POLICY BRIEF

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Summary

Fiscal rectitude, progress towards macroeconomic stabilisation, and past structural reforms have been necessary and desirable, but have not yet been sufficient to raise potential growth to rates that would allow closing the gap in living standards with other OECD countries. Prolonged cyclical weakness, with no unambiguous signs yet of a vigorous upturn, has depressed private investment, which is also hampered by legal and regulatory obstacles in key sectors, electricity in particular. Mexico's catching-up is further hindered by low human capital accumulation. The administration has insufficiently solid and stable revenue to finance necessary social spending and public infrastructure investment on the required scale. Policies should therefore give priority to broadening the tax base and creating conditions – economic, financial and legal – in which a competitive private sector has the ability and incentives to invest more. It is also important to spend more productively in areas such as education; efforts there should concentrate on making the existing school system, and the teaching body, more effective, and on allocating more resources to the training of adults. Although the large informal sector provides a kind of safety valve for many of the low-skilled, the formal sector must become a more attractive place in the longer term in which to work and to employ. Emigration also provides a safety valve, and remittances lift many households out of acute poverty. A migration agreement between the United States and Mexico would bring

This Policy Brief presents the assessment and recommendations of the 2003 OECD Economic Survey of Mexico. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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benefits to both. Levels of water and air pollution are unacceptably high in Mexican urban areas, and though policies are addressing this, the (implicit or explicit) pricing of natural resources and of polluting activities is far from optimal. Overall, Mexico needs to move ahead with comprehensive structural reforms, including most immediately approval of the tax, electricity and labour reforms, so as to fully release the country's growth potential and provide resources to deal with important issues of human capital and poverty relief. ■

What stops Mexico from growing faster?

In most respects, Mexico's economic performance improved over the 1990s. GDP growth was vigorous, inflation fell steadily, and the current account deficit was of only moderate size. Even the downturn which followed on the heels of the United States slowdown in 2001 was mild by Mexico's standards. Since the 1995 peso crisis, the financial system has been strengthened and, relative to its own past history and experience in many other Latin America countries, the Mexican economy has been stable. This improvement in economic performance owes much to sound macroeconomic policies. Yet, the wide-ranging structural reforms of the past fifteen years, including the entry into NAFTA, have not yet led to an unambiguous rise in labour or total factor productivity growth. Even abstracting from the recent cyclical weakness, Mexico's growth performance since the restoration of macroeconomic stability has been unsatisfactory. Potential GDP growth estimates have been revised down to below 4 per cent, too slow for a country with low levels of income and productivity and high rates of population growth, and too slow to narrow the gap in living standards relative to other OECD countries. Furthermore, the delayed impact of previous reforms is uncertain and is unlikely to raise potential growth sufficiently in the near term.

Potential growth is constrained by low levels of human capital, while additional fiscal resources are needed to improve and expand inadequate physical infrastructure, and combat widespread acute poverty that lead to poor health and social marginalization. Furthermore, there are poor incentives for labour to work in the formal sector, where productivity is higher, but where there are blunted incentives for the private sector to invest and innovate. There is thus a need for further reforms that will raise the rates of growth of labour and total factor productivity. The objective should be to increase the growth of potential GDP by at least two percentage points, to above 6 per cent annually. The main challenges are to:

- remain committed to macroeconomic stability;
- put public revenue and expenditure on a more solid and predictable footing;
- ensure that resources for education and training are used more effectively;
- raise and improve the stock of infrastructure capital;
- pursue labour market reforms;
- ease regulatory measures and other impediments, including failings of the judicial system and high perceived levels of corruption, that weigh on entrepreneurial activity and business investment.

Growth-oriented policies must also be flanked by measures specifically addressed at alleviating extreme poverty and ensuring that benefits of stronger growth are shared more broadly across population groups. ■

What are the risks to the recovery?

Mexico did not escape the economic slowdown that hit OECD countries in 2001, and the recovery has yet to become firmly established. GDP growth is likely to be below 2 per cent in 2003 (not much above population growth of 1½ per cent). Economic activity is expected by the OECD to gather momentum in the latter part of the year and expand by around 3½ per cent in 2004, as exports quicken in line with foreign markets. And business investment, which has been particularly sensitive to global economic developments and uncertainties surrounding them, should gradually pick up. The main risks to the outlook concern world oil prices, financial markets and, above all, the speed of the United States recovery and how this translates into rising demand for Mexico's exports. On the domestic front, advances in the structural agenda would help create an environment more supportive of private investment, including foreign direct investment, and could lead to stronger GDP growth as early as in 2004. ■

What should be the budget priorities over the next few years?

The public sector financial deficit would have come in at 0.7 per cent of GDP, just below target in 2002, but the cost of liquidating a small development bank towards the end of the year and creating a new institution for the rural sector pushed it up to 1¼ per cent of GDP. Meanwhile, the broader public sector borrowing requirement (PSBR) was slightly above 3 per cent of GDP, excluding non-recurrent revenues. The 2003 budget deficit is targeted at 0.5 per cent of GDP, with the objective of achieving balance by 2005. By then, the PSBR is to be brought down to around 2 per cent of GDP. Thereafter, a reasonable medium-term objective would be to put the PSBR on a track consistent with a steadily falling ratio of broad debt to GDP.

Although the public sector deficit has been reduced over the years, the allocation of public spending has been improved and tax revenue has been increased, further improvement in public finances is achievable and necessary. General government revenue is still low relative to GDP and highly dependent on volatile oil-related revenue. The scope of the 2002 tax reform fell short of initial proposals, especially as regards indirect taxes, and the actual impact on revenues of the incomplete reform also fell short of official estimates. Spending in areas conducive to economic development (poverty relief, human and infrastructure capital) need to be financed at a higher level and on a more predictable basis, while explicit and implicit liabilities will continue to affect the budget over the medium term. Hence further action on the tax front is indicated. A reasonable benchmark would be to raise tax revenue in the medium term by 2 percentage points of GDP. Even then and considering that Mexico uses tax concessions where other countries use social transfer payments, the ratio of tax revenue to GDP (excluding oil-related revenues) would still be one of the lowest among OECD countries. A widening of the VAT base, with the elimination of exemptions and zero rating would facilitate tax administration. Changes in that direction could be revenue-enhancing even if rates are lowered. A number of issues will have to be addressed, such as how to limit the impact of the VAT change on low-income groups. Although there is wide agreement in Mexico that more tax revenue is needed, what has been lacking is an agreement on how to achieve this. Political parties are currently discussing with the government various options for another set of tax measures.

The medium-term national programme for financing development (PRONAFIDE) should be broadened. The government has a commendable record of meeting annual budget targets even in adverse conditions, but the large volatility in revenue has often led to *ad hoc* adjustments to spending, especially on public investment. Another side-effect is that fiscal policy has typically had a pro-cyclical bias. On the tax side, the existence of numerous special regimes and exemptions has meant that the government has had to make recurrent changes to the tax law, complicating tax collection and adding to the cost of compliance. A medium-term goal for Mexico should be to set public expenditure programmes in a multi-year framework while maintaining fiscal prudence. This would encourage both policy-makers and Congress to focus more attention on the longer-term development needs of Mexican society, how best to finance them, and when. ■

How can the Bank of Mexico maintain a low inflation environment?

The inflation objective of the monetary authorities for 2002, of 4.5 per cent year-on-year by December was missed, mainly because of increases in food and government-regulated prices. However, core inflation declined steadily to below 4 per cent by end-year. The inflation objective is to bring the CPI inflation rate down to 3 per cent, with a variability margin of plus or minus one percentage point, by December 2003, and keep it in that range over the medium term. At the beginning of 2003, to drive inflation expectations down, the Bank of Mexico tightened the policy stance. By July 2003, headline inflation was down to 4.1 per cent and core inflation to 3.6 per cent, with inflation expectations also down. In that context, the Central Bank did not try to oppose the strong decline in market interest rates induced by lower country risk perception in financial markets. The Bank's readiness to respond quickly to changes to the inflation outlook is appropriate.

Looking ahead, continued caution on the part of the monetary authorities is required to meet their objective and stabilise inflation at around 3 per cent. Although the targeted inflation rate is higher than the average in major trading partners, it is adequate over the next few years. A moderate, predictable and stable inflation environment is necessary to further reduce risk premia required by domestic and foreign lenders, and to encourage long-term investment by the private sector. As inflation recedes and the pass-through from exchange rate fluctuations to domestic prices diminishes, thus obviating the need for large changes in interest rates, the Bank of Mexico could consider changing its operating procedure to set interest rates directly, instead of bringing about changes in market conditions through its announcement about the overall position of banks (*corto/largo* mechanism). This would enhance transparency of monetary decisions. ■

Is the banking sector ready to resume large scale lending?

Actions taken in the aftermath of the 1995 peso crisis have strengthened the Mexican banking system: it is now as solid and profitable as in other OECD countries and the supervision and regulatory framework are close to best practices. Although there has been a resumption of credit growth to consumers especially after the credit crunch of the mid 1990s, lending to private firms remains somewhat hesitant. The test will come as demand picks up. To address some remaining weaknesses in the legal and regulatory framework that increased credit costs and might have deterred banks from taking risks, the Congress in April 2003 approved several welcome amendments to strengthen the legal framework for secured credit transactions. To bring about the revival of bank credit in practice, especially to small and medium-sized enterprises (SMEs), these amendments need to be translated into action. Other channels for SMEs' financing might be explored, as long as they do not create distortions. The state-owned development bank segment is currently being rationalised, and this is welcome. Credit unions and Savings and Loans institutions have increased their share in the SME and housing credit markets, calling for a strengthening of the sector's supervision. Measures to address this last concern have been decided, and they should be implemented without delay. ■

Why is it important to gather a consensus for reforms?

Previous *Surveys* have underlined the solid progress made over the last decade on the structural reform front. The size of direct government intervention and participation in the productive economy has been substantially diminished, and the business environment has become more market-oriented. There nevertheless remain several areas where efforts could be stepped up to correct inadequacies in the implementation of earlier reforms and overcome delays in others, in order to raise potential growth. The focus of reform should be on the basic determinants of growth: investment in human capital and the fostering of conditions conducive to investment and innovation.

The authorities are committed to a comprehensive strategy that aims at raising investment rates and improving the country's international competitiveness, as underlined in the PRONAFIDE and the Development Plan 2001-2006. But on many fronts, it has been difficult to reach consensus and reforms have stalled, even in areas where there is general agreement on their desirability. Progress in coordination and dialogue between the government and the newly-elected Congress will be key to moving ahead decisively in areas which need urgent action, including electricity and labour market reforms, in addition to the tax reform. At the same time, it is essential to step-up progress in areas where legislative changes are not necessarily required, such as the education sector. ■

What should be done to increase human capital and reduce poverty?

Improving the effectiveness of the education system, and thereby strengthening human capital, is indeed a necessary condition for high sustained growth in the long term. Despite major improvements over the past decades, especially in increasing basic school enrolment for a rapidly growing school-age population, Mexico's human capital lags far behind most other OECD countries. The quality of education services and training is well below OECD best practice, many school-leavers have poor literacy and numeric skills, and the cost effectiveness of education programmes needs to be improved. Additional resources could be used to address some of the shortcomings, but more importantly, what is required is further modernisation of curricula, providing better training to teachers, enhancing the accountability of schools and rewarding individual effort by teachers. Resources to be allocated to pre-school education should not be at the expense of greater efforts to ensure that more children remain in secondary school and for longer periods. New options should also be investigated to improve access of the less well off to tertiary education. To avoid massive redistribution in favour of higher income families, tuition fees should be raised while increasing the availability of grants for poor students and making student loans more readily available. Adult training, including in basic skills, plays a decisive role in increasing labour force mobility and is the key to removing unskilled adults from poverty traps. On-the-job and formal training programmes should therefore be continued, and publicly funded programmes should be made more cost efficient.

The scale and acuteness of poverty in Mexico is an important factor influencing policy making. While in the longer run, poverty can be reduced as more people get more and better education and work opportunities, in the short-term targeted programmes, such as those currently in place, are necessary to ensure that the basic needs of the population are met. Since the mid 1990s, public spending on poverty alleviation has been increased, and targeted action for the most disadvantaged groups has widened in scope. The integral programme for education, health- and nutrition (PROGRESA/*Oportunidades*), which was extended to cover more than 4 million families (21 million people) has had a significant positive impact on the welfare of supported families. It should be continued. Progress made in specific actions for the poorest, to provide food assistance and improve access to basic education and health services is welcome. Attention should now focus on improving the quality of services provided. Beyond such targeted measures, the development strategy that is required to lift the population out of poverty on a lasting basis must aim at facilitating access to goods and financial markets, and fostering the expansion of productive jobs in the formal sector. ■

How to make work in the formal labour market more attractive?

The main labour market problem that policy has to tackle is to increase the relative size of the formal sector while maintaining a high degree of real wage flexibility in a low inflation environment. Since there are few effective sanctions against working in the very large informal sector, it is the attractiveness of the formal sector that needs to be enhanced. Social contributions and benefits need to be reviewed. For employers, social security contributions, relatively high for the lower salary scales, create a possible obstacle to hiring low skilled-workers with a formal contract. Moreover, workers in the formal sector view the social benefits for which they qualify as being of low quality in relation to their contributions. A comprehensive reform of the housing fund (INFONAVIT), which gets a significant share of social contributions, should be considered to address this issue, as well as improvements in the quality of health services financed by the social security institute (IMSS).

If approved, the labour market reform proposal presented to Congress in December 2002 would represent a decisive step in making it more attractive for employers to hire in the formal sector. In particular, it would allow probationary periods and ease some of the regulations on permanent contracts. The proposal needs to be adopted and it should be followed by additional elements to improve incentives on both sides to raise formal employment. For example, overly strict regulation of atypical forms of employment and dismissals should be relaxed, while introducing an unemployment compensation scheme, carefully designed to avoid both creating unemployment traps and giving incentives to "surf" between the formal and informal sectors. ■

Is the business environment sufficiently friendly and competitive?

To take full advantage of other growth-enhancing reforms, actions are desirable to improve the business environment. Measures have been rightly taken in recent years to reduce bureaucracy and accelerate firm creation and exit procedures, but their effects are not yet fully visible. Moreover, a serious and persistent problem is the poor rule of law, as illustrated by long judicial processes, poor enforcement of judicial decisions especially at the local level, weaknesses in the protection of intellectual property rights and corruption. Actions to address these issues are required at the Federal and the State levels.

Cross-country evidence shows that competition is an important driver of innovation and productivity levels and growth. Product market competition has been sharpened in recent years and trade liberalisation has made the Mexican economy more responsive to market forces. However, there are legal and regulatory obstacles to investment in certain key sectors, electricity in particular. In telecommunications, maintaining a level playing field between the incumbent and new entrants remains a big challenge. Given the importance of these sectors for future growth, reforms should not be delayed:

- In the *electricity sector*, a coherent reform strategy will have to be implemented (whether based on the current proposal or a new blueprint) so as to ensure reliable and growing generation and distribution capacity at low prices for Mexican industry and households over the medium to long term. Since the state does not have the resources required to finance investment on a sufficient scale, it is essential that the private sector be allowed a bigger role. Political obstacles to this need to be resolved quickly.
- In the *telecommunication sector*, despite the privatisation and deregulation of the 1990s, and the growth of the industry and the drop in tariffs in real terms, telecommunication density remains lower and tariffs

higher than in most other OECD countries. To enhance competition in the market, the authority of COFETEL, the regulatory body, has to be strengthened. ■

How to achieve a cleaner environment?

Water use in Mexico is on an unsustainable path. A large number of underground aquifers are being depleted. In many cases this is the result of over-extraction by the agricultural sector for irrigation use. Farmers are now paying a larger part of the operating costs of irrigation systems but the remaining direct subsidies need to be ended and the agricultural sector should be obliged to pay the market price for electricity used for pumping. As well, the irrigators should pay for extraction rights, rather than being exempted. In urban areas, the challenge is to convince local authorities, who control the utilities, to place water distribution on an economic footing. Raising water charges would also help finance the major investment programme that is needed both to improve the treatment of wastewater, more than three-quarters of which is discharged without treatment into rivers, and to expand the provision of potable water in rural areas and its quality in both rural and urban areas. Ensuring that both local authorities and industry pay the legislated penalties is also essential in order to lower pollution.

The need for stronger policies to reduce air pollution is clearly evident in Mexico. Urban areas in the country suffer from some of the highest pollution levels in the OECD area, bringing significant social costs. New emphasis is being given to the reduction of air pollution through national and local programmes, but further initiatives may be necessary. Diesel fuel quality needs to improve at a quicker pace using economic instruments to ensure adequate investment by the state-owned petroleum company (PEMEX). Vehicle inspection programmes need to be tightened. Registration taxes for diesel vehicles should be made dependent on emission characteristics so speeding the scrapping of old trucks and buses. There is also scope for reducing emissions from large stationary sources. A trading system might be difficult to introduce as there would be few participants in the market, given that the nearly all electricity plants and petrochemical plants are state-owned. However, a tax-based system could be considered. Finally, enhanced cross-border co-operation is essential, given the rapid economic development in areas that form common air sheds with the United States. ■

What are the economic benefits of migration to the United States?

Emigration plays an important role in the increasing integration of the Mexican and US economies. The equivalent of one tenth of the Mexican-born population lives and, for the most part, works in the United States, and gross flows of temporary migrants across the US/Mexico border amount to several hundred thousand annually, well above the legal quota limits. Mexican emigrants to the United States are overwhelmingly low-skilled young adults looking for work and (usually) intending one day to return to Mexico. Traditionally, such migrants were seasonal agricultural workers, mostly males, coming disproportionately from a limited number of rural areas, and working in States just across the border. Although this pattern remains important, migrants increasingly eventually settle in the United States, more of them are women, they more often work in low-paid service jobs in the US, they come increasingly from urban areas, and large numbers of them now work in the north of the United States. High-skilled emigrants remain comparatively rare.

Migration confers economic benefits on both Mexico and the United States, though the social costs in terms of disruption of family and social life are borne mainly by Mexicans. The US economy benefits from the presence of a sizeable and prime-age labour force willing to work for low wages. Although Mexican migrants work in low-paid jobs, often informally, their wages are typically six times higher in the United States than in Mexico, and migrants typically remit a quarter of their earnings to their families, as well as accumulating savings during their stay in the United States. Thanks to enhanced competition and better technology, the cost of remitting funds to Mexico has fallen in recent years, and the financial authorities of both countries should encourage this trend by requiring the publication of comparable information on service costs. The remittances themselves are mostly used immediately to finance consumption. Many recipient households are thereby lifted out of acute poverty, with its associated ill-health and social exclusion, and children can more easily attend school. The high proportion of low-skilled emigrants from specific regions and sectors partly reflects low levels of economic development there. The project to develop local financial networks under the aegis of BANSEFI should raise financial intermediation in rural and low-income populations and at the same time spread the benefits of remittances more widely across the community and over time.

Mexican migration policy was traditionally one of benign neglect, emigration being seen as a safety valve to offset the chronic inability of the Mexican economy to create jobs fast enough for the expanding working-age population, and as an important source of dollar income. During the 1990s, the Mexican authorities started to take a more active stance, trying in particular to reach an agreement on several aspects of migration with the United States. After the 11 September 2001 events, negotiations were interrupted. Instead, border security has been tightened further, making illegal migration even more risky and costly. But the economic incentives remain huge and once across the border and into a job, migrant workers can live comparatively openly in many areas. Current stringency of border security may also encourage Mexican immigrants to remain in the United States for longer spells than they would otherwise have chosen. Efforts to reach a migration agreement should be pursued in the interests of both countries. It would strengthen the position of Mexican workers in the United States, thus possibly increasing remittances and reducing the deadweight costs of illegal border crossings. ■

For further information

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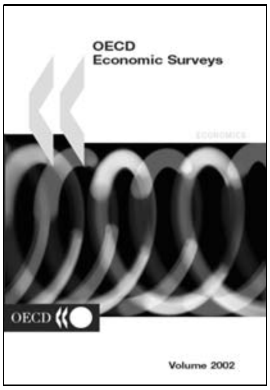

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