive Infrastructure Projects with Deferred Expenditure Impact) program since 1996 and through Multiple Services Contracts (CSM) since 2003.

With the Pidiregas, the private sector has built natural gas extraction and processing plants that have subsequently been transferred to Pemex. Through the CSM agreements, under similar policies, investments have been made in natural gas not associated with oil in the

Graph 4
National Balance of Natural Gas
Billions of cubic feet daily, 2005-2013



Source: Ministry of Energy

3 In BBVA Bancomer Serie Propuestas No. 30 the reader can find a broader analysis of the natural gas industry in Mexico.

Chart 1
Type of Market and Public and Private Sector Participation in Natural Gas Production, 2004

	Type of participation	Type of market	Place*
Russia	Mixed	Competitive	1
United States	Private	Competitive	2
Canada	Private	Competitive	3
United Kingdom	Private	Competitive	4
Netherlands	Private	Oligopoly	5
Mexico	Public sector	Monopoly	11

Source: BBVA Bancomer with data from Sener (Energy Ministry)

Burgos Basin. However, these schemas are a transitory solution for financing infrastructure for production, because both represent contingent liabilities for the state, and their effect on the public accounts is similar to government debt placements. Thus, such instruments will reach a limit and will impose greater pressure on public finances to the detriment of a balanced budget.

Therefore, the proposal is to formalize the total participation of the private sector in the production of natural gas not associated with oil through concessions granted by the state, as occurs in other fields of economic activity such as mining. This would allow an increase in production and the establishment of a market structure with numerous participants and significant gains in efficiency, because producers must invest in technology in order to offer attractive prices and place the greatest amount of production in the market. This ensures conditions for the efficient use of the country's energy resources. Furthermore, the international experience is positive in terms of the possibility of having multiple bidders compete for the concessions (see Chart 1).

In the long term, the formal participation of private investment in the production of natural gas not associated with oil is also a way of allowing the state to reallocate its resources from a high-risk business activity to the administration of justice and fighting extreme poverty, which have high social profitability. For example, the Ministry of Energy (Sener) estimates that to complete the exploration and production requirements of the Strategic Gas Program, it is necessary to ensure financing of 15 billion dollars through 2008. This amount is five times greater than what has been allocated to the "Opportunities" anti-poverty program in 2005.

√ By guaranteeing open access to the national gas pipeline network

Although the transportation of natural gas has been open to private sector participation and the corresponding regulation anticipates open access to the National Gas Pipeline Network (RNG) under non-discriminatory conditions as long as there is available capacity, the fact that Pemex is the dominant player both in production and in the transportation and marketing of the country's natural gas discourages the entry of private companies in transporting the resource, especially through open access. For example, through June 2005, the CRE has granted 124 permits for the transportation of natural gas: 105 for self-use, and only 19 for open access.

This occurs because Pemex's integration in the production, transportation, and marketing of natural gas generates strong incentives for the company to manage the available capacity in its pipelines based on the interests of its subsidiary divisions, but in detriment to the competition in its segments. Due to problems of information and monitoring, it is difficult for the authorities to be able to completely correct these strategies, but something should be done to ensure lower costs in the transportation and supply of natural gas. To do so, Pemex could be withdrawn from natural gas transportation and a new state-owned company, independent of Pemex, could acquire ownership and control of the RNG. The function of this new company would be to transport natural gas, provide maintenance to the network, and manage its available capacity to offer access to all users, with the right to charge a commission for its services.

What must be done?

6. Support the Formation of Human Capital

We must do it, because . . .

Opportunities for individuals to generate income are tied to their productivity through the use of their skills and knowledge. Health and education are important assets to improve both of these tools and increase social well-being (see Graph 1). A number of studies show a strong positive relationship between these human capital variables and economic development. Barro (1996) found that an additional year in average schooling or in the life expectancy of the population increases the annual growth rate in per capita income by 1.2% and 4.2%, respectively.

Given the extensive benefits that health and education represent, it is common that the state intervene in these sectors to ensure their coverage and quality. In Mexico, the strategy of the state of providing these services, has led, in the case of health-care, to the eradication of most communicable diseases and, in education, has guaranteed almost universal coverage in basic instruction. Nevertheless, this strategy has also generated incentives that undermine efficiency and quality in hospitals and public schools.

Deficiencies in quality prevent the Mexican health-care and educational systems from being competitive. For example, according to the 2004 World Health Report, Mexico ranks 44th among 192 countries in terms of the number of years in which its population enjoys a healthy life. Also, in international studies testing overall knowledge, Mexican students score low in educational quality. To reduce health risks and increase the opportunities for improving the income level of the population, the formation of human capital must be strengthened in Mexico.

How can we do it?

In Health

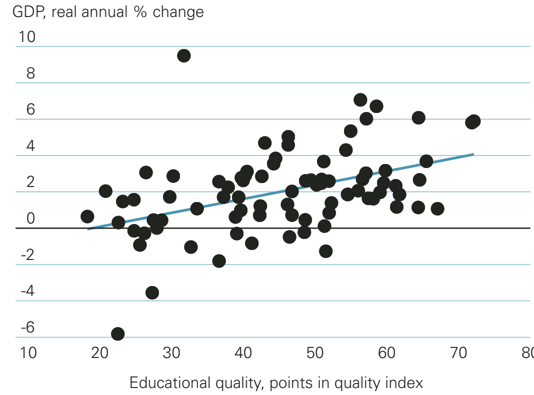
• By expanding the coverage of health-care services

The formal coverage of the public health-care system is 89%. However, the Ministry of Health (SSA for its Spanish initials) reports that less than 50% of the population is enrolled in some health insurance system. Since 2002, low-cost insurance for the population (the Popular Insurance plan) has been an important means in extending medical services to the most vulnerable population groups (see Graph 2). As has been pointed out, this instrument should be reinforced with more efficient public spending.

√ By integrating public health-care services

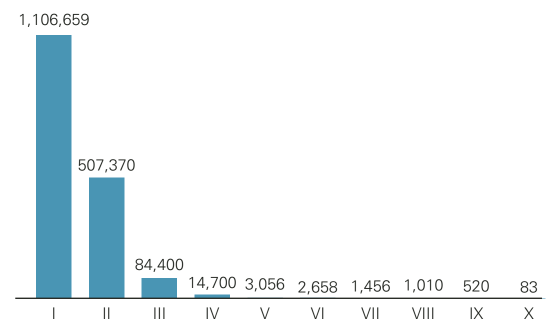
The segmentation of the supply of public health-care services in different institutions has generated a gap among their users, limiting their potential coverage and the resources that could be earmarked to vulnerable sectors. Among others, this is one reason why the public health-care system attends to less than half of the total demand for such services. Meanwhile, recent information from the SSA reveals that the amount of resources earmarked for fighting poverty through the IMSS-Opportunities program (of the Mexican Social Security Institute) is very low in relation to that allocated to other institutions (see Graph 3).

Graph 1
Per Capita Income & Educational Quality
1970-1990



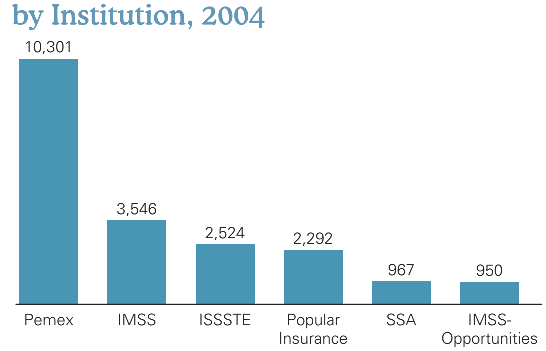
Source: BBVA Bancomer with Hanushek (2000) data

Graph 2
Families Enrolled in Popular Health Insurance Plans by 10 Percentage Point Income Bracket, 2004



Source: SSA (Health Ministry)

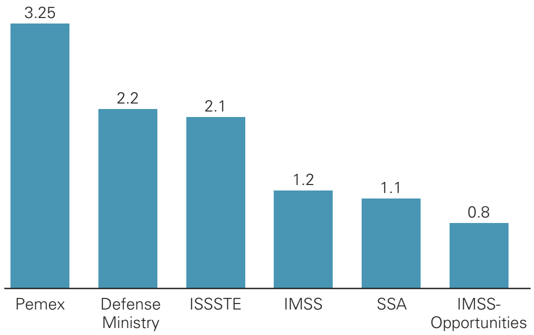
Graph 3
Per Capita Health Care Spending by Institution, 2004



Source: SSA

Graph 4

Public Sector Doctors per 1,000 Inhabitants by Institution, 2004

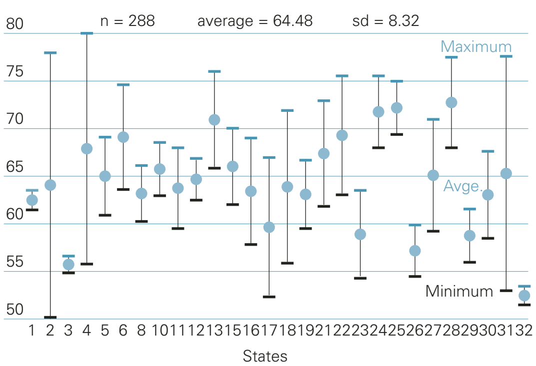


Source: SSA

Graph 5

Quality Level in Hospitals

1997-2000, percentage

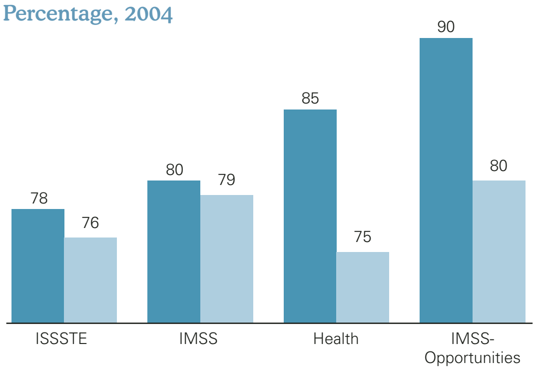


Source: Program for Continuous Improvement in the Quality of Health Care, Health Ministry, 1997-2000

Graph 6

Users who Participated in Decisions Related to their Health

Percentage, 2004



Source: SSA

Advancing toward viable pension systems in the country's main social security institutions offers major possibilities to free resources for programs such as that of the Popular Insurance and IMSS-Opportunities. To make available additional resources and expand the coverage of the public health-care system, the federal health system could be consolidated into only two institutions, the Mexican Social Security Institute (IMSS) for private sector workers and the SSA for the general population and government employees, even those in state-owned firms. With this, substantial medical care funds now only benefiting bureaucrats or government administrative employees and officials could also favor the general population (see Graph 4).

- ## By increasing the quality of health-care services

The quality of the public health-care system is, on average, low and dissimilar. In 2001, an SSA study revealed that, on a scale of 0 to 100, hospitals and ambulatory clinics rated 68.5 and 52.2 respectively in terms of service quality. (See Graph 5).

The *National Crusade for Quality in Health Care Services* has represented, since 2001, an important effort at improving the quality of public health care services. Nevertheless, its results will take time to materialize, since through the first half of 2005, less than 40% of the total of public health-care units were enrolled in the program, and above all because different factors affect efficiency and quality in public health-care institutions. For example, the multiplicity of objectives in the social security institutions hinders accountability. Furthermore, the lack of a direct relation between salaries paid to health-care personnel and their productivity does not promote quality in the care provided. Improving the quality of public health-care services thus requires appropriate conditions and incentives.[1]

√ By strengthening free choice in selecting health-care sservices

In Mexico, the option for users of the health-care system to choose their doctor and the clinic where they wish to be attended is very limited. For example, access to social security institutions depends on the condition of the affiliated worker and in most cases the patient does not select his or her attending physician. Thus, even though Graph 6 illustrates that at least 75% of the patients hospitalized in public health-care institutions indicate that they have participated in decisions regarding their medical care, the SSA in its report Health in Mexico in 2004 acknowledges that given low expectations on the part of the users, they might consider as favorable situations that would be unacceptable in other circumstances.

The aim is to increase the freedom of choice for users of medical services because this will allow the quality of the health-care services received to be "rewarded" or "punished" in terms of their demand. The pay received by medical personnel should then incorporate a component that is determined by the quality of the medical care reported by users. This mechanism would facilitate the accountability of those providing health-care services and would generate strong incentives to offer quality health care. Shown in Graph 7, health-care institutions in Mexico extending greater "freedom of choice" to users register higher satisfaction levels.

1 For further information see BBVA Bancomer Serie Propuestas No. 19.

√ By adopting certified international quality standards

One of the main actions of the National Crusade for Quality in Health-Care Services is the certification of hospitals and clinics. This strategy seeks to ensure a minimum compliance with national regulations and the standardization of satisfaction procedures for users of such medical services. Nevertheless, the efforts in this regard should be reinforced because up until 2004, of 1,005 public hospitals, only 32.7% had current certification, while for a total of 2,822 private hospitals, the corresponding figure was only 2.6% (see Graph 8).

The low number of certified hospitals is because certification is only extended to those establishments that request it. Therefore, the proposal is to modify the National Program for Certification of Medical Care Establishments so that certification is mandatory. However, the health-care institutions, whether public or private, should have the option of accrediting their compliance with quality standards, either through a certificate issued by the national division in charge of such efforts or with an international certification such as the ISO-9000 standards. This option would not only allow national quality standards to be made uniform, but would also mean advancing toward the use of international standards, which are widely recognized and valued by the public.

In Education

• By improving the quality of educational services

Of the total number of students enrolled in the national educational system, 87% are in a public education facility and 77% are studying at the level of basic education (pre-school, primary, secondary schooling). Thus, without undermining the importance of other educational levels, the greatest contribution of the national educational system to the formation of the country's human capital should begin with substantial improvements in basic education services and in public educational facilities.

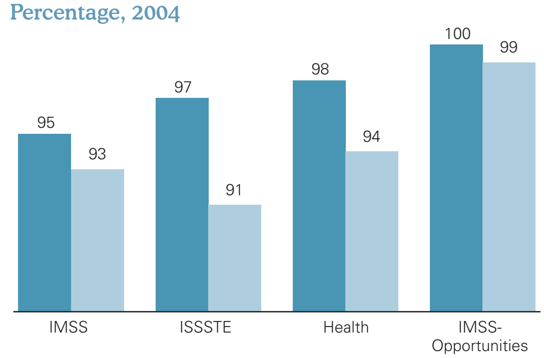
Although coverage is relatively high in basic education, it is in the quality of education that significant improvement is required. According to the Program for International Student Assessment (PISA) sponsored by the OECD, 15 year-old Mexican students, who are in the final stage of their basic education, register the lowest scores in international tests measuring knowledge of mathematics and sciences as well as in reading ability (see Graph 9). However, rather than a shortage of resources, the low academic performance of Mexican students reflects the lack of appropriate incentives to improve the quality of education in the public schools[2], since, in Mexico, public spending on education as a percentage of GDP registers levels similar to those of OECD member countries (see Graph 10).

√ By allowing free choice in selecting a public school

In any market, freedom of choice by the consumer in relation to his or her service provider is essential for initiating a healthy competition among the potential suppliers and to generate incentives among them that encourage quality in the services they offer. If this is the case with private sector educational services, those offered by the public sector should not be an exception. Therefore, the proposal is that parents should

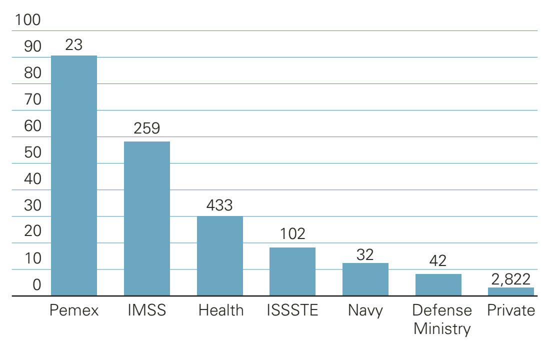
2 For further information see BBVA Bancomer Serie Propuestas No. 26.

Graph 7
Users who Returned to the Same Health Care Unit Upon Requiring Medical Attention Again
Percentage, 2004



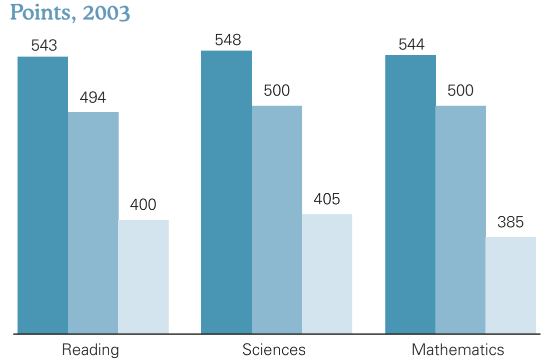
Ambulatory
Hospitals
Source: SSA

Graph 8
Certified Hospitals by Institution
Percentage, 2004



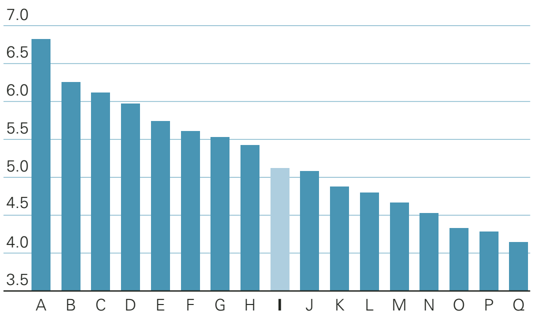
Note: The number over the bars corresponds to the total number of hospitals in each institution
Source: SSA

Graph 9
International Student Evaluation
Points, 2003



Maximum ranking
OECD average
Mexico
Source: PISA, OECD

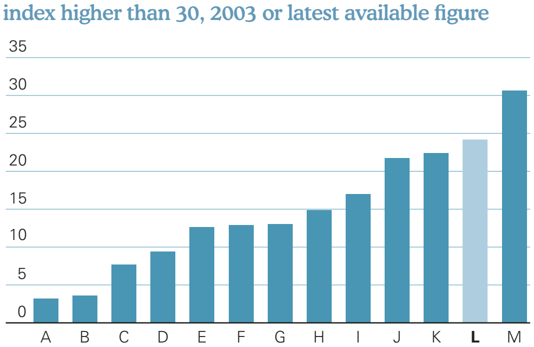
Graph 10
Public Spending on Education, 2001
% of GDP



A Denmark
B Sweden
C Norway
D Belgium
E Finland
F France
G New Zealand
H Switzerland
I Mexico
J United States
K Canada
L South Korea
M U. Kingdom
N Australia
O Spain
P Germany
Q Ireland

Source: OECD Factbook 2005

Graph 11
Obesity in OECD Member Countries
% of the population 15 years or older with a body mass index higher than 30, 2003 or latest available figure



A South Korea
B Japan
C Switzerland
D France
E Spain
F Germany
G Ireland
H Canada
I New Zealand
J Australia
K U. Kingdom
L Mexico
M United States

Source: OECD Factbook 2005

have the freedom to choose the public school they prefer, with no other limitation than the available space or capacity of the educational institution, in which case they should select the best alternatives among the options available. Free choice of schools will allow demand for educational services to be a useful instrument in distinguishing between good and bad educational institutions and will promote improvements in the study programs that they provide. For example, Hoxby (2002) points out that in the United States the option of choosing among different public schools has led their productivity to increase by 28%.

√ By financing the demand for educational services, rather than their supply

So that parents' free choice of schools can become an effective means of "punishing" or "rewarding" the quality of the educational services provided, the financing model for public education should be transformed. Instead of assigning a fixed budget to schools, the proposal is that the government should gradually move toward a model whereby resources are transferred based on the number of students enrolled in them. Thus, since public education is free, the educational facilities will have incentives to compete and improve the quality of their services in order to attract students and thereby obtain greater funds. This step could also lead to an increase in school enrollment, which would have a positive impact on the coverage of secondary education.

√ By granting administrative autonomy to the public schools

To enable the public schools to respond efficiently to the demand for their services, the proposal is that their administration should have autonomy to manage their resources and in addition, have the possibility of offering extracurricular courses to the public that can supplement the official study program.

Administrative autonomy will allow public resources to be used more efficiently to meet the educational needs of the communities, such as for example, in the form of better sport facilities and laboratories. In terms of the possibility of offering extracurricular courses, such as vocational training, computer sciences, or others very much in demand by parents, such administrative autonomy will allow the public schools to also compete to attract the best students, based on offering a more complete educational program.

√ By strengthening the official curriculum

Basic education should provide students with solid bases to advance toward higher education and/or to improve their quality of life. With this in mind, the proposal is to make the learning of the English language and nutritional knowledge mandatory beginning in primary school. Learning the English language will allow Mexican students to have access to information and global knowledge. Singapore, China, and Chile are among the nations that have already incorporated English into their basic education as a means of strengthening their human capital.[3] In turn, nutritional knowledge will allow reducing cases of high impact illnesses such as obesity and other related diseases that have high mortality rates (diabetes, heart disease, thrombosis, etc.). (See Graph 11).

3 See the case of Singapore at www.moe.gov.sg/cpdd/syllabuses.htm.

What must be done?
7. Achieve Flexibility in the Labor Markets

We must do it, because . . .

Mexico demands sustained creation of jobs in order to improve the population's living conditions. Data from the National Population Council (Conapo for its Spanish initials) reveal that in the next 10 years the country should generate at least one million jobs annually just to cover the demand from those who will be entering the work force. (See Graph 1).

However, the legal framework currently in effect for labor protection imposes high costs for the use of labor and discourages the creation of formal jobs. For example, several regulatory provisions regarding work contracts, working hours, and the payment of wages make the employment of labor in Mexico rigid, and its productivity lower than in other countries. (See Graph 2). This is cause for concern because the international experience indicates that inflexible labor markets generate low levels of employment. The reason for this is simple: companies, particularly smaller enterprises, have no incentives for employing personnel if they anticipate that it will be very difficult to move and reposition them in response to changes in the economic conditions. (See Graph 3).

Therefore, it is imperative to change the previous focus of job protection in Mexico in favor of a modern promotion of employment, which could provide formal job opportunities to the unemployed and the underemployed. This can be achieved in a regulatory framework that allows for part-time employment and the possibility of offering training and retraining periods for personnel to improve their workplace skills.[1]

How can we do it?

- **By respecting the right of those involved to freely enter into contracts**

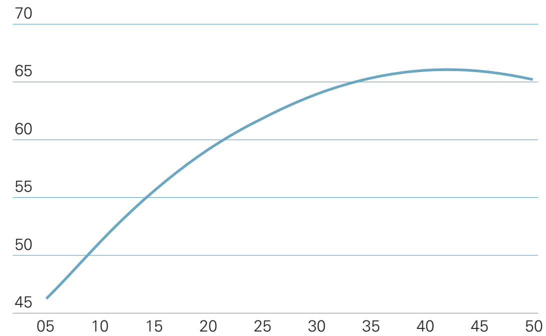
The success of the markets in recognizing the creation of value in different activities and services lies in the free and voluntary participation of those on both the providing and receiving ends. There is no reason for the labor markets to be an exception since this limits job opportunities.

√ **By eliminating the use of industry-wide collective bargaining agreements**

In Mexico, one of the most important legal obstacles for flexible labor relations lies in what is known as industry-wide collective bargaining agreements. These contracts characteristically impose labor conditions on the country for specific sectors of economic activity. Currently, there are eight branches of activity with an industry-wide collective bargaining agreement, five of which belong to the textile sector, while the remaining correspond to industries using rubber, radio and television, and the sugar and alcohol industries. Since companies in these sectors must comply with the same labor obligations, independently of how long they have been in existence, size, or their financial situation, the industry-wide collective bargaining agreements are an obstacle to adapting to market changes and put the competitiveness and durability of companies as sources of employment at risk.

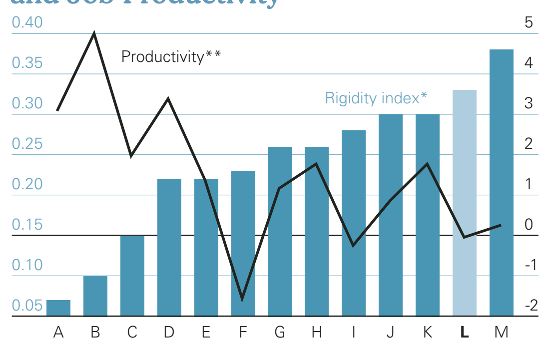
1 For further details, see BBVA Bancomer Serie Propuestas No. 27.

Graph 1
Economically Active Population
Millions of persons, 2005-2050



Source: Conapo

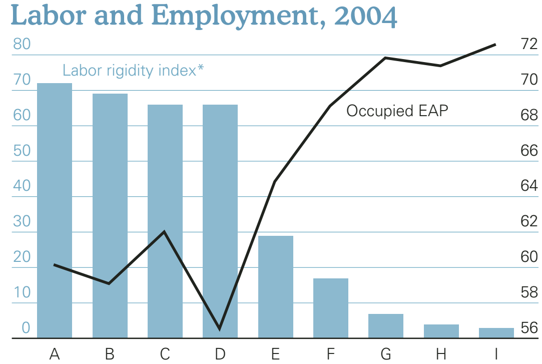
Graph 2
Labor Legislation Rigidity and Job Productivity



A Hong Kong
B China
C Chile
D India
E United States
F Venezuela
G Canada
H Japan
I Brazil
J Colombia
K Germany
L Mexico
M Argentina

* Scale of 0 (less) to 1 (more)
** Added value per employed individual, % change 1980-2000
Source: BBVA Bancomer with data from Forteza and Rama (2001), World Bank (2003), Fraser Institute, and IMF

Graph 3
Lack of Flexibility in Labor and Employment, 2004



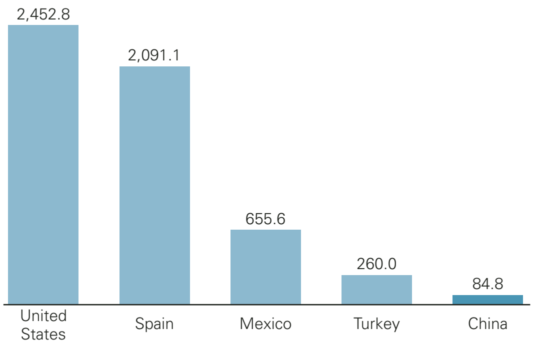
A Mexico
B Spain
C France
D Greece
E Ireland
F Australia
G New Zealand
H Canada
I United States

* Scale from 0 (less) to 100 (more)
Source: BBVA Bancomer with OECD and World Bank data

Graph 4

Average Monthly Salary in Manufacturing

Current 2004 dollars



Source: BBVA

Chart 1

Labor Rigidity in Temporary Hiring

OECD member countries

	Rigidity level*		Rigidity level*
Australia	3.0	Japan	2.5
Canada	3.0	Czech Republic	2.5
Denmark	3.0	Sweden	2.5
United States	3.0	Belgium	2.0
Netherlands	3.0	Portugal	2.0
Ireland	3.0	Spain	1.0
New Zealand	3.0	Finland	1.0
Poland	3.0	France	1.0
United Kingdom	3.0	Italy	1.0
Switzerland	3.0	Norway	1.0
Germany	2.5	**Mexico**	**0.5**
Austria	2.5	Greece	0.0
South Korea	2.5	Turkey	0.0
Hungary	2.5		

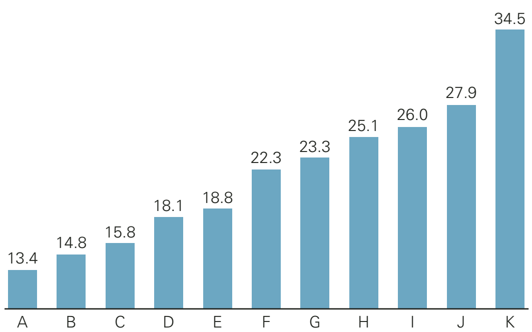
* Scale of 0 to 3 with the higher figures corresponding to lower rigidity for temporary hiring

Source: OECD Employment Outlook, 2002

Graph 5

Use of Part-time Employment

% of total employment, 2003



A Mexico
B OECD
C Denmark
D Ireland
E Canada
F New Zealand
G United Kingdom
H Switzerland
I Japan
J Australia
K Netherlands

Source: BBVA Bancomer with OECD data (2005)

This has been the case with the textile sector and industries that use rubber, labor-intensive activities in which the lack of labor flexibility has translated into high production costs and unemployment. For example, in apparel and tires, this situation has clearly weakened the position of the national industry against very competitive foreign producers. (See Graph 4). Based on these considerations, the proposal is to eliminate the collective bargaining agreements in these industries and use individual work contracts to formalize labor relations. This will allow management and workers in each company to define the most appropriate conditions to preserve sources of employment, and, at the same time, achieve gains in productivity that will make the operation of each business viable. This occurs within a context of global competition, and will also provide real support to productive expansion and to obtaining competitive wages.

Furthermore, individual labor contracts will be an excellent option for employees and employers to conduct their labor relations on a more equitable plane. This is the case because, with such contracts, differences in each worker's productivity can better be rewarded to the advantage of those involved. Employers have strong incentives to pay each worker a wage that will recognize the value of his or her contribution to production, and each worker is motivated, in turn, to improve his or her productive capacity, thus benefiting the company, in order to obtain higher income. Clearly this does not prevent the existence of wages or contracts on a collective level. These incentives, which favor productivity, together help achieve sustainable expansion in production and favor employment in the country.

• By facilitating the use of labor

Mexican legislation does not consider the possibility of per-hour contracting, and it is particularly rigid as regards temporary hiring. As illustrated in Chart 1, Mexico is one of the countries with the highest restrictions on temporary employment.

√ By establishing work contracts by packages of service hours

As shown in Graph 5, the temporary use of labor represents an important share of the job market in many countries. In Australia and New Zealand, temporary employment has led to sustained gains in productivity due to improved synchronization between productive activities and demand for such labor. It has also allowed for offering more jobs and stable sources of income for the population, since, even with a high turnover in the workplace, the likelihood of finding new temporary jobs is greater than obtaining permanent employment.

To increase formal employment and improve income opportunities among Mexico's population, the possibilities to hire workers in Mexico should be more in line with the needs of the various productive processes (cyclical, seasonal, etc.). With this in mind, the proposal is to incorporate in the country's labor legislation the possibility of contracting workers by packages of hours of service. Service hours assigned in these packages should be freely negotiated by the parties involved in terms of schedule and terms, which may or may not coincide with calendar periods. Those employed under such packages should have the same benefits and obligations of permanent workers while their contracts are in effect (medical insurance, taxes, social security fees, etc.). When the contracts expire, they may negotiate a new package or leave the job without the employer bearing any responsibility. Nevertheless, independently of the employer, workers should accumulate the hours of their service packages with the social security institution to which they are affiliated, so as to maintain their pension rights for retirement following lifetime work.

Employment by packages of service hours will allow for greater and more efficient use of labor in the productive processes, thereby increasing productivity, job opportunities and income for the population. In particular, it will benefit women, students and the elderly, who, under the current legal framework, have few or almost no opportunities for formal employment. Above all, it will not affect the rights of permanent workers, since temporary jobs are typically used as a complement to respond to peaks in demand or when there is uncertainty regarding how long jobs will last.

• By reducing hiring costs

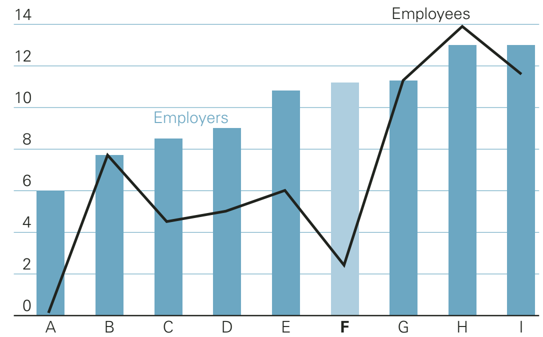
An important obstacle to greater job creation in Mexico is the high payroll costs for items other than wages. Typically, various compensations are added to wages for social security fees and other encumbrances such as those applied to payrolls by some state governments. This increases wages by at least 33%, which can result in companies hiring fewer workers.

√ By balancing fees paid into the social security system

Social security is an important mechanism for risk prevention and is a workers' right. Nevertheless, it should not be nor is it necessary for it to represent an obstacle to hiring workers and to productivity. As illustrated in Graph 6, in contrast with Mexico, in various countries, the social security system is financed with fees that are relatively balanced between employees and employers. This not only provides financial feasibility to the system but also facilitates hiring workers.

In Mexico employment could be further promoted by changing the structure of worker-employer fees paid into the IMSS. Such fees could be based on progressive criteria in the case of the employee, that is, in accordance with his or her income level, with the employer only completing the difference to the IMSS. Another possibility is that fees for workers with an income of up to four times the monthly minimum wage would remain unchanged and the rest would pay progressive rates up to a maximum equal to that paid by employers. This measure would maintain solidarity-based financing of the social security system, would increase its feasibility, reduce hiring costs, and boost employment. Furthermore, it would raise productivity and benefit workers, because employers could use payroll plans that would make it easier to obtain higher income (variables) based on performance, without being penalized with higher social security fees (see Graph 7). In addition, employment could be boosted at a state level, eliminating payroll taxes and offsetting the corresponding revenue with a local sales tax with the same basis as the VAT.

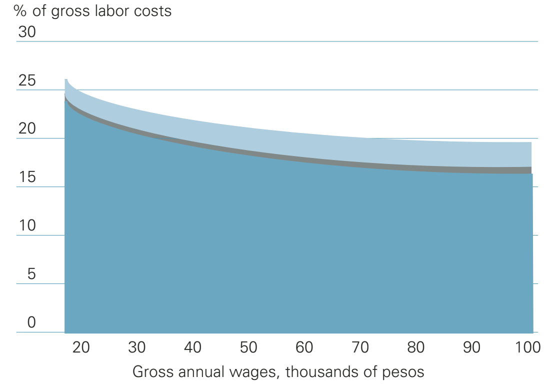
Graph 6
Social Security Fee Payments*
2003



A Australia
B United States
C Korea
D Canada
E Ireland
F Mexico
G Switzerland
H Luxembourg
I Japan

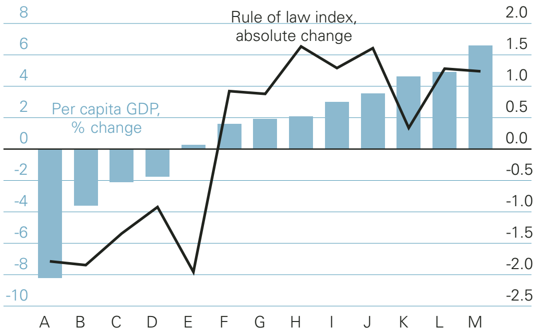
* Estimated on a worker's average wage in the manufacturing sector
Source: OECD Tax Database 2004

Graph 7
Social Security Fee Payments by Income Level



Worker social security fees
Employer payroll tax
Employer social security fees
Source: OECD (2004)

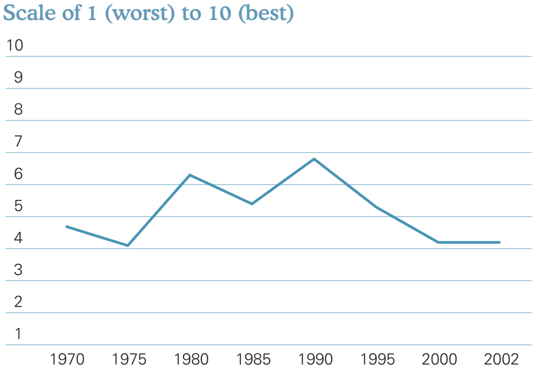
Graph 1
Rule of Law and Economic Growth, 1990 to 2000



A Sierra Leone
B Bulgaria
C Cameroon
D Niger
E Venezuela
F Canada
G United States
H Australia
I Hong Kong
J India
K Chile
L Singapore
M Ireland

Source: BBVA Bancomer with Fraser Institute and IMF data

Graph 2
Rule of Law Index in Mexico
Scale of 1 (worst) to 10 (best)



Source: BBVA Bancomer with Fraser Institute data

We must do it, because

A system based on the rule of law is essential for peaceful coexistence and equality of opportunities, but for economic development as well. This is because respect for the rights of individuals and legal sanctions for failure to comply with contracts allows people to organize their productive activity and participate with legal certainty in the markets. Thus, the relationship between respect for the rule of law and economic growth is clearly positive (see Graph 1).

In Mexico, the possibilities of greater development are limited by deficient legal protection of property rights and an inadequate application of the law. This is the case because frequently individuals or groups can invade plots of land, damage the property of others, or deprive individuals of their freedom or even their lives without being sanctioned. The seriousness of these problems has been reflected for some time in the low ratings for Mexico's system of administration and application of justice.[1] (See Graph 2).

Advancing toward a better application of the law, legal sanctions for failure to comply with contracts, and respect for property rights can have a notable effect on the performance of private investment and economic growth. Barro (1996) estimated that a one-point improvement in the rating of the rule of law (on a scale of 1 to 6) results in an average increase of 2.62 percentage points in the growth rate of per capita income.

How can we do it?

- **By increasing legal certainty**

The international experience shows that in countries where the rule of law is most respected, better conditions exist for investment and economic growth (see La Porta (1998)). This is because legal certainty allows individuals to expand their productive activities, in the understanding that they will be able to enjoy the benefits of their efforts.

√ **By strengthening the protection of private property**

There are many areas in which Mexico must strengthen the protection of property rights. In terms of intellectual and industrial property, it is clear that the use of law enforcement agents and police intelligence should be increased to reduce piracy. Real estate property, extremely important for family patrimony and companies, lacks effective protection and faces high costs and uncertainty due to various institutional deficiencies. One being the operation of the Public Property Registry (RPP).

In Mexico, the RPP operates in accordance with the procedures established in the laws of each state. Thus, the content and management of real estate information differs widely within the country. Furthermore, the handling of this information is slow and not very reliable because many states, with a few exceptions, keep a manual registration of such data based on a system of accounting books and not real estate folios, which hinders the updating and consulting of

1 For a more extensive analysis, see BBVA Bancomer Serie Propuestas No. 20.

the records in question. This generates uncertainty for individuals regarding the legal status of properties and their background history.

To increase legal certainty in relation to the country's real estate property, the information in all the RPPs should be standardized and brought into line to facilitate its consultation on a national level, especially electronically. With this in mind, the proposal is to provide continuity to the Comprehensive Registration Management System, which provides for the operation of a National Public Registry of Commerce, and to strengthen it to create a national Public Registry of Property and Commerce (RPPyC for its Spanish initials) through coordination agreements between the states and the federal government in which: a) the federal government develops and manages an information system to which the local RPP can funnel data to form a national database, b) the states modify the operation of their RPP so that the latter can function as a service counter or office to enter or remove data from the RPPyC,) and c) participation in the national RPPyC is voluntary, but the federal government can facilitate it by financing the development of the local RPPs that comply with its specifications (see Chart 1).

A national RPPyC will offer greater certainty regarding the legality of real estate property, the registration of loan collateral, and a better knowledge of individuals' legal rights and proceedings. This will strengthen the regional development of the real estate markets, which has been a source of economic growth in other countries and will facilitate the financing of the country's productive activities, especially in those states where at the present time the RPPs are most deficient.

√ By offering legal certainty in applying the law

In Mexico there are important deficiencies in the protection of people's rights due to lack of clarity, contradictions, and loopholes in legislation. To address the problem of deficiencies in the country's legislation, the Mexican Supreme Court (SCJN for its Spanish initials) rules on the meaning and the scope of the law through jurisprudential decisions. However, the SCJN's jurisprudence does not have the power to amend the law, since its rulings do not have general effects and can only be applied at the request of an interested party.

Strengthening the country's legal framework requires a review of the laws to facilitate their application in concrete cases. For such effects, the proposal is that Congress through its organic law create a bi-chamber commission for legislative improvement. This commission would be responsible for the permanent review of SCJN jurisprudential rulings in order to point out the deficiencies detected in the drafting of laws and to present legislative reform proposals to correct such problems (see Diagram 1). This measure would allow for coordination between the legislative and judicial branches to expand the benefits of the law to the population. More specifically, the judiciary branch and individuals engaged in legal conflicts would not repeatedly have to spend resources in resolving disputes involving the same assumptions. Furthermore, broad sectors of the population that due to ignorance or lack of funds are unable to go to court and/or file a writ of *amparo* (a legal claim in Mexico to make constitutional rights effective), could benefit from the general effects that would result from amendments approved by the Commission on Legislative Improvement.

Chart 1
National Public Registry of Property and Commerce (RPPyC)

Administration
- Fed gov't in coordination with local governments

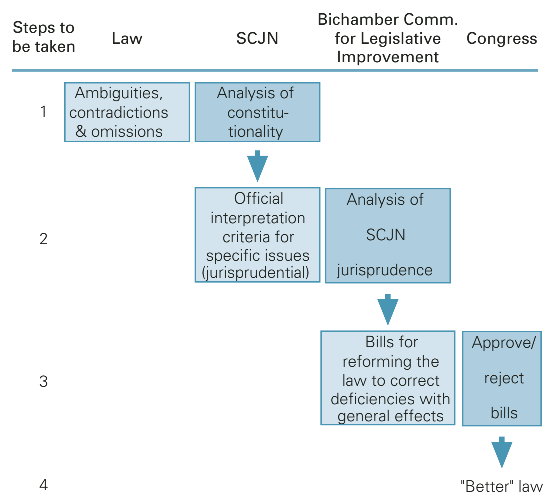
Service counters
- State RPPs (Public Property Registry)

Users
- General public
- Notaries public and brokers
- Fiscal institutions
- Credit institutions and auxiliary credit institutions
- Housing promotion agencies
- Federal and local public administration

Computing platform
- Integral Registry Management System
- See www.siger.gob.mx

Source: BBVA Bancomer with SIGER data

Diagram 1
Process to Improve Legal Certainty in the Application of the Law

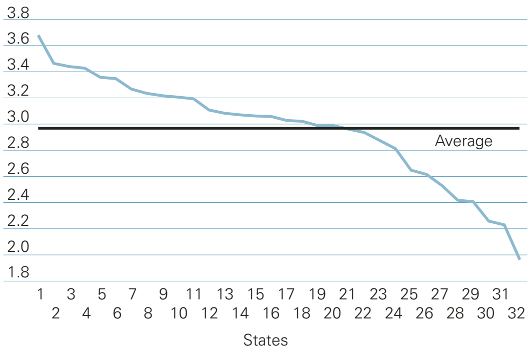


SCJN: Mexican Supreme Court
Source: BBVA Bancomer

Graph 3

Impartiality of Judges, 2004

Scale of 1 (low) to 5 (high)



Source: BBVA Bancomer Financial Coordinating Council (2004) data

- **By assuring impartiality in court decisions**

An impartial judicial system is key in resolving disputes and for the efficient operation of the markets.

√ **By guaranteeing the independence of the judicial branch of the state**

Recently, the federal judiciary branch strengthened its powers and independence. For the appointment of a SCJN justice, the country's president submits a list of three candidates to the Senate, which—with a two-thirds vote of its members present at the session—designates the Supreme Court Justice appointee. After a period of 30 days with no resolution by the Senate, the president designates one of the three candidates he has proposed as Supreme Court Justice.

At a state level, the governor's office has a stronger intervention in the appointment of members of the local judiciary. The existence of possible conflicts of interest between the state executive and judicial branches works against impartiality in court rulings. Data from the Financial Coordinating Council (2004) indicate that on a sliding scale of dependence ranging from 0 at 5, the ranking of the local judicial branches is, on average, 2.3; while, on a scale of 0 to 5 that rates impartiality, local justices and judges register, on average, 3.0 and 2.9. (See Graph 3).

The influence of the state executive branch in the local judicial branches obstructs the use of the court system as a means of resolving disputes. Therefore, it is necessary to guarantee the independence of the local judicial branch of government to guarantee impartiality in the administration of justice. An alternative for achieving the independence of the court system would be to ensure that all the states have a Judiciary Council and that based on these institutions all the members of the local judicial branch be designated based on the criteria of experience and technical competence. This measure would not only strengthen the independence of the judiciary in relation to the other branches of the state, but would also encourage its efficient and merit-based operation, since the appointment of its members would correspond to the bodies responsible for the judicial system as a professional career option.

√ **By making judiciary rulings transparent**

Following the approval of the Federal Law on Transparency and Access to Public Government Information, different federal government activities have been subject to greater public disclosure. A notable example is the SCJN sessions, which are televised so that the population is informed on the background and criteria behind Supreme Court resolutions.

To extend the example established by the federal courts to the local level will result in increasing the quality of court rulings in the country, given that decisions will be subject to public scrutiny and it will be easier to identify the criteria used by judges. With this in mind, the proposal is that the state courts also air their sessions over the Internet or on television so as to make their accountability explicit to the population and consolidate their independence. Furthermore, the local legislatures that have not yet enacted a law on transparency should set a deadline for doing so and act on behalf of their constituents.

• By facilitating the application of justice

In Mexico, the time frame in which court decisions are implemented, for example, in commercial or business disputes, varies tremendously and there are even cases where rulings are never carried out (see Graph 4). Given that a court decision establishes a right or a sanction, it is necessary to guarantee its implementation in order for the rule of law to prevail.

√ By creating specialized federal courts

The administration of justice should not fall behind in the face of a reality marked by a growing specialization and changes in the forms of economic organization. Such a situation demands up-to-date juridical statutes and regulations and specialized courts that can provide more rapid and effective solutions in accordance with the law.

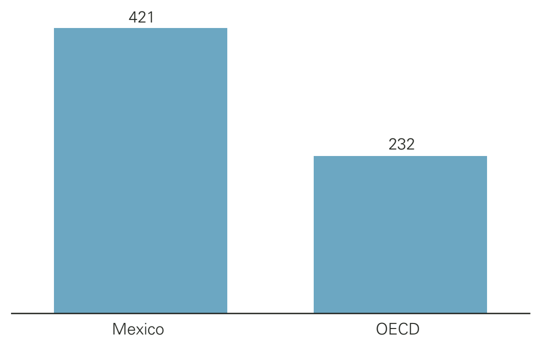
In Mexico, the work of the judicial branch is still not sufficiently specialized. Although an important precedent exists with the Federal Electoral Tribunal of the Judicial Branch of the Federation, a specialized court for electoral disputes, the organization of the judicial branch anticipates that different issues in the fields of financial affairs and economic competition are analyzed by courts that have only a generalized knowledge of business issues. This organization does not facilitate a rapid application of justice because such questions demand knowledge that is increasingly technical such as that related to financial derivatives and relative monopolistic practices. This merely extends the time frame for the administration of justice. To correct this situation, the proposal is to modify the Organic Law of the Federal Judicial Branch so that the judiciary can develop other specialized courts similar to the Electoral Tribunal at least on the level of financial affairs and economic competence. This will allow the specialization of judges, the unification of their criteria on these issues, and a more rapid response in applying the law.

√ By standardizing criteria: the Public Prosecutor's Office with the Judiciary

The most serious challenge faced by the judicial bodies responsible for enforcing the law and administering justice in Mexico in criminal cases is impunity. Of every 100 crimes, only 20 are reported to the authorities, and only 10 of them are subject to a criminal investigation before a judge (see Navarrete (2004)). Because the Public Prosecutor's Office (MP, for its Spanish initials) is responsible for pursuing crimes and presenting evidence that establishes responsibility, the fight against impunity can only improve by strengthening the MP.

Not denying that all resources at the disposal of the Public Prosecutor's Office play a key role in the effective exercise of its functions, it is important to strengthen the MP's capacity to offer quality value judgments on the juridical considerations for it to determine whether or not to file an indictment. Proof of this is that judges continually deny the MP arrest warrants due to deficiencies in the criminal investigation procedures. The proposal is for the Federal and State Judiciary Councils, in coordination with the attorney generals' offices to provide permanent training to MP personnel and grant them a certification of knowledge that is renewable every four years. This certification of the MP by the judiciary will enable both of them to have uniform criteria on the interpretation and application of the law, which will allow a more effective fight against impunity.

Graph 4
Average Time Involved to Achieve Compliance with a Business Contract through the Judicial System
Days

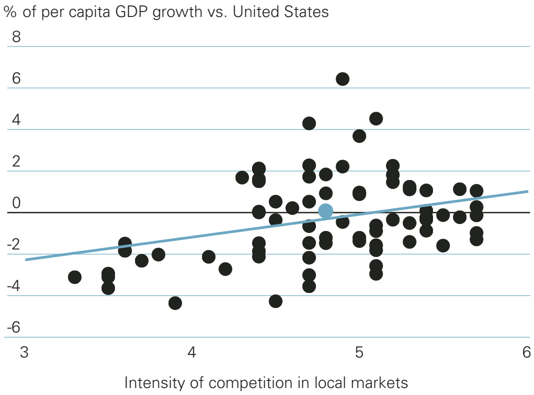


Source: World Bank, Doing Business 2006

9. Strengthen Economic Competition

Graph 1

Competition and Economic Growth



Source: Perez Motta, Eduardo, "*Principales Retos de la Política de Competencia en México*", June 2005

We must do it, because . . .

Competition is the essential ingredient for the Mexican markets to be increasingly more efficient. This is because in serving consumers who freely decide who should supply them, competing companies have strong incentives to innovate and expand the supply and improve the quality of their services. In the long term, competition generates important benefits for society, because it strengthens the growth of the economy. Indeed, when individuals and companies have to improve their efficiency and incorporate technological innovations in their activities, they obtain gains in productivity.[1]

Various international institutions such as the OECD and the Inter-American Development Bank agree in pointing out that Mexico has an advanced institutional framework to protect competition, but that it is necessary to strengthen it. This will permit increasing the competitiveness of Mexican products and companies and improving social well-being. As Graph 1 illustrates, countries with intensely competitive markets also tend to experience high growth and offer better living conditions for their population.

How can we do it?

- **By strengthening the Federal Law on Economic Competition**

√ By expanding the scope of its application

Article 4 of the Federal Law on Economic Competition (LFCE for its Spanish initials) points out that the functions exclusively reserved to the state do not constitute monopolies in the strategic areas indicated in Article 28 of the Constitution. However, in non-strategic sectors, the exclusive handling of certain specific assets , in practice, confers on the state a relative advantage in relation to other competitors, which can hardly be considered compatible with free market competition. This occurs, for example, in natural gas transportation—a non-strategic activity—in which the main network of gas pipelines also belongs to the only national producer of the hydrocarbon. This has restricted the development of new private transportation networks for open access and, more subtly, competition in the transportation service, when access to the network is conditioned on signing long-term supply contracts with the natural gas producer. In this regard, also see the section entitled "Facilitating Access to the Markets".

Moreover, although most of the sectorial or regional legal codes and regulations in Mexico contain general provisions that adhere to the principles of competition, their historic evolution prior to the LFCE and their lack of precision leads to their having their own or *ad hoc* regulations in accordance with the characteristics of each sector or region. Such regulations do not necessarily coincide nor are applied with the same intensity demanded by the LFCE. For this reason, the proposal is to extend the scope of the application of the LFCE, so that it will be the legislation that regulates competition with a uniform criterion.

1 See BBVA Bancomer Serie Propuestas No. 32 for a more extensive analysis of the relation between productivity and well-being.

Among the alternatives for achieving such competition are: a) conducting a re-evaluation of the state's productive activity—for example, based on criteria of social and economic profitability— to redefine its strategic areas. Thus, based on solid arguments, some state activities could remain excluded from the application of the LFCE, but others could now be included, b) divesting assets that are non-strategic for the state, so as to promote greater participation and competition on the part of private enterprise in all the markets and, c) reaching coordination agreements between the Federal Competition Commission (CFC for its Spanish initials) and the local governments on different legal issues, such as those involving business law and health controls so as to standardize criteria in relation to the restrictions that could emerge on free trade and competition. (See Diagram 1).

√ By strengthening the LFCE's legal criteria

The LFCE does not contain the necessary legal provisions that could remedy some behaviors that, in practice, inhibit competition. For example, in Article 7 of its regulatory decree, the LFCE establishes five concrete behaviors that represent relative monopolistic practices: predatory prices, exclusivity agreements in exchange for a discount, crossed financing, discrimination in prices or sale conditions, and boosting competitors' costs. However, although the CFC has resolved cases in which these monopolistic behaviors are stipulated in the law, such decisions have been declared unconstitutional by Mexico's Supreme Court (SCJN for its Spanish initials) because they are contained in the regulatory decree but not in the legislation itself.

This clearly undercuts competition, although it can be corrected easily. With this in mind, the proposal is to include the five sections of the regulatory decree relative to such practices in the LFCE. This would eliminate the unconstitutional nature of the disposition determined by the SCJN and would strengthen the CFC's capacity to comply with its legal mandate to defend competition by preventing and combating activities prohibited by the LFCE.

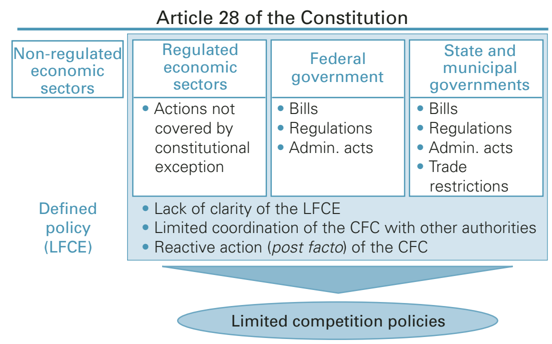
√ By increasing the law's sanctions

Although the law provides for fines on practices that harm competition and free market participation, the sanctions in many cases are mild in terms of discouraging illicit behavior. This is the case because, while the law contemplates a maximum sentence of 375,000 times the daily minimum wage (US$1.6 million) for an absolute monopolistic practice and, in serious cases, fines of up to 10% of the value of the assets or of the annual sales of the offender, whichever is higher, OECD studies indicate that the typical profits of an economic agent that incurs in such illicit practices are within a range of 10% to 15% of the value of its sales. Thus, while the maximum sanction for a monopolistic practice could be within the lower limit of its potential profits, this will hardly discourage such behavior.

It is more with the objective of discouraging rather than punishing monopolistic practices in Mexico that the sanctions in the LFCE should be increased. However, since it is very difficult to detect monopolistic practices, it is necessary to raise the fines significantly, so that the expected corresponding losses will be much higher than their potential benefits.

Diagram 1

Competition Regulations in the Preparation of Public Policies



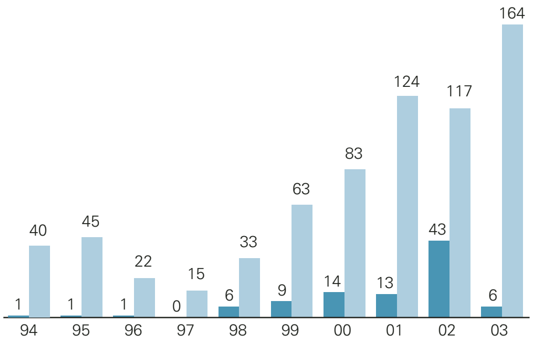
Note: Article 28 of the Constitution defines the exceptions to the general rule for the prohibition of monopolies, monopolistic practices, and state monopolies; the diagram refers only to the scope of the application of the prohibition

Source: Perez Motta, Eduardo, "*Principales Retos de la Política de Competencia en México*" June 2005

Graph 2

"Amparo" Injunctions and Fiscal Annulment vs. CFC Procedures and Resolutions

Annual cases



Fiscal annulment
"*Amparo*" Injunctions
Source: Perez Motta, Eduardo, "*Principales Retos de la Política de Competencia en México*" June 2005

To this end, Mexico could consider the international experience. In the United Kingdom, for example, fines can reach up to 10% of the sales of the offender, although they are applied over the entire period in which the law was violated (up to three years). Other countries, such as the United States, apply a maximum fine of US$100 million or double the profits or losses that the illicit practice generates.

- **By expanding the powers of the Federal Competition Commission**

√ **By extending the scope of its resolutions on competition**

The CFC, as an agency in charge of applying the LFCE, has made important advances in protecting competition and free market participation. However, the existence of multiple sectorial regulatory agencies in Mexico, with short-term objectives different from those of the CFC, has resulted in a lack of coordination in public policies in the field of economic competition, which has only created confusion for those involved. Even worse, this has led to opportunities for CFC procedures and resolutions to be obstructed on numerous occasions, through legal claims or injunctions called "*amparos*", to the detriment of greater competition in the markets. (See Graph 2).

It is imperative to unify public policies on economic competition in Mexico. To this end, the proposal is to strengthen the authority of the CFC, providing it with the power to issue opinions binding on federal public administration ministries and departments in dealing with actions contemplated by the LFCE. Giving the CFC the last word in relation to competition and making its resolutions applicable to other federal government divisions, meaning that they must be accepted by other authorities, will lead to an effective application of the law on competition and to obtaining all of its anticipated benefits such as making markets efficient, limiting market power, optimizing the use of resources, and favoring economic growth.

√ **By incorporating the CFC's opinion in the Regulatory Impact Analysis (RIA)**

In Mexico, draft regulatory proposals for the federal public administration should be submitted to the Commission for Regulatory Improvement (Cofemer) for review and for the corresponding ruling to be issued, together with a regulatory impact analysis (RIA) in those cases where compliance costs are implied for the parties involved.

The RIA is a document that presents a thorough study on the justification of issuing a specific regulation, identifying the problem or situation that the draft proposal seeks to resolve or deal with. It also verifies that the draft proposal is consistent with the national legal framework and estimates the expected costs and benefits for the parties involved. As can be seen, the RIA is a very complete document, which, should it incorporate the opinions of the CFC into law as we have proposed, would be an even more effective instrument, since, by facilitating the inclusion of the concepts of competition in the legislation, it would be much easier to prevent than correct the practices that harm competition and, at the same time, promote the self-regulation of the productive sectors.

What must be done?

10. Facilitate Access to the Markets

We must do it, because. . .

People's sources of funds are defined, in the final analysis, in terms of their possibility of exchanging goods and/or services in the markets (commercial, labor, capital, etc.). Thus, to the extent that there is an open and low-cost access to these markets, individuals' opportunities for generating business and income are multiplied. This is why countries where there is greater economic freedom —those where businesses can be conducted in various productive activities, where regulation of such activities is simple and low-cost, and there is a greater trade opening—also register a high per capita income. (See Graph 1).

Therefore, it is encouraging that in the past few decades, the state in Mexico has taken firm steps to expand economic freedom in various spheres by reducing its direct intervention in production, facilitating the entry of competitors in various economic branches, introducing market mechanisms in providing public services, and negotiating trade agreements. The World Bank (2004) has reported that the North American Free Trade Agreement (NAFTA) expanded Mexico's possibilities for development in its first 10 years because it increased the country's export levels and foreign direct investment by 25% and 40%, respectively. (See Graph 2). In addition, various measures were undertaken to increase economic efficiency and promote competition in the country's domestic markets.

While the previous examples represent important advances in strengthening economic freedom, additional steps must still be taken. Such measures must be extended to many other spheres, since, compared to other countries, serious barriers to trade, investment and business activity still persist in Mexico, which are an obstacle to free access to markets, undermining greater economic development and well-being for the population. (See Graph 3).

How can we do it?

• By strengthening the creation of infrastructure

For the country to achieve higher levels of social well-being, communications and transportation infrastructure must be expanded. (See Chart 1 and Graph 4). This will lower the cost of moving merchandise and people, expedite foreign and domestic trade, reduce gaps in productivity between regions, and contribute to improving the country's standard of living. Nevertheless, in view of the insufficiency of public funds that could only be increased with improved tax collection levels and/or a greater tax base, it is imperative to facilitate private participation in such activities.

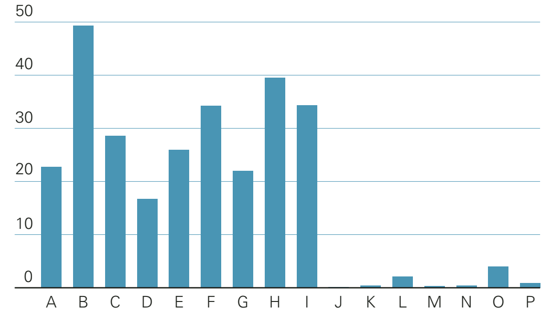
√ By promoting greater competition in infrastructure networks

In Mexico, infrastructure networks (telecommunications, railways, transportation and gas distribution, etc.) have traditionally been operated by the state, although, more recently, private sector participation has been allowed. Nevertheless, on occasions the absence of conditions for intense competition has inhibited greater private sector participation.

Graph 1

Per Capita Income in Relation to the Degree of Economic Freedom

Thousands of dollars, 1996-2004



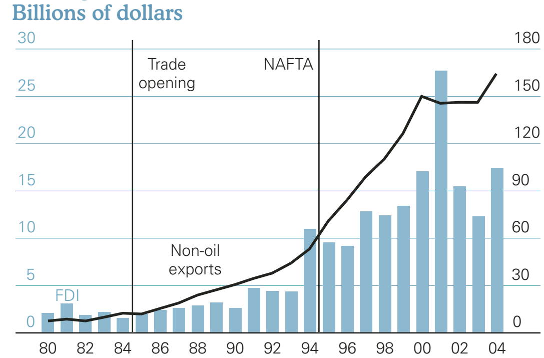
A Singapore (2)
B Luxembourg (3)
C Ireland (5)
D N. Zealand (5)
E U. Kingdom (7)
F Denmark (8)
G Australia (10)
H Switzerland (12)
I U. States (12)
J S. Leone (135)
K Vietnam (137)
L Surinam (140)
M Nigeria (141)
N Haiti (145)
O Venezuela (146)
P Zimbabwe (151)

Note: The relative position of each country among a total of 166 countries in the Economic Freedom Index in 2005 is shown in parenthesis
Source: BBVA Bancomer with Heritage Foundation and IMF data

Graph 2

Non-Oil Exports and Foreign Direct Investment in Mexico

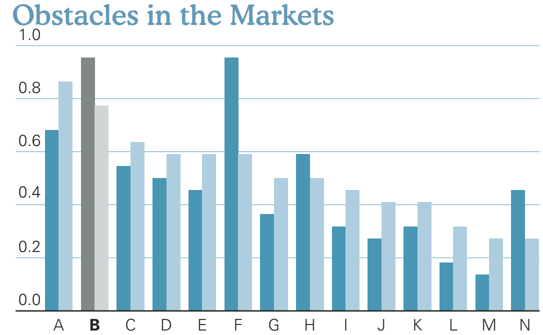
Billions of dollars



Note: NAFTA has had a more than 25% effect on exports and more than 40% on foreign direct investment
Source: BBVA Bancomer with Banco de Mexico data

Graph 3

Obstacles in the Markets



A Turkey
B Mexico
C Australia
D Korea
E Greece
F Poland
G Japan
H Hungary
I Portugal
J United States
K New Zealand
L Ireland
M United Kingdom
N Canada

To trade and investment
To business activity

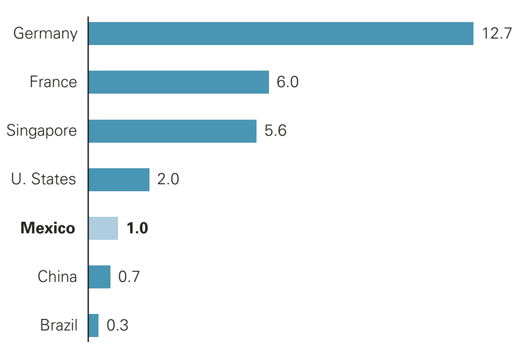
Note: Values for 2003. Scale of 1 (less) to 6 (more restrictive)
Source: BBVA Bancomer with OECD data (2005)

Chart 1
Internet Users, 2003
Per every thousand inhabitants

	Number
United States	557.8
Singapore	115.5
Canada	101.2
South Korea	79.8
France	40.1
Spain	22.2
Brazil	18.0
Chile	13.8
Mexico	**13.1**

Source: Cofetel

Graph 4
Railways
Length per each 100 square kilometers, 2000



Source: BBVA Bancomer with OECD data

This has occurred because in this infrastructure there generally exists a service provider, concessionaire, or license holder enjoying some relative advantage in the use or operation of the network. This generates strong incentives to obstruct access or to set high interconnection fees for other suppliers of substitute services that could represent competition. The same phenomenon has occurred where there are independent infrastructure networks in existence that should interconnect, but which are characterized by an unequal negotiating power among the parties involved. See studies by Del Villar and Soto (2005) regarding telecommunications and railways, and Brito and Rosellón (2005) for natural gas transportation.

To a certain extent, the sectorial regulation recognizes this situation, since it forces concessionaires and license holders of public networks to allow connection, access, or interconnection to other networks, through freely negotiated contracts. However, when there is no agreement between the parties involved, the sectorial authorities generally have the right to determine the corresponding interconnection conditions. Among the most important conditions are the connection and interconnection fees.

To strengthen Mexico's development, free entry to and competition in infrastructure networks should be encouraged. One alternative for this is for connection and interconnection rates, which should be determined by the sectorial regulatory bodies in the absence of an agreement between the parties involved, to be subsequently submitted for approval and possible modification by the Federal Competition Commission (CFC for its Spanish Initials). This would also allow such rates to incorporate uniform criteria regarding access and competition.

• By facilitating foreign trade

Today, economic growth is increasingly linked to foreign trade and a satisfactory integration in international production. China is one of the best examples of specialization in production and integration in the value chains of different Asian countries, since, while it is a large-scale exporter, it is also a major importer of raw materials and intermediate goods, especially from Asia.

Similarly, Mexico's geographic position with respect to the United States offers the country comparative advantages to attend to the world's most important market efficiently and reap many benefits. Thus, in principle, Mexico's proximity to the United States offers advantages in relation to other countries in terms of productive processes involving merchandise with high shipping costs or value chains that must be rapidly adjusted in response to changes in demand. To derive greater benefit from these assets, Mexico should adopt measures such as strengthening competition in infrastructure development, improving the quality of education, making the formal labor market flexible, ensuring the supply of energy, and facilitating flexible trade conditions.

√ By reducing most favored nation tariffs

About 85% of Mexico's foreign trade is conducted with countries with which it has free trade agreements. The tariff that Mexico applies to imports from these countries is 2.2%, on average. So, to begin with, Mexican markets are among the most open in the world, which favors the competitiveness of the country's productive plant.

Nevertheless, for countries that are not signatories to the free trade agreements with most favored nation status, Mexico maintains relatively high tariff rates, set at an average of 16%. However, maintaining a dual structure for Mexico's imports is, in the long term, very detrimental. This is because to the extent that tariff differentials are high between countries with and without a free trade agreement with Mexico, (see Graph 5), importers have strong incentives to seek to pay the lowest tariff rate and undertake illegal "triangulation" practices; that is, by importing products as if they were originally produced in free trade agreement countries even though they were manufactured in other nations.

In order to eliminate illegal practices that are harmful to free trade, the proposal is to reduce the most favored nation tariffs to the average level applied by the country's NAFTA partners. (See Chart 2). This will strengthen the competitiveness of Mexican companies, since, by reducing the apparent "protection" in some sectors, the capacity of the national productive plant to respond will improve in face of the unilateral trade opening that the country's main trading partners have agreed to with third countries.

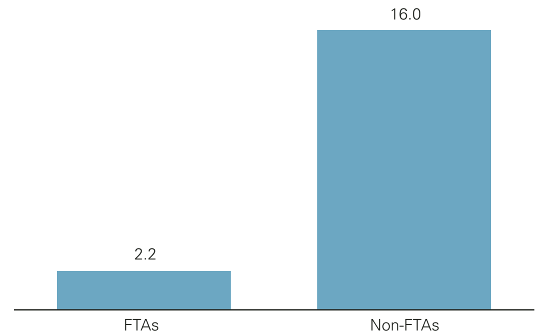
√ By making customs clearance more efficient

More dynamic trade requires fast-moving operations for merchandise and people crossing borders. This demands that operations in Mexican ports and airports be expedited, particularly in customs clearance. However, customs operations in Mexico are still slow and costly. For example, at the Nuevo Laredo (Tamaulipas)-Laredo (Texas) border, the most important for Mexico-U.S. bilateral trade, the time that it takes for a tractor-trailer to cross into Mexico varies greatly, depending on the merchandise, the hour, and even the season of the year. Furthermore, the flow of traffic is affected not only by the saturation of the highway infrastructure but also by excessive delays in official inspections, procedures involving documentation, and changes in requirements without prior notice. See Canada BCR (2004)

In recent years, important advances have been made toward a more efficient operation in Mexican customs in the automation of customs clearance systems, the electronic registration of foreign trade transactions, the use of non-intrusive inspection technologies, such as X and gamma rays, etc. However, it is necessary to simplify customs regulations and procedures more to promote and motivate efficiency in dispatching merchandise and to reduce costs. (See Graph 6). This simplification will also allow greater transparency in customs procedures, offer legal security to importers and exporters, and discourage the illegal introduction of merchandise.

To achieve these objectives, the proposal is to facilitate procedures for releasing merchandise from customs by bringing Mexico's import-export customs tariff rates into line with those of the United States; to expand and coordinate the business hours of the various federal authorities with the customs offices, since there are serious differences between them; to standardize procedures and formats used by Mexican authorities with those of their U.S. counterparts, and in time, to comply with all the import/export paperwork procedures for moving merchandise before the physical shipments actually reach the borders, by adopting, for example, the use of electronic seals on the containers, in coordination with U.S. and Canadian authorities. This technology allows the use

Graph 5
Tariff Structure
Percentage, simple average, 2004



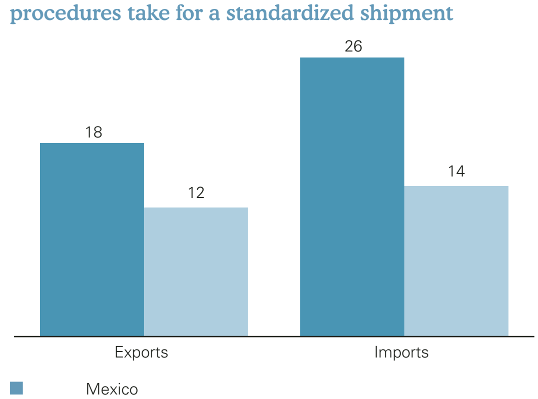
Source: BBVA Bancomer with Ministry of the Economy data

Chart 2
Most Favored Nation Tariff
%, simple average

	Total	Agricultural products	Non-agric. products
Mexico*	18.0	24.5	17.1
Canada	4.1	3.1	4.2
United States	3.9	5.1	3.7
Average	**4.0**	**4.1**	**4.0**

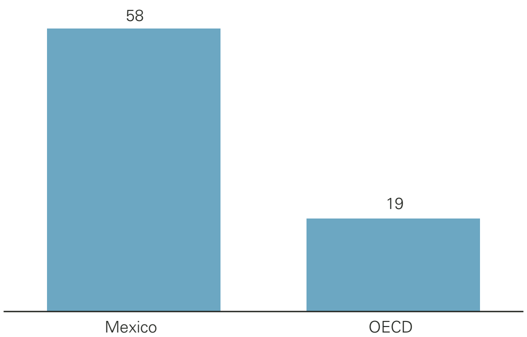
* Has 2003 as reference year, while for Canada and the United States, it is 2002
Source: World Trade Report, 2004, WTO

Graph 6
Border Trade
Time, in days, that export-import paperwork procedures take for a standardized shipment



Source: BBVA Bancomer with World Bank data, Doing Business 2006

Graph 7
Average Time in Procedures for Opening a Business
Days



Source: BBVA Bancomer with World Bank data, Doing Business, 2006

of satellite systems and radio frequencies to determine the contents, the position, and integrity of the containers, which would facilitate and expedite customs revision in warehouses, ports, railways, tractor-trailers, etc. Thailand and Singapore are pioneer countries in the use of this technology, which is now at an experimental stage in the United States. (See http://www.itsdocs.fhwa.dot.gov/JPODOCS/REPTS_TE/13770.html)

• By eliminating obstacles to business operations

Mexico's institutional framework imposes a high cost on social well-being, because its excessive regulation discourages the creation of companies and formal jobs. (See Graph 7). It is necessary to correct this situation in order to increase the number of efficient productive units, to obtain gains in productivity, and to improve the possibilities for growth of the country's economy.

√ By strengthening local deregulation programs

Mexico has taken important steps to reduce the costs that its federal government regulations impose on business operations. For example, the System for the Rapid Opening of Companies (SARE for its Spanish initials) currently allows 685 industrial, commercial, and service business lines, considered to be low-risk and able to be developed by micro, small and medium-size firms, to receive federal authorization to be established in just one working day.

However, a strong limitation to the SARE is that it does not include state or municipal regulations. This could sometimes cancel out the benefits of improved federal regulations, due to heavy local regulations. While efforts have been made to correct these deficiencies by signing coordination agreements between federal and local authorities, the participation of the parties involved is voluntary, and is influenced by political considerations. Thus, through May 2005, of the 2,443 of the country's municipalities, only 65 had mechanisms by which to comply with the paperwork procedures of the three levels of government in order for companies to be able to open in less than 72 hours.

In order to expedite the use of mechanisms similar to the SARE at a local level, it would be necessary for the public and the authorities to be better informed of its potential benefits. To this end, the proposal is for the Federal Regulatory Improvement Commission (Cofemer for its Spanish initials) to more thoroughly publicize its successful cases with the SARE at a local level. Furthermore, the Cofemer should present an annual evaluation, for information purposes, of the regulatory costs for business activity at a local level. Among the indicators that due to their national scope could serve as parameters to measure such costs would be those associated with the paperwork procedures on zoning restrictions or sanitary licenses.

In addition, Cofemer should offer, for information purposes, proposals for the deregulation of local paperwork and administrative procedures on its Internet web page. These proposals should be presented in a format that would allow for an easy comparison between what is currently in effect and what is being proposed. This would facilitate deregulation efforts and, at the same time, would guide the public regarding the deregulation that should be demanded.

How to Achieve New Structural Changes in Mexico? A Political View

Federico Reyes Heroles*

1. Tradition versus modernity

Building a democracy is slow and difficult. It implies not only juridical and procedural type reforms, but also a transformation of the political culture. The political culture is the result, in part, of the socioeconomic conditions that prevail in a given country. Mexico began the 20th century as an agrarian, predominantly rural society, with extremely high levels of illiteracy, a very geographically dispersed population, and a very low per capita income. At that time, the country was ruled by a long-standing dictatorship that led to the Maderista revolution. Effective suffrage was sought. However, the conditions for national integration were not in place. This initial spark of the transformation propelled the country into a long period of internal conflicts with a high human cost, of around a million deaths. At the same time, the national economy entered into a downturn that would last about two decades. Local and regional centrifugal forces led by political leaders known as "*caciques*" strongly resisted national integration. It would not be until the beginning of the third decade of the 20th century that based on an authoritarian system that subdued the *caciques* and very different peripheral interests, the country would again resume its economic direction.

There were three pillars of the authoritarian system that generated a phase of stability and growth. The first was an agrarian land reform that pacified rural demands but which, taken to the extreme, ended up distorting the country's true agricultural calling. The second political anchor of the predominant system for more than half a century was a corporativism that allowed the state to erect political intermediaries between the massive peasant population, the growing working class, and the nascent middle classes. The third anchor for the system was a presidentialist regime that concentrated three leadership positions, namely head of state, of the government, and of the political party, in a single individual. The absolute domination of the legislative branch achieved through internal negotiations in the ruling party allowed the presidency to become a force for modernization in the face of a disarticulated and dispersed society. This is why many authors describe the founding of the modern Mexican state as an inverse process, namely, from the top down. The way in which the system was designed afforded state projects—electrification, communications, education, and health-care—certain continuity in their goals. The formula was not democratic but was indeed quite efficient.

The democratization of Mexico has to do with various phenomena occurring simultaneously. The first would perhaps be the improvement of educational levels that slowly allowed for the emergence of more informed and demanding sectors of society. The second phenomenon involves a social mobility that was very rapid, especially during the period of stabilizing development. High economic growth and the generation of urban employment led to the emergence of middle income layers of the population for whom the old satisfying benefits of the authoritarian system were no longer sufficient. The responses of stability and growth were not enough. Demands were raised for a greater political opening, greater liberties and greater participation.

The emergence and development of this new country experienced several implosions: the various organized movements of railway workers and doctors, the student uprising of 1968, the repressive measures of 1971, the social organization following the 1985 earthquake, the division of the predominant or hegemonic party in 1988. Meanwhile, the government was opening up partly in response to social demands and partly because its own political stability demanded it. The party's congressional deputies and the different political reforms of the 1970s and 1980s, which allowed for the incorporation of new political parties and the clear expansion of liberties, also enabled a peaceful transition toward a democratic system. The opposition was gaining spaces, first on the level of municipal mayoral races and state legislatures, and later in the national Congress, until in 1989 the first opposition governor was elected and finally, in 2000, a change in party was achieved in the presidency.

Throughout this entire long journey filled with exciting episodes and modernizing advances in the political arena, two factors necessary for promoting the modernization of any country were, however, lost in the process. The first is that the old superstructure had instruments at its disposal to generate the necessary base consensus to be able to move the country. The second is that the Presidency, which in the past was considered as almighty, appears weak in a multiparty system. With all crudeness, it is necessary to admit that the recent structural changes in Mexico still took place as a result of an initiative on the part of the Presidency, with the executive branch achieving a

* Independent text. The author's opinions do not necessarily reflect the institutional viewpoint of BBVA Bancomer.

consensus between two of the main political forces, the Institutional Revolutionary Party (the PRI) and the National Action Party (the PAN). The North American Free Trade Agreement, the reforms to constitutional articles 127, 130, and even the juridical independence of the agency that today administers Mexico's electoral system were born this way. This was also the case with the reform of the judicial system, to which we can attribute the same explanation. This painful paradox does not allow for much maneuvering room: is it possible that Mexico, with all its traditional anchors, could only be modernized at the economic level based on a greater concentration of power in a single party and in particular, in the Presidency of the country? Is it that perhaps democracy, with the current institutional agreement, presupposes paralysis?

2. The next steps, how to reach consensus

From a distance, it would appear that Mexico is trapped in a multi-party system in which a perverse competition on the part of the political players prevents reaching a consensus. Mexico is faced with several reforms that cannot be postponed, such as modifications to the pension system, which is aggravated by a population pyramid whose aging is already forewarned, and the capitalization of the energy sector, which severely burdens the country's productivity. There are also the legislative modifications that must necessarily arise from the investment required in infrastructure, especially in urban development, in order to provide room and housing for the 135 million inhabitants that Mexico will have by the middle of this century, and the reforms that will inevitably flow from a demand for investment in infrastructure to ensure that the needs of a global economy are not held back by problems of communication and transportation and, above all, there is the need for skilled human capital to contend with the labor requirements of the 21st century. The list of challenges cannot exclude the need to make the country's currently existing labor legislation more flexible, given that it is presently characterized by a rigidity that harms employees and employers alike.

And of course there is also in-depth fiscal reform. But where are we to begin? All of these reform proposals presume the need to leave behind traditions and social agreements. Some small sectors will lose their privileges for the benefit of the majorities. Although none of the proposals are popular, all are necessary.

The first point would be to recognize that the paralysis that many are concerned about basically occurs at the federal level. The different state governments, led by different political parties, have reached important internal agreements that contrast with what has occurred at the federal level. The same citizens and the same political parties are involved, and the negotiations, which are equally complex, have prospered, based on rules of the game that are very similar to those that guide the federal government. The systemic thesis, in the sense that there will be no successful reforms unless we move toward a semi-parliamentary regime, collapses with the local examples in which complex renegotiations on public debt or new fiscal policies have made progress. There is no maneuvering room for speculations and indeed, we do not even have an agreement to achieve a new government formula that would lead to new agreements. What should be done? It would seem that communication has been much more efficient at the state level than at the federal. What has failed in the past few years? How can we reach such consensus?

First of all, it must be emphasized that, since there is no possibility of reelection in Congress, this has led to a lack of specialization at the legislative level. Independently of the ideological positions of the different parties, it is clear that there is an enormous lack of information among the five hundred legislators that are elected every three years to the Chamber of Deputies. The learning period complicates the possibility of reaching agreements, a process that only takes place slowly. Therefore, it is not surprising to see how the same arguments and counter-arguments are repeated, without reaching any conclusion. Schemes are hatched and un-hatched to Mexico's detriment. This has been the case with reforms to the energy sector, in particular, in relation to electric power.

A second element that has hindered the negotiations has been the division of segments within the different political parties. Among the country's main political forces, in the past few years the party leaderships have been particularly weak, which has not helped the process of reaching agreements. How can stable leaderships be guaranteed? It is impossible to do so from the ranks of society.

A third element that, viewed in perspective is no minor matter, is the fact that the population lacks the information necessary to understand the urgency and importance of some of the reforms that are pending. The dynamics, perhaps explainable but for this reason no less perverse, has led public opinion in the past few years to be much more attuned to everyday problems, to superficial issues, than to the underlying questions on which there should be agreements. Here the question arises as to whether the mass media could not have been able to play a more decisive role in offering an explanation of the problems that the country is facing, in order to achieve a social clamor in favor of a more prosperous future. It should also be noted that business associations have also been unable to find efficient formulas to transmit to the general public the enormous challenges and opportunities that Mexico faces.

The result is that in a country inhabited predominantly by young people, two out of every three Mexicans do not consider corruption to be a serious issue, the great majority does not have the slightest knowledge of the crisis of the pension system, and even less of the growing unsatisfied demand for energy. A misinformed population is the best breeding ground for launching demagogic proposals that have nothing to do with why it is necessary to increase fiscal resources or the sad future that awaits us if we do not improve our country's educational levels. Given the absence of a generalized social clamor that pressures the political parties through public opinion, what has occurred is an extremely costly dispersion of the debate. This has made it easier for groundless arguments to advance. Can this situation be corrected? Of course it can, but this requires a coordinated effort on the part of the public sector, private enterprise, and the media in order to focus the national agenda.

By broadening the knowledge of the problems and convincing public opinion of the need for the reforms that the country faces, what has come to be called the "political cost" decreases or disappears. This expression refers to a condition in which a political force can electorally make gains by not entering into an unpopular discussion. This leads to the political forces avoiding thorny discussions because they know that someone will wind up unduly profiting as a result of avoiding such a debate. But this "political cost" only functions in misinformed societies. In a society that is attuned to problems of any nature that directly concern it, the mechanics operate inversely and by avoiding a discussion of the political agenda the cost could be losing part of the electorate. This eliminates a false dilemma in the sense that in-depth reforms, which in the short term might be unpopular, are only feasible in societies with strong or frankly authoritarian regimes. Most of the democratic countries face their discussions with wide-ranging publicity campaigns that inform the citizens of the alternatives. This way, there is no escape for political forces to resort to the option of avoiding a discussion.

What have we done in Mexico in the past few years to promote a common agenda? Very little. It is enough to review the use that has been made of the official time slots on radio and television to conclude that these spaces that belong to all Mexicans and which could facilitate generating consensus, unfortunately have been used for political gain based on a very short-term vision. We thus face the paradox that the first president elected as a result of parties alternating in office will conclude his administration with a high level of approval, but with a low or zero popular understanding of the dilemmas that he and the country have faced. As to the question of how and who should lead the economic reform processes, the only valid answer is everyone. No matter how popular a president is, he appears weak if the problems within his administration are not shared with public opinion. Meanwhile, the political parties that believe they have been astute in avoiding the complex problems of the national agenda cannot have a worse rating in public opinion, which frequently rates them last in an institutional evaluation. A similar phenomenon occurs with the legislative branch, which suffers from enormous discredit among the country's citizens. The myopic thinking that avoiding problems improves their rating in the eyes of the population could not receive a more decisive response.

3. Renewal of the branches of the state, a great opportunity

The 2006 elections are an excellent opportunity to prevent this vicious cycle from being renewed. If through the communications media, companies, mass organizations, those responsible for forming public opinion, and why not, the contending players themselves, we are able to inject an unavoidable national agenda into the debate, we will prevent such evasion of the discussion from being rewarded. The topics are clear: taking advantage of the favorable demographic panorama that will last around a quarter of a century more and finding a new system for financing pensions that affects public institutions such as the Mexican Social Security Institute (IMSS), the State Employees Social Security and Services Institute (ISSSTE), Petroleos Mexicanos, the public universities, and state and municipal governments. In resolving the problem of pensions, which is medium and long-term, we could simultaneously increase domestic savings, which is one of the country's biggest weaknesses. By finding formulas for the capitalization of the energy sector, this could allow us to put the finances of Petroleos Mexicanos on a healthy footing and in the process expand its horizon, avoiding parallel financing such as the PIDIREGAS (Productive Infrastructure Projects with Differed Expenditure Impact) program. By explaining to Mexicans that only by inappropriately diminishing the resources of Petroleos Mexicanos can public finances—to which 50% of potential taxpayers do not contribute what they should—be sustained. All of these questions are of such importance that they cannot be subject to considerations of a temporary nature.

If the population is not aware that Petroleos Mexicanos could exhaust its reserves and that the country might see the need to import crude in a not very distant future and if it also does not understand that Petroleos Mexicanos has ceased providing value to the energy resources that it extracts for lack of capital, any proposal will seem appropriate. If we are not able to socialize the discussion on productivity and through it, raise awareness among potential voters that in a globalized world there are no magic solutions, we will have lost the battle. If Mexicans do not have information on the growth rates of other nations and of the in-depth transformations that are occurring in the world, any proposal offered by the candidates could seem attractive to them.

Promoting a long-term vision is an effort that could seem monumental and that, nevertheless, is the only guarantee, over the long run, that the ups and downs of political developments do not harm what are authentic state projects. In a population in which 55% of the country's inhabitants are still under 25 years of age, the challenge would not seem impossible to meet. Already in the past we have had national campaigns that have demonstrated the public's capacity to absorb this type of information. An example in this regard is the information used by the Federal Electoral Institute as to the importance of citizen participation in the electoral processes, which allows us to guarantee that every three years almost one million Mexicans will vote to make sure this process is carried out as intended.

Something has been made clear in the democratic experience of the past few years, and I am referring to the fact that the way in which a country is run cannot be relegated exclusively to the domain of the political parties and the elected representatives. In the process of Mexico's modernization, there is a missing piece, the importance of which is quite clear today. If the population does not organize balances and counterbalances to the traditional mechanisms of governance, the latter will be insufficient. In the old way of politically running the country … centralized on the Presidency of the Republic, the participation of the private sector, of the communications media, of the civic organizations appeared merely as a decorative covering or as an element that could be dispensed with. When 85% of a country's citizens admit to never having been involved in a community issue, we do not have to search for many further explanations for our mistakes. Despite the electoral game, despite the democratic progress, the great majority of Mexicans continue to believe that the responsibility of leading the country falls on others.

In Mexico, liberties have been expanded and highly intense election campaigns take place in around 80% of the country. Divided governments and balances and counterbalances are now very common occurrences. Political parties alternating in office occurs in all levels. However, today we have to admit that the puzzle of that democratic and prosperous society that we all desire will only be complete when its citizens are fully involved.

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