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OECD Review of Budgeting in Mexico

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Foreword

This review of budgeting in Mexico was carried out at the request of the Mexican authorities and concentrates mainly on the national government. This review was conducted as part of the work programme of the OECD Working Party of Senior Budget Officials (SBO). The objective of OECD budgeting peer reviews is to provide a comprehensive overview of the budget process in the country under examination, to evaluate national experiences in the light of international best practice, and to provide specific policy recommendations. Following a common methodology and conceptual framework, reviews promote the sharing of experience among countries and the formulation and diffusion of policy recommendations.

The report is divided into five chapters. Chapter 1 discusses Mexico's fiscal performance and challenges. Chapter 2 focuses on the budget formulation process. Chapter 3 discusses the role of Congress in the budget process. Chapter 4 examines the budget execution process, and Chapter 5 examines performance budgeting and management reforms.

An OECD mission led by Dr. Teresa Curristine (OECD) and including Mr. Richard Emery (an independent consultant), Mr. Philipp Krause (London School of Economics) and Mr. Eduardo Aldunate (Economic Commission for Latin America and the Caribbean) visited Mexico City in December 2008 to prepare this review. During its visit, the mission met with senior officials from various parts of the Ministry of Finance, including the Directorates General for Programming and Budgeting. As well the mission met with officials from the Office of the Presidency, the Ministry of Public Administration, and several spending ministries and agencies. The mission also met with senior congressmen and officials of the Mexican Chamber of Deputies and the Mexican Federal Supreme Audit Office. In addition, the mission met with representatives of the National Council for the Evaluation of Social Development Policy and with academic experts.

The mission would like to express its gratitude and appreciation to Mr. Dionisio Pérez-Jácome (Under Secretary for Expenditure, Ministry of Finance) and Mr. Max Alberto Diener Sala (Legal Director-General of Public Expenditure, Ministry of Finance), and all the staff of the

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This book was written by Teresa Curristine, Eduardo Aldunate, Richard Emery, Philipp Krause, and Agustin Redonda (OECD Secretariat). The views contained in this book are those of the OECD Secretariat and should not be attributed to governments of OECD member countries, or to any organisation or individual consulted for this report. The review was completed in June 2009.

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Acronyms and Terms

Aportaciones: earmarked federal transfers to states and municipalities

ASF: *Auditoría Superior de la Federación* (Federal Supreme Audit Office)

BFRL: 2006 Budget and Fiscal Responsibility Law (*Ley Federal de Presupuesto y Responsabilidad Hacendaria*)

BM: *Banco de México* (Central Bank of Mexico)

CA: *coordinaciones administrativas* (administrative co-ordination)

CEFP: *Centro de Estudios de las Finanzas Públicas* (Center of Public Finance Studies, within the Chamber of Deputies of the Mexican Congress)

CFE: *Comisión Federal de Electricidad* (Federal Commission of Electricity)

COMPRANET: online electronic system of government procurement

CONEVAL: *Consejo Nacional de Evaluación de la Política de Desarrollo Social* (National Council for the Evaluation of Social Development Policy)

DGPpP: *Dirección General de Programación y Presupuesto* (Directorate General for Programming and Budgeting)

IADB: Inter-American Development Bank (*Banco Interamericano de Desarrollo*)

ICO: internal control offices

IFR: 2007 Integral Fiscal Reform

IMSS: *Instituto Mexicano del Seguro Social* (Mexican Institute of Social Security)

INEGI: *Instituto Nacional de Estadística, Geografía e Informática* (National Institute for Statistics, Geography and Informatics)

- INTOSAI: International Organization of Supreme Audit Institutions, based in Vienna, Austria
- IPAB: *Instituto para la Protección al Ahorro Bancario* (Institute for Banking Savings Protection)
- ISSSTE: *Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado* (Public Sector Social Security Institute)
- Ley de Obras Públicas y Servicios Relacionados con las Mismas*: law concerning procedures for expenditures in infrastructure projects
- LFC: *Luz y Fuerza del Centro* (Central Light and Power Company)
- MIR: Matrix of Indicators for Results
- MXN: Mexican pesos
- NDP: National Development Plan
- OM: *Oficialía Mayor* (central administrative unit in each line ministry which includes responsibilities for planning, programming, budgeting, spending and financial control in that ministry)
- OMB: Office of Management and Budget, United States
- PAN: *Partido Acción Nacional* (National Action Party)
- Paquete Económico*: comprehensive assessment of the Mexican economy and the policy context for the annual budget
- PART: Program Assessment Rating Tool (performance reform in the United States)
- Participaciones*: non-earmarked federal transfers to states and municipalities
- PEMEX: *Petróleos Mexicanos* (national oil company)
- PIDIREGAS: *Proyectos de Inversión Diferida en el Registro del Gasto* (multi-year investment projects, a Mexican type of public-private partnership)
- PIPP: *Proceso Integral de Programación y Presupuesto* (integrated programming and budgeting system)
- PMG: *Programa de Mejoramiento de la Gestión* (Management Improvement Programme)
- PMP: *Programa de Mediano Plazo* (Medium-Term Programme, a programme for reducing administrative expenses and energy costs)

- PPSL: 2003 Professional Public Service Law (*Ley del Servicio Profesional de Carrera*, LSPC)
- PRD: *Partido de la Revolución Democrática* (Democratic Revolutionary Party)
- PRI: *Partido Revolucionario Institucional* (Revolutionary Institutional Party)
- PRODEV: IADB Programme to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness (*El Programa de Implementación del Pilar Externo del Plan de Acción a Mediano Plazo para la Efectividad del Desarrollo*)
- PROMAP: *Programa para la Modernización de la Administración Pública* (Programme for the Modernisation of Public Administration)
- PRP: performance-related pay
- SED: *Sistema de Evaluación del Desempeño* (Performance Evaluation System)
- SEDESOL: *Secretaría de Desarrollo Social* (Ministry for Social Development)
- SFP: *Secretaría de la Función Pública* (Ministry of Public Administration)
- SHCP: *Secretaría de Hacienda y Crédito Público* (Ministry of Finance)
- SIAFF: *Sistema Integral de Administración Financiera Federal* (Federal Integrated Financial Management System)
- SIMEP: *Sistema de Metas Presidenciales* (presidential targets system)
- SSE: *Subsecretaría de Egresos* (Under Secretariat for Expenditure, within the Ministry of Finance)
- STA: single treasury account
- UPCP: *Unidad de política y control presupuestario* (Budgetary Policy and Control Unit)
- USD: United States dollars

Executive Summary and Recommendations

Over the past decade, Mexico has undergone significant economic and political reform. This period has witnessed important improvements in the health of public finances. The government's narrow measure of the budget deficit has been below 1% of GDP for the past five years (2003-08). Furthermore, the public sector borrowing requirement – the broader definition of budget deficit¹ – has been below 3% of GDP for the same period. Although these improved fiscal balances have been aided by higher revenues as a result of significant increases in oil prices, Mexico's recent public finances have clearly reflected an era of fiscal responsibility. This improved fiscal situation should place Mexico in a better position to withstand the current global economic crisis.

Despite this good fiscal record, and notwithstanding the current crisis, Mexico faces underlying structural challenges. These include: reducing its dependency on oil revenues; improving its growth rate; enhancing both fiscal sustainability and the efficiency and effectiveness of public spending; and improving the accountability of spending at the sub-national level.

Since 2006, the Mexican government has made progress and introduced a number of laws and reforms that aim to address these challenges and improve fiscal responsibility and transparency. The main fiscal reforms are described below:

- The 2006 Budget and Fiscal Responsibility Law (BFRL) created a balanced budget rule, established a formula for calculating oil prices, institutionalised stabilisation funds mainly for surplus oil revenues, and modified the congressional budget approval process.

- The 2007 Integral Fiscal Reform, a wide-reaching reform package, introduced tax reform and altered the fiscal framework between the states and the federal government. This act also established the framework for performance budgeting and management.
- The 2007 New ISSSTE Law (*Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado*) reformed the public sector pension scheme and aims to create a more sustainable pension system over the longer term.
- The 2008 Governmental Accounting Law seeks to establish accrual accounting and harmonisation of the accounting and budgeting norms across all levels of government.

The government's reforms have significantly improved the overall fiscal and budget framework and are an important step in seeking to address the underlying structural challenges. These reforms are also important in terms of bringing the Mexican budget process and fiscal framework more in line with the new political reality that has evolved since the 1990s.

Implementing these reforms is the key challenge facing the government. The passage of these acts is not sufficient to ensure change. It is vital to push ahead with the initiatives at all levels of government and to maintain pressure for reform. Several reforms have been introduced quickly and with very ambitious timetables. Thus, co-ordination and co-operation across ministries and levels of government are vital.

The performance budgeting initiative is the cornerstone of the government's efforts to improve the efficiency and effectiveness of public programmes. This initiative has an ambitious timetable that requires the simultaneous implementation of performance budgeting by the national and state governments. In its first year of operation, it has made important progress at the national level and has high-level political support. If this progress is to continue, it is important that implementation challenges be addressed.

Key challenges are defining the exact roles and responsibilities of each of the institutions and improving institutional co-ordination and co-operation. This requires establishing clearly and in detail, possibly in legislation, who is responsible for each aspect of this reform initiative. The organisation, purpose and functions of the programme evaluation units of the Ministry of Finance and of the Ministry of Public Administration, and the overall role of the National Council for the Evaluation of Social Development Policy (CONEVAL), should be clearly set out, and overlaps in responsibilities should be minimised. A co-ordinating council should be

established to ensure co-operation among the offices of the different organisations and to prevent duplication of efforts.

Other challenges include enhancing institutional capacity, especially at the state and municipal levels, in order to implement performance budgeting and the new accounting reform. Another issue is the compatibility of the current system of accountability and control with a performance system. The Mexican public service has a strong legalistic tradition that stresses adherence to rules and regulations and punishes individuals that fail to adhere. Moving from this system to one that stresses performance is a large cultural shift and a long-term process. To facilitate this change, actions needed are: *i)* the creation of new incentive structures; *ii)* streamlining and eliminating the current excessive internal rules and regulations; and *iii)* increasing flexibility in budget execution and in management and personnel issues.

For Mexico, like other OECD countries, challenging times lie ahead, which makes it all the more important to move forward with these reforms and to put in place frameworks that promote budgeting for the medium and longer term and value for money in public spending. During crises, the temptation is to abandon reform projects in favour of short-term solutions. But in addition to challenges, crises also present windows of opportunity for change that should be grasped to push ahead with reforms that can generate longer-term benefits.

In sum, recent reforms mark a crucial step in improving the Mexican government's budget and fiscal frameworks and in creating a budget process that is more efficient and transparent and more in line with international practices. Strong and continued political support is needed to ensure that the recently enacted laws become a reality and are implemented in practice at all levels of government. In the future, more initiatives will be needed to continue to address the longer-term structural issues.

The key recommendations of this report are summarised below and are discussed in greater detail in the relevant chapters.

Improving budget formulation

- **Developing a more comprehensive medium-term expenditure framework would lend greater stability to the government's fiscal framework and would improve planning.** The first step in this process is to develop medium-term estimates for major programmes for the base year and at least three years out. These estimates should be tied to sectoral planning and to the National

Development Plan within the context of budget constraints. The Ministry of Finance should develop and publish a current services baseline to act as a benchmark for considering out-year policy changes. In addition, consideration could be given to developing either a flexible or fixed medium-term expenditure framework.

- **Budget ceilings should specify limited constraints and, within these limits, provide ministries and programme managers with discretion to allocate resources wherever possible to strengthen programme performance.** For example, it may be appropriate to specify a budget ceiling for each ministry, an employment ceiling, and assumptions for a few selected programmes that are of high national significance. The allocation of the resources within these constraints – including the allocation of personnel – should be at the discretion of the ministries.
- Currently, the budget formulation process is heavily overloaded in the final two months before submission to the legislature. The Ministry of Finance seems to rely on its close relationship with budget staff in sector ministries to reduce the number of unresolved issues as they arise in the preceding months. It would be desirable for the budget negotiations between sector ministries and the Ministry of Finance to be rearranged so as to formalise the interactions taking place in spring and early summer. **This would include communicating the ceilings for each ministry well in advance, to give sector ministries enough time for proper policy deliberations on how best to use the fiscal space available.**
- **Developing and using longer-term estimates will contribute towards enhancing fiscal sustainability.** It would be beneficial for the Ministry of Finance to develop longer-term estimates for 20 to 30 years out. This would help plan for the longer-term fiscal policy issues which Mexico will be facing, namely the declining oil revenues and changing demographics.
- **Investment decision makers should consider funding large investment programmes on a multi-year basis.** Up until 2008, it was not possible to properly budget for multi-annual capital investments. The recent introduction of multi-year funding for investment programmes is a welcome improvement. Decision makers should use this new authority to engage in more multi-annual planning and funding for large investment programmes. The Investment Unit in the Ministry of Finance should do more *ex post* assessments of selected investment programmes to determine the accuracy of project plans and cost estimates.

- **Consideration should be given to improving budget presentation.** This could be done by reducing economic classification data that do not contribute to budget management and by expanding programme information. Budget documents should include information about programme changes – both those that are proposed and those that have been implemented.
- **The efficiency of the budget formulation process has been improved by enhancing the co-ordination role of the Ministry of Finance. This should be continued.** Under the current administration, the budget formulation process has become more co-ordinated, both within the executive and in relations with Congress. The Ministry of Finance has played the leading role in co-ordinating the process. This centralisation has helped to enforce budget discipline by avoiding the situation of previous administrations when line ministers resorted to the President or the Congress to override the ceilings previously established by the Ministry of Finance.
- **Reorganisation of the budget office (*Subsecretaría de Egresos*) will help better manage workloads and increase the focus on performance initiatives.** The proposal to create a third Directorate General for Programming and Budgeting (DGPYP) and a separate evaluation unit is to be commended, although it is important that this organisational change include a viable framework for involving budget analysts in the performance system. Many operational decisions are delegated upwards, resulting in extreme workloads for top officials. In the case of the two existing DGPYPs, the workload problem is compounded by a high degree of detailed supervision over spending ministries. Reducing this level of detailed oversight and concentrating more on aspects of programme review and analysis will help reduce workload.

Enhancing the role of Congress

- The introduction of performance budgeting and management will provide Congress with more information on programme performance. **It is important that Congress be engaged in this reform initiative and be encouraged to use performance results to follow up the performance of the relevant ministries and agencies and to use this information when discussing the draft budget.**

- **As part of the existing public consultation exercise for proposed reforms, it could be helpful to establish an informal advisory committee on budget reform.** The committee could serve as a sounding board or consultative body to obtain congressional views on proposed budget reform initiatives before reform bills are introduced in the legislature. This committee would consist of representatives from all legislative political parties and the Ministry of Finance.
- **When preparing and amending the draft budget, the executive and the Congress should abide by their respective constitutional limitations.** Differences may generate conflicts, such as the one brought before the Supreme Court in 2005.
- **The Federal Supreme Audit Office (ASF) should consider producing information in a more streamlined and easily accessible manner.** The ASF undertakes approximately 800 audits per year and produces a single report after the end of the fiscal year that consists of 40 volumes and 25 000 pages. Rather than generating one single large report, the audit institution should consider publishing summaries of individual reports and presenting them to the relevant congressional committee.
- **Audit reports and performance information should be provided to Congress in a timely manner.** It would be highly desirable for Congress, the Federal Supreme Audit Office and the executive to improve the organisation of their workloads so that performance reports and other relevant audit reports are effectively used in decision making and provided in a timely manner.

Improving budget execution

- **It would be desirable for the budget execution functions to be reviewed, to enhance the discretion and flexibility of programme managers and budget officials.** Within the budget office, budget analysis should focus more on programme review with less emphasis on *ex ante* budget controls. Staff mobility within the budget office should be encouraged, to minimise programme advocacy and to strengthen analytical skills. Agency programme managers should be given greater control over details of budget management and reallocation of resources within their programmes.
- **To manage the implementation process for the accounting reforms, it is important to generate realistic expectations about**

the timelines and challenges ahead. The focus should be on getting the basics right. The initiative to harmonise accounting systems for the Mexican central government, the states and the municipalities and to shift to an accrual-based financial reporting system has a challenging time frame. The task is highly complex and requires patience and adequate time to implement. The primary emphasis should be placed on getting a correct cash system and on establishing a register of assets, before adopting accrual measures.

- **The Federal Supreme Audit Office (ASF) should improve the timing of the submission to Congress of its report on the review of the public accounts.** The “OECD Best Practices for Budget Transparency” (OECD, 2002) recommends that a supreme audit institution should submit its opinion on the audited public accounts to the legislature no later than six months after the end of the fiscal year. The current period in Mexico is 14 months.
- The Ministry of Public Administration has internal control offices within each ministry. In the past, these offices have focused on enforcing government regulations and resolving complaints against public servants. While these functions are necessary, **the internal control offices should shift more towards programme improvement rather than performing legal compliance audits that may result in the sanction of public servants but not in the improvement of public services.**
- The 2003 Professional Public Service Law (PPSL) has now been in place for over five years. **The implementation and results of this law to date should be externally evaluated and reviewed in order to provide recommendations for improvements.** The introduction of the PPSL was an important advance on what had gone before; however, there are many areas in which it can be improved.
- **Strengthening performance management should be emphasised in the personnel, procurement and regulation functions of government:**
 - Expand the performance-based personnel recruitment, review and compensation, using performance-based incentives wherever possible.
 - Simplify procurement rules and regulations and shift more to e-procurement and common service procurement. Focus procurement review on larger-scale, longer-term projects.

- Reduce regulation and administrative paperwork and expand the use of e-government to reduce the bureaucracy of the system.

Improving accountability for results

The latest performance budgeting and management initiative is part of a reform effort that has been ongoing for over 15 years. In its first year of implementation, the initiative made important progress. Mexican public officials at all levels appear to be aware of this latest initiative. However, in moving ahead, efforts must be made to ensure its continued implementation:

- **Co-ordination among institutions needs to improve significantly.** The roles and responsibilities of the key institutions and ministries – the Ministry of Finance, the Ministry of Public Administration, and CONEVAL – have to be clearly defined and implemented in practice.
- **A co-ordinating council or working group should be established to ensure co-operation among the offices of the different organisations and to prevent duplication of efforts.** This council should include high-level representatives from the Ministry of Finance, the Ministry of Public Administration, CONEVAL, and the Office of the Presidency. The current proposal is that this council be headed by the Ministry of Finance as part of its legal remit to co-ordinate the Performance Evaluation System (SED).
- The new evaluation unit within the Ministry of Finance, which is responsible for operating the Performance Evaluation System (SED), **should be active in producing reports and information in a timely manner for key decision makers.**
- **Consideration should be given to the continuation and wider application of the “traffic light” system used by CONEVAL for evaluating performance results.** Also, it would be helpful to adopt its proposed timetable for producing performance evaluation reports in time for key decision making in the budget process.
- **There should be clear guidelines on the development and use of indicators.** Recent initiatives have resulted in an array of requirements to produce programme indicators for planning, budgeting, evaluation, programme management, and audit functions. There should be a clear indication of the purpose and use of each measure or category of indicator. To avoid redundancies and confusion, one institution should be clearly in charge of developing

guidelines and standards for the development and use of performance indicators.

- **To engage line ministries more in the reform process, the position of performance co-ordinator or manager should be created in the *Oficialía Mayor* (central administrative unit in each line ministry).** This person would report directly to the minister and serve as a reform champion in that ministry. To date, it is clear that most ministries have fulfilled the requirements of the law to provide indicators; however, more needs to be done to engage them in the reform process and to encourage them to use performance information to improve the management of their programmes.
- The initial efforts to include performance information in the budget formulation process are to be commended. **If progress is to continue, it is important to institutionalise some of the current practices and to integrate performance information more into the decision-making processes.** For this to be successful, it is important that the new evaluation unit, the DGPyPs, and the Budgetary Policy and Control Unit work closely together.
- **The incentive structure needs to change to reflect this new performance approach.** The current system strongly stresses compliance rather than performance. Moving to a performance-focused approach requires: i) the creation of new incentive structures; ii) streamlining and eliminating the current excessive internal rules and regulations; and iii) increasing flexibility in budget execution and in management and personnel issues.
- **To move ahead, a staged and sequenced approach would be helpful.** An implementation plan should be developed, with defined timetables and stages, actions to be taken, and milestones to be achieved. Potential stages and sequencing could be:
 - First, improving the quality of performance information and IT support systems and further integrating performance information into the budget process and other planning and management processes.
 - Second, strengthening and modernising financial management in line ministries. This stage includes a manageable timetable for the implementation of accrual accounting reforms in line ministries and for the development of cost information.

- Third, changing the government-wide accountability systems and incentive structures. One aspect could be the use of a pilot scheme to test the delegation of financial and managerial responsibilities to line agencies on a case-by-case basis.

Note

1. The public sector borrowing requirement includes the costs of the banking sector rescue package and the PIDIREGAS (multi-year investment projects).

Chapter 1

Fiscal Performance and Challenges

Over the past decade, Mexico has made significant improvements in its fiscal performance by implementing important reforms to establish macroeconomic and financial stability, to open the economy to trade and investment, and to change the political environment. The prudent fiscal policies pursued by the Mexican government have resulted in strong fiscal performance. Albeit aided by higher oil prices, these policies have successfully lowered public sector debt and reduced the budget deficit to 3% of GDP or below for the past five years (2003-08).¹ Economic growth has improved over the past decade, although the economy is not expanding rapidly enough to make living standards equivalent to richer OECD countries.

Despite these improvements, Mexico continues to face a number of underlying structural challenges. The ongoing government reform agenda is seeking to address these challenges. Since 2006, the pace of reform has accelerated with a number of important initiatives to improve the fiscal framework, the budget process, and fiscal sustainability.

This chapter is divided into six sections. The first describes the general characteristics of the Mexican political and government system. The second discusses Mexico's fiscal performance. The third discusses structural challenges facing the Mexican government. The fourth describes the recent government reform packages. The fifth discusses the current economic crisis. The sixth section concludes.

1. General characteristics

The United Mexican States, commonly known as Mexico, is a federal constitutional republic. The Mexican federation has a population of around 107 million people. It is made up of 31 states and the federal district of Mexico City (*Distrito Federal*) and includes more than 2 500 municipalities, which are the smallest unit of political division.

Like most Latin American countries, Mexico has a presidential political system. For 70 years, one political party – the *Partido Revolucionario Institucional* (PRI) – dominated the political landscape and controlled the Presidency, the Congress, and state and municipal governments. During this period, the State and the party became intrinsically linked, and a highly centralised political and administrative structure emerged (Arellano Gault, 2002).

Over a decade, the political system transformed from a single-party system to a competitive multi-party one with three main political parties: the PRI, the *Partido Acción Nacional* (PAN), and the *Partido de la Revolución Democrática* (PRD). In 1997 – in the aftermath of the Mexican peso crisis – the PRI lost its majority in the Chamber of Deputies for the first time. This transformation culminated with the PAN winning the presidential elections in 2000. At the national level, divided government – where one party controls the Presidency and another the legislature – has become common. In some cases, this has resulted in complicated and difficult negotiations between the President and the Congress, and between the lawmakers of the three main parties within Congress.

The transformation of the political system has impacted the fiscal policies and processes of the Mexican government. On one hand, the increasingly active role of Congress in the budget process has resulted in a move towards greater transparency in public finances and budget management (Larre, 2006, p. 153). On the other hand, the active participation of all political parties has resulted in very intense executive-legislative budget negotiations. In 2005, the President used his veto power to veto the budget decree (see Chapter 3). The situation had to be resolved by the Supreme Court. Since the Supreme Court's decision on this conflict and the passage of new legislation, the situation has improved. Recent reforms – especially the 2006 Budget and Fiscal Responsibility Law – enacted necessary institutional changes to reflect this new political reality. For the last three years (2007-09 budgets), the budgets have been approved by a consensus of the three larger political parties.

1.1. The federal government

The federal government of Mexico employs approximately 2.6 million people. The President is the head of the government. The Office of the Presidency is the apex of the government structure; there are 18 central government ministries plus the Attorney General's Office and 77 co-ordinated agencies. There are 210 federal entities, including decentralised agencies/institutions (98), public trusts (21), and public enterprises (91). The most important public enterprise is PEMEX, the national oil company, which produces directly approximately 7% of GDP (OECD, 2007b, p. 66).

The federal government has a role in the provision of most public utilities, such as energy, water, oil, and postal services. The federal annual budget includes subsidies for those sectors. Apart from the public entities that supply public utilities, the most significant public entity is the development banking system. The government owns second-level financial

institutions which grant credit for infrastructure projects or the expansion of small or medium-sized enterprises (SMEs).

1.2. Federal and sub-national governments

Mexico is a federal country. The states of Mexico vary significantly in their economic strength, level of development, and institutional capacities. The political structures of the states mirror those of central government; there is an elected governor and an elected state legislature. There is substantial sharing of government functions among the federal government, the states, and the municipalities.

In 1978, the federal government and the sub-national governments created a new fiscal federalism framework. States and municipalities renounced their right to impose certain local taxes, in exchange for a share of all taxes collected by the federation. This framework established two types of grants transferred from the federal government to the states. The first is *participaciones*, non-earmarked transfers from the federation to the sub-national governments in amounts fixed by law. There are no restrictions on how the sub-national governments can spend this money. Each state's share is defined on the basis of the state's population relative to the national population. In 2009, these transfers are budgeted to be 21.1% of the federal primary expenditure.

The second type of grant is known as *aportaciones*. These are federal government transfers that are earmarked for specific purposes, for example for the salaries of teachers, health care workers and the police, and for infrastructure. These are decentralised federal programmes; state and municipal governments do not have discretion to change the purpose for which these funds are earmarked.

Over the past decade, a distinctive framework has evolved which is highly centralised in terms of revenue collection and decentralised in terms of spending. The federal government collects the taxes and is the main source of revenue for sub-national governments. The federal government provides nearly 90% of sub-national government revenues. Only about 10% of sub-national government revenues come from sub-national taxation and non-tax revenues (4.6% and 6.1% respectively). Over the past decade, there has been an increased decentralisation of public expenditure to sub-national governments (*aportaciones*), especially in education and health. Today, more than 29% of programmable expenditure is allocated to the states.

This fiscal framework was designed when the PRI controlled state and municipal governments; however, the situation changed significantly with multi-party competition as other political parties, with different political

agendas, gained control of the state and municipal governments. As the political realities in Mexico evolved, the system suffered from a series of patchwork changes that resulted in a very complex set of rules. The fiscal pact has not contributed to strengthening public finances at any level of government. Recently, changes have been introduced to improve the pact and to hold the states and municipalities more accountable for public spending and to give states more incentives to raise their own revenues (see Section 3 below).

2. Fiscal performance

Mexico's current fiscal and economic performance has come a long way since the difficult times of previous decades. In the 1980s and early 1990s, Mexico struggled with high fiscal deficits and debts resulting from two major economic crises, the 1982 debt crisis and the 1995 "tequila" crisis. Both crises had a profound impact on the Mexican economy and generated a contagion effect throughout the rest of Latin America. In 1982, Mexico became the first country in the region to default on its debt of USD 86 billion, triggering a spiral effect throughout Latin America. In 1982, the Mexican budget deficit reached a high of 16% of GDP. In reaction to the crisis, the government introduced macroeconomic adjustments including strong fiscal consolidation and price controls in all sectors (Arellano Cadena and Hernández Trillo, 2006).

The tequila (or peso) crisis was triggered by the devaluation of the Mexican peso in December 1994. In the wake of the crisis, the GDP growth rate shrank by 6.2% in 1995, and real wages fell by about 20%. The government introduced a number of reforms to deal with the crisis, including raising value-added tax from 10% to 15%. The Mexican economy made a rapid recovery: economic growth became positive again during the first quarter of 1996 and, over the period 1996-98, reached an impressive 5.9%. There is a general consensus that the different political and economic reforms implemented since the tequila crisis have played a key role in explaining the rapid recovery and in ushering in a new era of great fiscal prudence (Cerra and Saxena, 2005; Lederman, Menéndez, Perry and Stiglitz, 2003).

Since the tequila crisis, Mexico has successfully followed prudent fiscal policies. The credibility of the autonomous Central Bank of Mexico has significantly improved over time, and a sound monetary policy has helped to bring annual average inflation down from a high of 35% in 1995 to close to 5% in 2008.²

Despite the undeniable role played by oil revenues, the government has reduced its budget deficit and public debt over the past ten years and especially in the last five. The Mexican government uses three measures of budget balance. The first is the financial balance, which is the budget balance for the federal government and public enterprises under budgetary control. The second is the primary balance, which is the financial balance less net interest payments. The third – and broader – definition of budget balance (the public sector borrowing requirement, PSBR) includes the net costs of PIDIREGAS (the Mexican type of public-private partnership³), inflation adjustments to indexed bonds, financing costs of the programmes for bank restructuring and debt support, and financial requirements to development banks (OECD, 2007c).

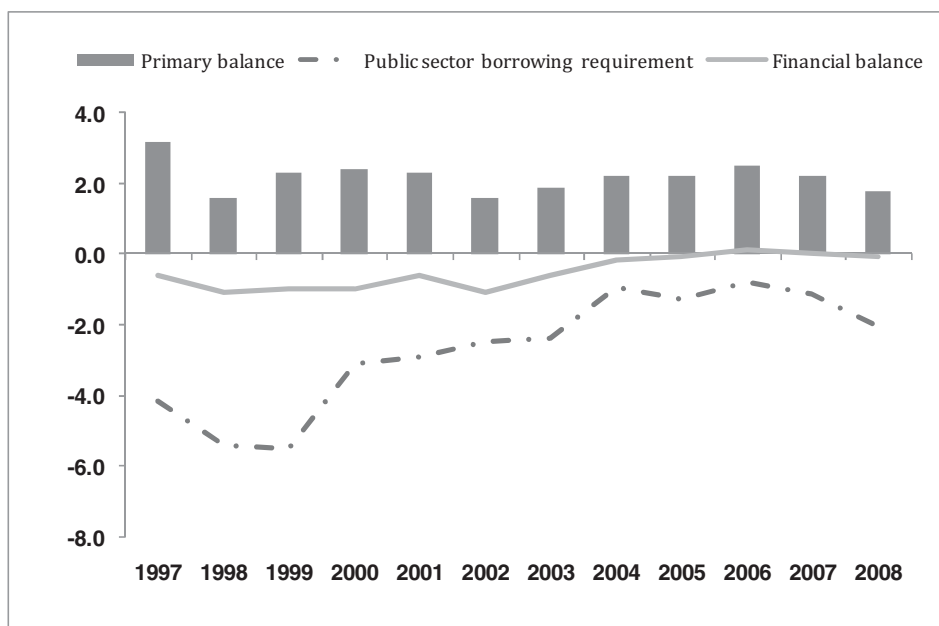
Since 2003, the financial balance has been below 1% of GDP. As can be seen in Figure 1.1, the primary balance has been in surplus for over ten years and, for the past five years, the public sector borrowing requirement (the broader definition) has been below 3% of GDP; nevertheless, in 2008 it did increase by 0.9%.

The government has also reduced its central government debt which, in 2007, was below 25% of GDP. As can be seen from Figure 1.2, this rate is very low in comparison with other OECD countries.

Based on the broader definition of debt, or the non-traditional measure, public sector debt was 40% of GDP at the end of 2008 (OECD, 2009e). This figure includes the net debt of the federal government, the non-financial public enterprises, the development banks, the official trust funds, the liabilities related to banking sector restructuring, and PIDIREGAS. This percentage is not high by OECD standards (Larre, 2006). Since the tequila crisis, the government has also changed the composition of its debt, reducing significantly the foreign-held debt and replacing it with internal debt held in pesos.

In 2006, the government introduced a fiscal rule requiring a balanced budget as measured by the financial balance. For 2006 and 2007, the government has achieved this fiscal goal, but a deficit of 0.1% of GDP was observed in 2008. For the 2009 budget, the government introduced a number of one-off measures that have enabled it to pass a balanced budget (see Chapter 2) while also introducing a stimulus package.

With the introduction of its reform packages (see Section 4 below), the government hopes to achieve the following medium-term fiscal goals: *i*) maintain a balanced budget and, by 2012, reduce the historical balance of the public sector borrowing requirement to 34.6% of GDP; and *ii*) reduce net public sector debt from 20.5% to 15.6% of GDP between 2007 and 2012.

Figure 1.1. Public sector budget aggregates (as a percentage of GDP)¹

1. The PSBR numbers include extraordinary or non-recurrent revenues.

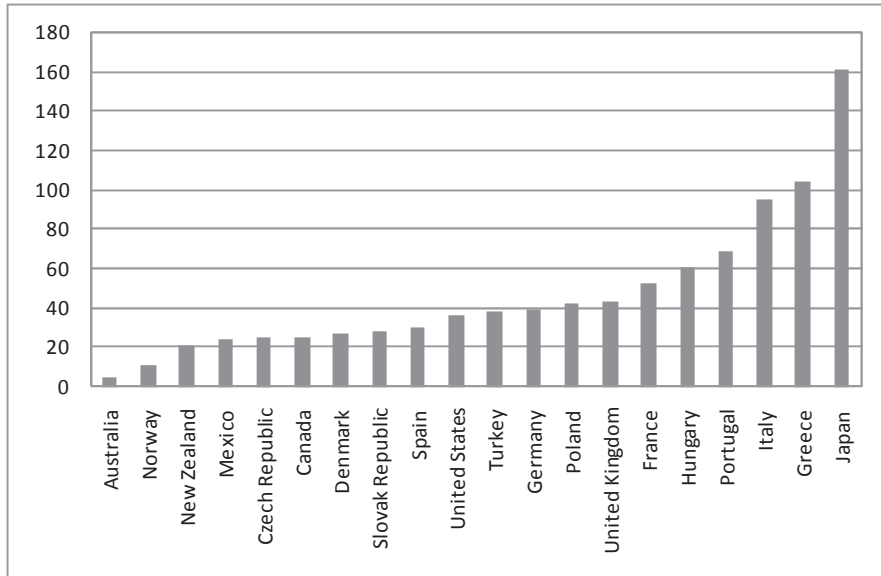
Source: *Dirección General Adjunta de Estadística de la Hacienda Pública, Unidad de Planeación Económica de la Hacienda Pública, Secretaría de Hacienda y Crédito Público, México.*

Prior to the current economic crisis, the government appeared to be on course to achieve these goals, but under current circumstances these goals no longer seem realistic. With the rapid decline in the world economy, Mexico like most OECD countries will be forced to considerably revise its fiscal goals.

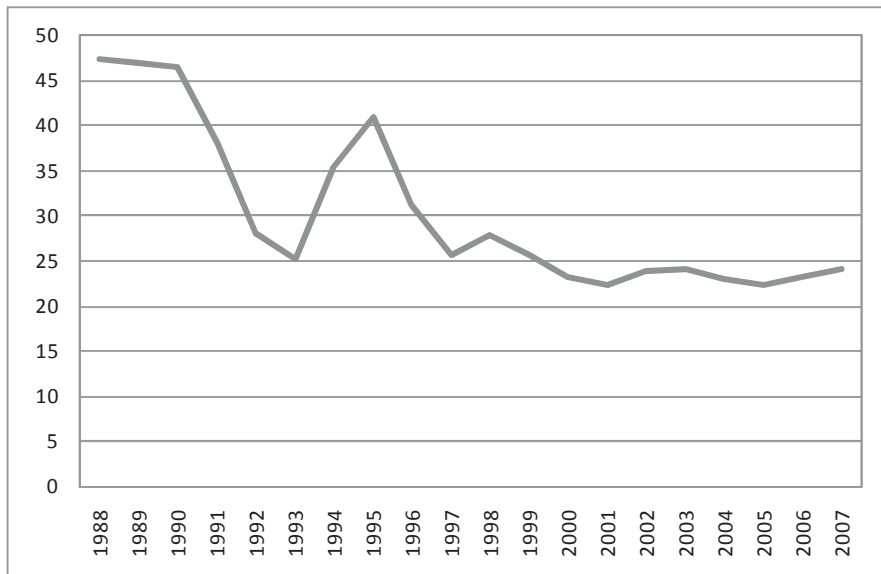
To date, fiscal reforms have paid off and allowed Mexico to achieve an enviable level of macroeconomic and financial stability. Nevertheless, public finances are facing increasing pressures from pensions, social and infrastructure expenditure needs, and a still high dependency on oil revenues. In this context, the consolidation of the improvements achieved is very important, but it is also necessary to go further in order to address structural challenges in several key sectors.

Figure 1.2. Central government debt, 2007 (as a percentage of GDP)

A. Selected countries



B. Mexico, 1988-2007



3. The challenges

Despite this good fiscal record, Mexico faces underlying structural challenges. These include: *i*) improving its growth rate; *ii*) finding additional sources of revenue so as to reduce dependency on oil revenues, especially given the declining oil reserves; *iii*) improving the efficiency and effectiveness of public spending; and *iv*) improving accountability and control of spending at a sub-national level. This section will examine the first two main challenges in detail.

3.1. Improving economic growth

In general terms, Mexico's economic performance is below the OECD average, but it has been improving in many aspects over the last decade. Recent economic growth, proxied by the GDP per capita growth rate, was very close to the OECD average performance, but it is still far from the rate that has been observed in rapid-growth emerging economies (see Table 1.1). Mexico's income levels have been relatively stationary over two decades and, in 2007, remained significantly below the OECD average and nearly one-quarter that of the United States (OECD, 2009e).

Table 1.1. Real GDP per capita

	In 2005 purchasing power parities (USD)		Annual average growth rates		
	1987	2007	1987-1997	1997-2007	1987-2007
United States	29 553	43 026	1.95	1.84	1.90
OECD average	20 800	30 410	1.92	1.92	1.92
Brazil	7 474	9 072	0.45	1.50	0.97
Chile	5 942	13 323	5.06	3.19	4.12
China	918	5 052	8.56	9.24	8.90
India	1 098	2 587	3.26	5.50	4.38
Mexico	9 250	11 983	0.70	1.91	1.30
Russia	10 199	13 482	-4.39	5.16	1.88
South Africa	7 492	9 096	-0.53	2.50	0.97
Turkey	5 230	8 387	1.87	2.91	2.39

Source: OECD (2009), *OECD Economic Surveys: Mexico 2009*, OECD Publishing, Paris.

For the past two decades, improving economic growth, creating jobs and reducing poverty levels have been key objectives for successive Mexican governments. They have pursued a number of strategies to achieve these goals, including reforms to liberalise the economy and opening the economy to trade and investment, most significantly by signing the North American Free Trade Agreement (NAFTA). Successive governments have also invested in infrastructure, in education, and in social programmes.

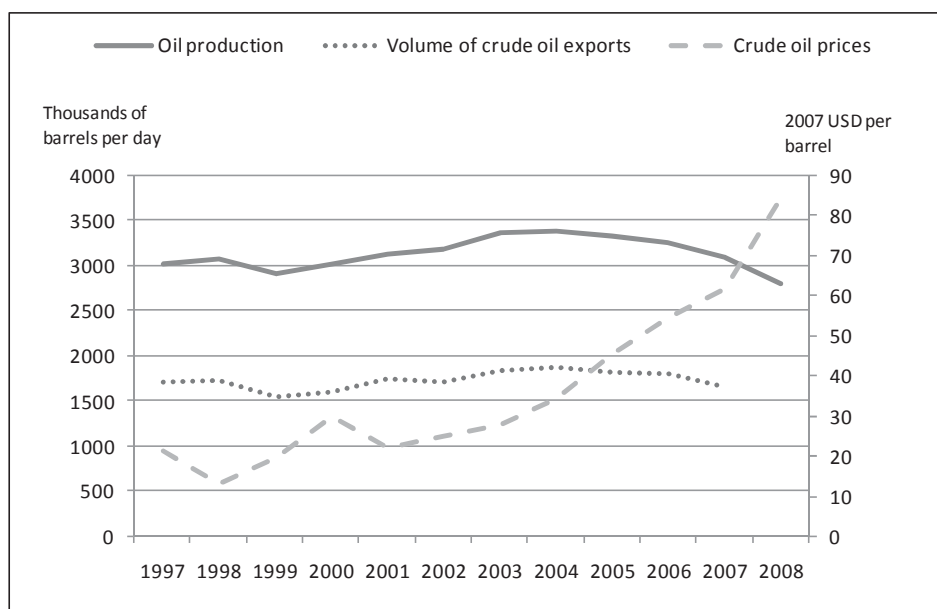
Over the past decades, growth rates in Mexico have improved and the poverty level has been reduced significantly. However, in comparison with other OECD countries, income inequality and poverty levels remain high. According to the World Bank's 2006 figures, 12% of the population still lived on an income of less than two United States dollars per day. Factors continuing to inhibit improvements in growth rates are: low labour productivity; poor quality and inefficient infrastructure services; weak rule of law; low levels of competition; high cost of doing business; rigidities in the formal labour market; trade barriers; low gross inflows of foreign direct investment; and low levels of educational attainment and training (OECD, 2007a and 2007c).

The key priority of the current administration is to improve economic growth. It is seeking to achieve this through maintaining and improving macroeconomic stability, stimulating higher investment, and increasing funding and investment in infrastructure and in human capital in order to improve people's capacities and increase labour productivity (SHCP, 2008).

Increased spending, however, is not sufficient to generate improvements in service delivery. Both current and new public spending must achieve results. This is especially an issue for education and training where outputs are low compared to other OECD countries. The Mexican government, through its performance budgeting and management initiatives and other reforms, is seeking to improve the efficiency and effectiveness of public spending.

3.2. Reducing dependency on oil revenues

The Mexican government is heavily dependent on oil revenues. In 2006, oil-related revenues accounted for approximately 40% of total revenues.⁴ While between 2007 and 2008 oil revenues increased 15.5% in real terms, oil production and exports decreased during this period. Indeed, the 200% increase of the value of oil exports observed between 2005 and 2008 is explained principally by price increases which compensated for the decrease in production (see Figure 1.3).

Figure 1.3. Oil sector evolution

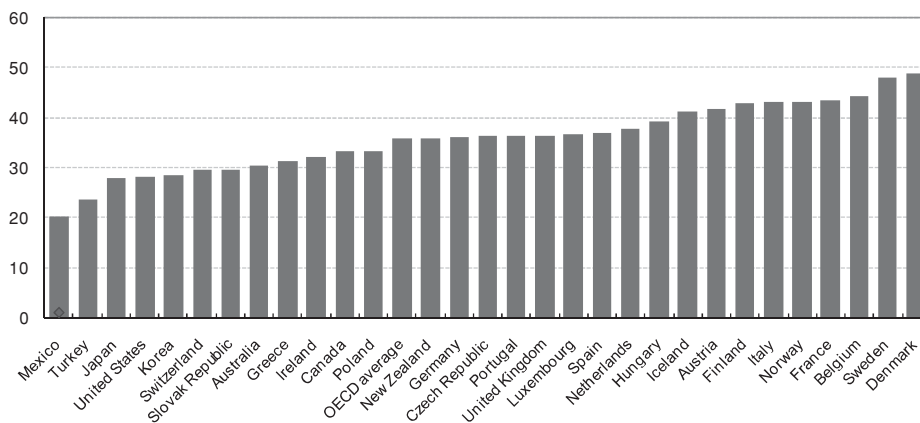
Source: PEMEX (*Petróleos Mexicanos*), Mexico.

This heavy dependency on oil revenue generates a number of issues for Mexican public finances. The price of oil, like all commodities, is volatile and has gone from a high of USD 147 per barrel in July 2008 to around USD 45 per barrel in March 2009 – a drop of over USD 100 in less than ten months. Also, Mexican oil reserves and production levels are declining. Current reserves will only last another ten years at present extraction rates. Investment in new technologies, increased capital for exploration of new fields and improved productivity are needed to increase oil supply in the future.

Mexico also has limited revenues to replace declining revenues from oil. The level of fiscal pressure and tax collection is not only the lowest of OECD countries but is amongst the lowest in Latin America. Tax revenues in 2007 accounted for only 20.5% of GDP, while the OECD average is around 36% (see Figure 1.4).

Figure 1.4. Total tax revenue (as a percentage of GDP)

2007 or latest available year



Source: OECD (2009), *OECD Factbook 2009: Economic, Environmental and Social Statistics*, OECD Publishing, Paris.

In addition, informality is high and further reduces tax collection. Informality is when workers and firms do not have any interaction with the State and do not register with authorities, comply with regulations, pay taxes, or benefit from any labour or social protection (Perry, Maloney and Arias, 2007). Informality is one of the main causes of the narrow tax base in most of Latin America, and the size of the informal economy in the region is high and growing (Gómez Sabaini and O'Farrell, 2009). The Mexican *Instituto Nacional de Estadística, Geografía e Informática* (INEGI) estimates that, in Mexico for 2006, the informal sector accounted for 27.6% of GDP.

States and municipalities are key entities in the Mexican fiscal system. While transfers to sub-national governments have increased from 6.2% in 2000 to 7.4% in 2008 as a share of GDP, sub-national governments' own tax revenue has remained constant at around 1% of GDP. The federal government has acknowledged the need to broaden the tax base; in 2007, it introduced a tax reform to increase revenues at the national level and to encourage sub-national governments to increase their own revenues.

4. The reforms

Since 2006, the government has introduced four major reforms to help address some of the underlying structural challenges described above and to improve fiscal sustainability and the budget framework and processes. These reforms are described in detail below.

The **2006 Budget and Fiscal Responsibility Law (BFRL)** replaced the previous legal budget framework. This new law sought to improve the efficiency and transparency of the budget framework. The law reformed the budget process through the following actions:

- Creating a balanced budget rule.
- Establishing a formula for calculating oil-related revenues and institutionalising the Oil Revenues Stabilisation Fund as well as the stabilisation funds for infrastructure and for states' revenues.
- Establishing a clear timetable for the budget approval process in Congress, including a separate timetable for the budget process in an election year.
- Stating that Congress cannot increase the overall budget balance proposed by the executive. For Congress, increases in expenditure have to be offset by decreases elsewhere.
- Assessing the budgetary impact for every new law proposed.
- Requiring the government to provide more economic and performance information to Congress.

In addition, the law established principles and rules for the evaluation of investment projects, required the establishment of the Performance Evaluation System (SED), and required that performance indicators be included in the budget. The law called for the establishment of guidelines for external evaluation of programmes. It also set out strict rules for controlling personnel expenditure, called for more efficient execution of public spending, and encouraged granting more autonomy to ministries and agencies.

The law established a formula for calculating oil-related revenues and clear guidelines for allocating windfall revenues. First, increased revenues will be used to offset any budgetary shortfalls arising from the difference between the actual budget and the budgetary estimates and to compensate for non-programmable increases in budgetary allocations that are not tied to federal programmes, such as modifications in interest or exchange rates. Second, any remaining money will be distributed to the three funds (the Oil

Revenues Stabilisation Fund, the States' Revenues Stabilisation Fund, and the PEMEX Infrastructure Fund) and the states' investment programmes and projects. Once these funds have reached a reserve limit, additional revenues will be allocated to investment programmes in the federal budget, investments at a state level, PEMEX investments, and the Pension Restructuring Fund.

The second reform, President Calderon's **2007 Integral Fiscal Reform (IFR)** proposal, was approved in September 2007 after tight negotiations with Congress. This reform package is wide-reaching and has several objectives:

- **Improving tax collection.** For example: a modification of the tax on cash deposits and the creation of a unique rate corporate tax⁵. It is predicted that these changes will raise the non-oil tax receipts by 2.1% of GDP over the period 2008-12.
- **Improving the efficiency and effectiveness of public expenditure** by establishing the framework for performance budgeting and management systems. Budgeting for results and the annual programme of evaluation are key components of the IFR. The Integral Fiscal Reform requires that the budget include objectives, goals and indicators for programmes, and calls for performance evaluations to confirm the achievement of these goals. In addition, the IFR established a federal programme – known as the Management Improvement Programme (PMG) – to promote efficient and effective public management.

Furthermore, the reform requires a 20% reduction in administrative expenditure by the end of the current administration, with a goal of 5% reduction each year. To achieve this goal, the executive has launched a programme in addition to the PMG: the PMP (*Programa de Mediano Plazo*). Under the framework of the PMP, ministries and agencies are required to provide information on the strategies and actions they will take to improve public expenditure and public management, to develop performance indicators and agreements, and to introduce austerity measures. The PMP requires ministries and agencies to follow austerity rules – for example, the creation of new positions is restricted (see Annex A for more details). Finally, the executive must report to Congress in its quarterly reports on the progress of the PMP in reducing costs.

- **Strengthening fiscal federalism** and encouraging states to increase their own revenues by giving them more tax powers and incentives to use them. Methods include giving the states power to introduce a

vehicle tax and taxes on the final sales of certain goods (for example, alcohol). The *participaciones* have been modified to be better correlated with economic activity and the *aportaciones* have been changed to make them more related to needs and more redistributive. All changes in the formulas include a hold-harmless clause in nominal terms.

The IFR also mandates the evaluation and auditing of federal resources transferred to state and local governments. The evaluation of federal resources transferred to the states will be carried out in co-ordination with state governments, municipalities, and the corresponding federal ministries. The Federal Supreme Audit Office (ASF) has longstanding powers to carry out audits of federal funds transferred to state and local governments. The IFR requires the state governments to strengthen the independence and technical capacities of the state audit institution which will co-operate with federal authorities. The law requires that the head of the state audit institution be appointed for a seven-year term and that the official has the requisite academic and expert qualifications. The results achieved by states should be incorporated in both federal and local finance reports. These changes must be approved by the local legislatures within one year.

The **2007 New ISSSTE Law** changed the public sector pension scheme and aims to create a more sustainable pension system over the longer term. This reform intends to relieve pressure on the fiscal accounts caused by imbalances in the federal government employees pension system, managed by the *Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado* (ISSSTE). The transition from a pay-as-you-go system to a system of individual savings accounts for retirement is expected to ensure the long-term financial viability of the pension system. The new system, which is fully funded, manages portable individual accounts for each worker and allows the transfer of pension rights between the government and the private sector. Current workers must choose between the traditional pension regime and the pension bonus scheme; new workers are enrolled in the individual accounts system.

This new model tries to mitigate the imbalances that the ISSSTE would have had to face without such a law. The Ministry of Finance is authorised to amend the annual federal budget in order to verify the inclusion of the expenses resulting from the obligations of the federal government in connection to this new ISSSTE law. The obligations of the ISSSTE are guaranteed by the creation of four reserve funds: the Operation Reserve, the Operation for Contingencies and Financing Reserve, the Financial and Actuarial Reserve, and the General Financial and Actuarial Reserve.

The objectives of the fourth reform – the **2008 Governmental Accounting Law** – are to improve accountability and to increase the oversight of federal funds at the sub-national level by the harmonisation of accounting and budget codes across all levels of government. The law seeks to introduce accrual accounting at all levels of government.

Some of the main characteristics of this reform are the harmonisation of the accounting techniques across the three levels of government, the implementation of a technological platform allowing real-time information generation, the inclusion of indicator-based information and programme evaluation results, and the provision of quarterly financial updates. State and municipal governments are required to implement these changes by 2012.

In addition, the government in 2008 sought to reform PEMEX, the national oil company, to improve and strengthen the company's corporate governance and transparency. The government proposed a package of reforms to increase resources to PEMEX as long as it achieves its modernisation goals. The reform allows PEMEX to use the resources in the stabilisation fund for infrastructure expenditures. It is hoped that these reforms will give the company more flexibility and resources and help to foster capital investments, which are needed to increase production capacity. Also, one of the main aims of the reform is to adjust the fiscal regime. Changes to the 2009 budget modified the balanced budget fiscal rule, to exclude the long-term PEMEX investment schemes from the balanced budget requirement, and moved the off-budget portion of PEMEX on budget.

The government predicted that the implementation of the four major reforms should account for an increase of 0.3 percentage points per year in the economic growth rate for the period 2009-12, and an increase of budgetary revenues from 22.8% in 2007 to 24.2% in 2008. For 2008, the government estimated an increase of non-oil revenues of 5.3% in real terms. In practice, the increase in revenues has been less than predicted. Given the current crisis, even if the government's goals are not achieved, the implementation of these reforms represents impressive progress in the area of fiscal responsibility.

5. Financial crisis and global recession

In recent times, Mexico has survived and prospered after two major economic crises. The current crisis is more significant in terms of its global reach and magnitude. The world economy is suffering from the spillovers of an extraordinary financial shock which have already started to reduce household expenditures, consumption, private investment, production, and

trade. The financial crisis triggered by the effects of the collapse of the United States mortgage loans market has spread with alarming speed throughout the rest of the world. Even if several packages of extraordinary measures have been launched to smooth the impact of the crisis and avoid liquidity constraints, expectations about their impacts remain cautious.

After several years of vigorous growth, the slowdown of economic activity is widespread, and there is uncertainty about how long it will continue. Most developed countries are in a recession, and economic growth has declined rapidly. The OECD interim report forecasts an overall contraction of 2.75% in the world economy in 2009. For the 30 OECD member countries, the contraction is even larger, namely 4.3% for 2009 (OECD, 2009a).

The Mexican economy is vulnerable because of its strong ties to the United States economy and because of the recent drop in oil prices. These factors expose the country to spillovers from the global financial crisis that are not within the government's control (IMF, 2009a).

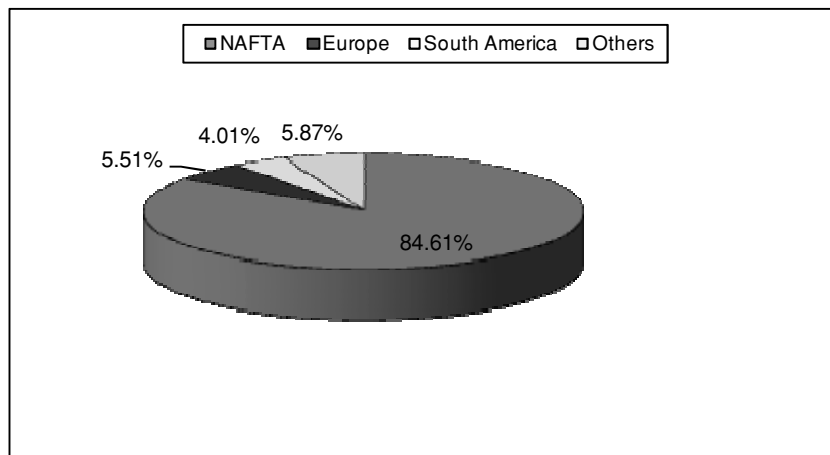
In 2007, the share of exports traded with the NAFTA partners was around 85%, of which more than 97% went to the United States (see Figure 1.5). Moreover, the lag observed between the peak of the financial shocks in the United States and their expected impact on Latin America is on average 1.5 years.

In Mexico's case, both the financial shocks and the output shocks in the United States have already started to affect the economy. Given a larger than expected international economic slowdown and in light of the H1N1 influenza virus, there has recently been a deterioration in the Mexican economic scenario for 2009. The Ministry of Finance estimates a GDP rate of -5.5%, assuming a partial recovery of the global economy by the end of the year. The OECD June 2009 estimate for Mexico forecasts -8% of GDP (OECD, 2009g). This assumes that the growth of the global economy will not pick up until 2010.

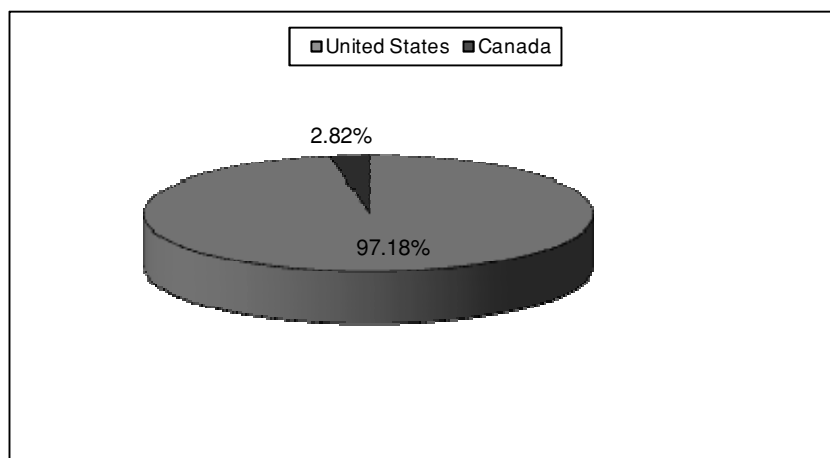
Real economic contagion is unavoidable. Industrial production and industrial employment have already been hit, showing an important contraction, whereas the investment level has been stabilised through public investment. Moreover, if the global crisis continues to reduce the prices of raw materials, the impact for Mexico could be even stronger. The drop in oil prices by USD 100 per barrel since July 2008 is already affecting Mexico's finances.

Figure 1.5. Exports by partner, 2007

A. All partners



B. NAFTA partners



Another issue for Mexico is the amount of remittances coming from Mexican migrants living in the United States. In 2006, remittances coming to Mexico reached USD 23.1 billion, becoming the third source of currency generation. The slowdown of remittances flowing to Mexico has already started. During the first half of 2007, the influx decreased 1.4% compared to the same period in 2006. In addition, many migrants work in the construction sector, one of the most affected areas. With the general

deterioration of the United States economy during 2008 and 2009, the expectation is that the impact on remittances will be worse.

Despite these problems, Mexico is better prepared to face this crisis than any previous one. It has significantly improved its fiscal framework through the recent reform packages. Over the past ten years, Mexico has maintained sound and healthy public finances and has reduced budget deficits, kept inflation under control, created high reserves, and considerably reduced total debt. Mexico has a sound banking system that is not exposed to the subprime market. Nevertheless, the magnitude of the crisis presents important challenges for Mexico's economy; therefore, the government's stimulus package is welcome and will be a very important factor to help reduce the impact of the global crisis, as will pushing ahead with the fiscal reforms that have already been enacted.

5.1. The government's responses to the global crisis

The Mexican government has already put into place a stimulus package which accounts for approximately 1.4% of GDP. The government and the Central Bank of Mexico have implemented several measures in order to stimulate economic growth, smooth liquidity constraints, and keep order in local markets. Below are some of the measures taken by the government:

- The government's bond auction mechanism has been modified in order to favour short-term bonds and to reduce the amounts of long-term bonds. The lines of credit from multilateral financial organisations have been extended up to USD 5 billion. The Ministry of Finance and the Central Bank of Mexico have purchased 190 billion Mexican pesos (MXN) of official stocks to increase financial market liquidity. In addition, the *Banca de Desarrollo*, the *Nacional Financiera* and *Bancomext* will assign around MXN 150 billion to stimulate private investment. The *Sociedad Hipotecaria Federal* (Federal Mortgage Association) will contribute MXN 40 billion to support the housing sector.
- The United States Federal Reserve has authorised the establishment of temporary liquidity swap facilities with the Central Bank of Mexico. These new facilities will support the provision of dollar liquidity in amounts of up to USD 30 billion each by the *Banco Central do Brasil*, the *Banco de México*, the Bank of Korea, and the Monetary Authority of Singapore. In addition, the International Monetary Fund approved access to a flexible credit line arrangement of approximately USD 47 billion. This credit line is not subject to conditionalities. The Mexican authorities intend to treat this credit

line as a precautionary measure to help bolster confidence while going through the global economic crisis.

- In October 2008, the government launched the Programme to Boost Growth and Employment which incorporates a large range of measures, including increasing transport and infrastructure investments through a fiscal stimulus package and public and private investment programmes. It also aims to ease credit to SMEs. The government announced a gradual reduction of the tariff applied to a wide range of goods between 2009 and 2013. This important measure, which mostly relates to intermediate goods, should reduce the impact of the financial crisis on Mexican international trade.
- Additional reforms to remove the long-term PEMEX investment schemes from the balanced budget rule requirements generated a fiscal space in the 2009 budget of MXN 78.3 billion that allowed an allocation of MXN 53.1 billion to additional infrastructure investment. Also, the hedging of oil prices at USD 70 per barrel for 2009 has freed up additional revenues and mitigated the impact of declining oil prices.
- Finally, in January 2009, the government announced the *Acuerdo Nacional en Favor de la Economía Familiar y el Empleo* (national agreement in support of households and employment). This programme aims to support households through improving the competitiveness of small and medium-sized enterprises (SMEs), investing in infrastructure, and creating employment. The expected impact of this programme includes a stimulation of local demand of 1% of GDP, a reduction of inflationary pressures⁶ and an improvement in economic competitiveness.

6. Conclusion

Mexico has come a long way from the home-grown financial crises of the 1980s and 1990s. Mexico's recent public finances have clearly reflected an era of fiscal responsibility. Mexico's fiscal situation and macroeconomic stability have improved considerably. The country is better prepared to face the current economic crisis than previous episodes.

The consolidation of the improvements achieved is very important, but going further with structural reforms in several key sectors is essential. The government has recently introduced a number of reforms that seek to address underlying structural challenges. It is important to push ahead with implementing these reforms even in the context of the current financial

crisis, as they are already having a positive impact. If the reforms continue, they can make a significant contribution to longer-term fiscal stability.

Notes

1. This calculation uses the public sector borrowing requirement (PBSR), the broader definition of budget deficit.
2. *Centro de Estudios de las Finanzas Públicas*, with data from the Central Bank of Mexico.
3. These liabilities (multi-year investment projects) are only recorded above the line when the project is completed; initially the payments for the first two years are recorded and annually a year of payments is added. This scheme is no longer available for PEMEX.
4. This number varies between 30-40% of fiscal revenues.
5. The applied rates will be progressively increased from 16.5% for 2008 to 17.5% from 2010 onwards.
6. During 2009, gasoline prices were frozen, the liquefied petroleum gas price was reduced by 10%, and industrial energy prices were reduced. These actions help reduce inflationary pressures.

Chapter 2

Budget Formulation

Over the past decade, the evolution of budgeting in Mexico has been driven by two main trends. First, in order to avoid crises like those of the 1980s and 1990s, the government has been working on developing an institutional framework for stable and sustainable fiscal management. Second, the country has completed the process of transition from a political system where one party dominated to a competitive multi-party system.

The reform process has been ongoing, with many stops and starts; however, the adoption of the 2006 Budget and Fiscal Responsibility Law (BFRL) and subsequent legislation is an important advance. This law replaced the budgetary legal framework that had been applied for almost 30 years.

This chapter is divided into seven sections. The first provides an overview of the roles of key institutional actors and central agencies in the budget formulation process. The second section discusses the annual budget formulation process. The third section describes the content of the budget documents presented to Congress. The fourth section discusses fiscal rules. The fifth section addresses the development of estimates and medium-term expenditure frameworks. The sixth section discusses contingent liabilities and long-term sustainability. The seventh section presents conclusions and recommendations.

1. Institutional overview

The executive is headed by the President and consists of 18 ministries (*Secretarías*) and the Attorney General's Office. All ministers have cabinet rank. Each ministry has authority over numerous agencies, governmental bodies, and state-owned enterprises. The Office of the Presidency is responsible for overall political direction and seeks to ensure that the annual budget is in line with the government's priorities for the president's six-year term in office.

1.1. Structure and operations of the Ministry of Finance and the budget office

The formulation of the executive budget is quite centralised and is directed by the Ministry of Finance (*Secretaría de Hacienda y Crédito Público*, SHCP). No other actors have broad authority over budget

formulation. Mexico previously had a ministry for programming and planning, but its functions were absorbed by the SHCP in 1992.

For the last 20 years, the SHCP has mostly been a very strong finance ministry. In Latin America, ministries of finance tend to be powerful in terms of both their formal mandate and their informal influence over other ministries. Mexico is no exception, although it does not reach the degree of centralisation seen in Chile. As far as the core functions of budgeting are concerned, all relevant processes in Mexico are run from the SHCP.

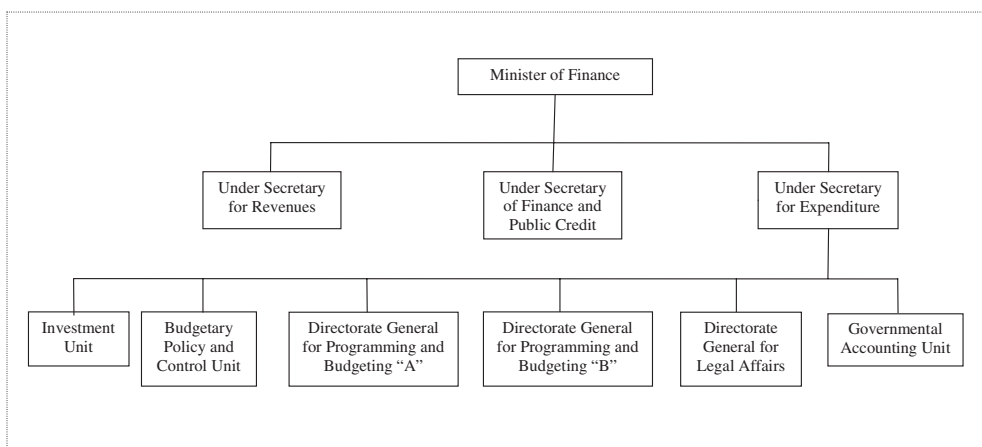
Within the Ministry of Finance, the Under Secretariat for Expenditure (*Subsecretaría de Egresos*, SSE) is the central budget authority (the “budget office”) and has broad and comprehensive responsibility over public expenditures. The SSE employs 1 145 people (out of a total of about 6 500 for the entire ministry). Its subdivisions cover budget policy, programming and budgeting, accounting, and investment spending (see Figure 2.1). The SSE also contains a legal directorate that has been greatly involved in the drafting of recent reforms and that manages relations with the legislature. The Budgetary Policy and Control Unit is responsible for the overall direction of budgetary policy and the internal co-ordination of budgetary decision making. It is also in charge of the day-to-day operation of the performance budgeting initiatives.

In addition, the SSE has two traditional budget monitoring directorates (*Direcciones Generales de Programación y Presupuesto*, DGPyPs, Directorates General for Programming and Budgeting) shadowing the various spending units of the public sector. These two directorates together have about 140 staff. They exercise control over nearly all aspects of budget formulation and execution throughout the year, most importantly communicating the annual budget ceilings, negotiating the draft budgets, authorising the release of funds for current spending and investment projects, and monitoring budget execution and performance. As a result, budget analysts at the DGPyPs are in constant contact with their ministerial counterparts and are generally very well informed of the details of their respective budget items. The ministry is currently considering an expansion of the DGPyPs from two directorates to three, aiming to increase the capacity of the budget office to scrutinise the budget.

During budget formulation, annual ceilings are only set for the overall budget of each ministry, and the most important spending categories at the aggregate level for each ministry. The Ministry of Finance controls spending at the level of aggregate categories for each sector, but budget analysts still keep track of key budget figures several layers below. The annual budget decree contains 110 appropriations, which is a very manageable number to track and quite low compared to other OECD countries. Yet the education

sector contains 6 500 line items (*registros*), and the transportation sector 9 000. There is a real concern about the degree of detail that the budget office (the SSE) can track on a day-to-day basis given the complexity of the federal budget and the workload of key staff. The recent expansion of performance monitoring alongside the traditional budgetary information system has clearly added to the workload of the budget office, especially the DGPpP staff. There is no indication that these new instruments have led to a corresponding reduction of other routine tasks.

Figure 2.1. Organisational chart of the Ministry of Finance



Responsibility for the macroeconomic forecasts and government statistics lies with the Economic Planning Unit, under the Under Secretary of Finance and Public Credit. The unit has a total staff of about 200; its most important task is to provide the macroeconomic assumptions at the beginning of each budget cycle. Apart from the usual key figures – namely GDP growth, the rate of inflation, and the exchange rate – calculating the assumed oil price for the coming budget is a key part of the planning unit's work. The expected price of oil is calculated according to a formula codified in the Budget and Fiscal Responsibility Law.

Overall, the Ministry of Finance appears to be a strong and capable actor, both in terms of its formal mandate and its technical capacity to carry out its tasks. All the main budget responsibilities are concentrated in the SSE under secretariat, and budget officials exercise considerable formal and informal influence over spending decisions across the public sector.

1.2. The role of the Presidency

At the top of Mexico's central government is the Office of the Presidency (*Presidencia de la República*). The highest decision-making body is the official cabinet, which has 19 members (the 18 ministers plus the Attorney General). The extended cabinet contains an additional 26 officials named by the President. The cabinet does not always meet as a full body; there are formal cabinets for economic affairs, security, infrastructure, and social affairs. The economic affairs cabinet does discuss different budget issues throughout the year. There is, however, no formal cabinet budget committee of the kind known in several parliamentary OECD countries. The last and highest step in any budget decision in Mexico is instead the President himself. The Office of the Presidency has a total staff of about 534 persons, but only a small staff of close advisers is involved in the budget process. There is no presidential budget office to duplicate any functions within the Ministry of Finance.

During this presidential administration, the President gets involved at the opening of the budget process to signal main priorities for the upcoming budget, agrees the ceiling for the total budget and for individual ministries with the Ministry of Finance, and also becomes involved during the final stage before the draft budget is sent to the legislature. The Ministry of Finance takes the lead throughout the budget formulation process. Academic studies of budgetary processes in other countries of the OECD (Hallerberg, 2004) and in Latin America (Alesina *et al.*, 1999) show that such a delegation is generally helpful for fiscal performance.

1.3. Line ministries

The main counterparts of the Ministry of Finance during budget formulation are the line ministries. Each ministry, irrespective of its size or particular outline, has a central administrative unit (*Oficialía Mayor*, OM), where budgeting, planning, spending, financial control and back office functions are located. Each OM has a ministerial budget office, which collects key information to forward to central ministries and other bodies in charge of the various monitoring systems currently under operation across the Mexican government. The ministerial budget office has as its counterpart a team of budget analysts in one of the DGPYPs in the Ministry of Finance. The two sides are in close and regular contact throughout the budget year; three or four conversations a week would not be unusual.

1.4. New actors for performance budgeting

For the regular executive budget formulation process, the Presidency, the Ministry of Finance and line ministries are all relevant institutions. The panorama broadens slightly if the recently created performance budgeting system is taken into account (see Chapter 5). Much of the system is still at the initial stage, but a very important actor in the current system is the National Council for the Evaluation of Social Development Policy (CONEVAL). It is a small technical agency with a total staff of about 60 persons, in charge of monitoring and evaluating the performance of the social sector. In practice, CONEVAL has been both a driver of reforms and the main source of technical expertise for performance information.

2. Annual budget formulation process

The Mexican budget year matches the calendar year. The formal budget calendar opens with the submission to the legislature of the first macroeconomic estimates by the Ministry of Finance, no later than 1 April. By 30 June, the executive gives the legislature the programmatic structure and main proposals for the next year, but does not provide detailed budget estimates at this time. The budget formulation stage ends with the submission of the budget to the lower house of the legislature by 8 September. These and several other main steps of the process are defined in the Budget and Fiscal Responsibility Law. The Ministry of Finance sets out further details through regulations and especially the annual budget circular. The calendar for the annual budget formulation process is described in Table 2.1.

The overall direction of year-on-year changes to the budget is set by the priorities of the National Development Plan, which coincides with the presidential term of office. Most ministries usually formulate their own plan to spell out the broader policy priorities of the national plan in more detail for each sector. The impact of the national plan on the annual budget cycle is uneven – first because it is often only finalised in time for a president's second or even third budget, and second because the plan has to be weighed against short-term priorities that were not evident at the time of its drafting. The National Development Plan is quite important as a basis for the reasoning employed by ministries when justifying new expenditures. Objectives for new programmes must be formulated in terms of their contribution to the highly aggregated objectives laid out in the national plan.

Table 2.1. Budget formulation calendar

Date	Event
1 April	The executive submits the macroeconomic projections for the next fiscal year to Congress.
June and July	Ministries start drafting their budget proposals.
July	Ministries must submit their multi-annual investment projects to the Ministry of Finance.
July	The Ministry of Finance sets the aggregate ceiling for the budget.
July	The Ministry of Finance circulates the handbook of programming and budgeting (<i>i.e.</i> the annual budget circular).
1-4 August	The Ministry of Finance communicates the sector ceilings to ministries.
11-22 August	Ministries submit their budgets electronically to the Ministry of Finance.
25 August	The Ministry of Finance integrates the draft budget.
25 August – 8 September	Final revisions before the budget is submitted to Congress.

In practice, the first stage of budget preparation within the line ministries is largely incremental, with line ministries drafting the earliest plans based on the past years and using reasonable assumptions of inflation and revenue growth. The proportion of legally binding non-discretionary spending (*gasto no-programable*) – mainly entitlements and constitutionally mandated transfers – varies by ministry but is about 25% of the total budget (mainly federal transfers and interest payments). The percentage of what officials at the Ministry of Finance call “inevitable spending” – crucially including personnel expenditures – reached 90% of total spending. In practice, the margin for new expenditures is probably much smaller still, and in a normal year would usually not exceed 2-3% of a ministry’s budget. The additional space becomes clear during the spring; ministries begin to put together their proposals, but the formal drafting process only starts in the summer. In May and June of 2008, the Ministry of Finance and spending ministries held a series of extensive high-level bilateral meetings at the under secretariat level. This official exchange set the stage for the formal budget formulation process of the following two months. By the end of June, the Ministry of Finance submits the programmatic structure of the budget to the legislature, essentially locking it for both branches of government for the rest of the cycle.

Ministries have to submit new or modified multi-annual investment projects by 15 July. On that date, the Ministry of Finance publishes the budget circular – the handbook of programming and budgeting – and updates the matrix of indicators for results (MIR) that are reported in the

budget. The circular defines the precise formats and methods to be used in putting together the draft budget. At the beginning of August, the final budget ceilings are communicated to the ministries, which then submit their budget information using an integrated programming and budgeting system (called PIPP, *Proceso Integral de Programación y Presupuesto*). The ministries have relatively little time to complete their submissions. In 2008, the PIPP system was open from 11-22 August. At the end of August and in early September, the budget document with all supplementary volumes of information is assembled by the Ministry of Finance to prepare the budget for submission to the lower house of Congress.

By the time the ceilings are communicated, most of the possible disagreements between spending ministries and the Ministry of Finance will have been pre-emptively resolved; otherwise the budget could not be integrated in the span of three weeks. As a result of the close working relationships between budgetary actors, and because of the incremental nature of the budget, mutual expectations are relatively well known and the scope for ministries to plan spending beyond the limits foreseen by the Ministry of Finance is very limited. Nevertheless, the formal steps of the budget formulation process seem quite skewed towards the final weeks, just before submission to the legislature.

In the final two weeks of August 2008, the Ministry of Finance held a second series of bilateral negotiations – between the Under Secretariat for Expenditure and sector ministries – to discuss the budget proposals as formally submitted, in order to reconcile outstanding discrepancies and narrow down the number of issues to be forwarded to the President for resolution. Apparently a similar process of high-level negotiations had existed in previous years, but in a much less extensive and structured way. The current two-stage process was used in 2008 for the first time.

The final stage of revision on the executive side – before legislators can have a chance to amend the budget – is for unresolved conflicts and for final touches in light of policy priorities, to be settled by the Office of the Presidency usually in the final days before the budget is presented to the legislature. Potentially, as is the case in countries with weaker finance ministries, spending ministers could appeal directly to the President at any stage of budget formulation, or indeed afterwards. The extent to which such bypassing of the finance minister is possible depends as much on the formal institutional setup as it does on the management style of particular presidential administrations, and it has been noted that, under earlier administrations, such bypassing did take place on a regular basis in Mexico.

The current administration has started to use performance information to align budget decisions and policy priorities in the final stage of budget

formulation. In 2008, a summary of performance information for all government programmes was prepared for the first time. The aim of this summary was to give high-level decision makers accessible performance information on which to base their decisions. Discussions take place between the Presidency and the Ministry of Finance when setting the ceilings for each ministry. Officials pointed out that the performance data were used as a formal input for these discussions. Although it is difficult to ascertain their precise influence, the data did play a role in a few cases (see Chapter 5).

The executive's draft budget and the revenues law are presented to Congress for approval by 8 September every year. The lower house has until 15 November to approve the budget. (This process is discussed in more detail in Chapter 3.) The new fiscal year begins on 1 January.

Overall, the annual budget formulation cycle seems to work reasonably well and delivers the results that the government expects: the Ministry of Finance keeps overall spending under control, the Presidency gives political direction to the budget process, and the executive delivers the budget proposal on time. Despite the very limited flexibility of the Mexican budget, in 2009 it did reflect the key priorities of the Presidency. (The key priority for the current government is internal security. The 2009 budget almost quadrupled spending for internal security: in 2004, the amount spent was MXN 8.4 billion; in 2009, the government requested MXN 31 billion.) However, the budget formulation process seems unnecessarily skewed towards the last weeks before the budget is submitted to the legislature, and the control exercised by the Presidency and the Ministry of Finance relies to some degree on the administrative practice of the current government and less on formal institutions.

3. Contents and structure of the budget

In Mexico, from the formal perspective, for laws to become laws they must be approved by both houses of Congress. The revenues law is approved by both houses. The budget is not – it is approved only by the lower house of Congress in the form of a decree, not formally a law. However, it is equally binding.

The executive branch prepares a set of draft laws and other economic documents called *Paquete Económico* that is submitted to the Congress no later than 8 September. The *Paquete Económico* consists of a macroeconomic framework, a draft federal revenues law, and a draft budget decree and supporting documents. The documents are both printed and

available in electronic format. Together these documents make up the budget for Mexico.

The macroeconomic framework provides the context for the budget. It is a document of approximately 90 pages. It provides background for the economic policy, the federal revenues law, and the draft budget. It includes a prospective analysis of the Mexican economy and of related international economies. Topics that affect the national and international economies are discussed, such as: oil prices, financial markets, the evolution of the Mexican economy, the labour market situation, guidelines of economic policy for the next fiscal year, the economic perspective of the national economy for the next fiscal year, the medium-term economic outlook, and the evolution of public finances. The macroeconomic framework provides estimates looking back five years and forward five years for selected analyses.

The draft of the federal revenues law is presented in three documents, all in the form of letters to the president of the Chamber of Deputies with appropriate attachments; in total there are about 200 pages of material. One letter presents the rationale for the tax revenue policy of the executive branch, the tax revenue amounts for the last five years, and the estimations for the next five years. It also presents the proposed legislation to provide all the tax-raising authority contained in the budget (the revenues law for 2009 is 62 pages long). The second letter provides an explanation of all of the fees and other non-tax revenues covered in the budget. The third document meets a constitutional requirement to review the legislative history of revenue proposals included in the budget.

The spending provisions of the budget are presented by organisation, programme, and economic classification. The rationale for the spending proposals is presented by organisation. For 2009, there were a total of 568 pages of explanations and tables. There are separate chapters for the ministries and other large agencies, for the four autonomous bodies (the judiciary, the legislature, the Federal Election Commission and the National Commission on Human Rights), and for the five directly controlled public enterprises.

The budget decree is the document that contains the rules for expenditure during the budget year. These rules supplement the *Ley Federal de Presupuesto y Responsabilidad Hacendaria* and its by-laws. Spending details are presented in an annex that contains a lengthy table for each agency with estimates for the budget year only. (The annexes are part of the decree.) The pages are numbered by agency, not as a continuum throughout the annexes. The 40 chapters of the annex present a consolidated table that is roughly 1 500 pages long.

The budget of Mexico provides an enormous volume of information. It is questionable whether all of the details of economic classification are necessary or useful. While these data are well organised, the sheer volume of information is beyond the comprehension of most decision makers. Focusing the budget documents more on programmes should enhance their transparency and readability. Another area that could be improved is the presentation of a medium-term perspective for the budget. The investment budget does present the out-year costs for the investment programmes. The macroeconomic data also present budget aggregates for the five years beyond the budget year. However, it would be useful to have medium-term estimates for major organisations and for programmes.

4. Fiscal rules

In Mexico, there are three main fiscal rules: two debt rules and a balanced budget rule. The first debt rule applies to the budget and is a golden rule which is enshrined in the Mexican Constitution (Article 73, Section VIII). The rule states that Congress must annually approve the debt ceiling for the year. Debt is only allowed to support the execution of projects that generate an increase in revenues, and to address an emergency declared by the President. This rule can be waived in exceptional circumstances and does not have an enforcement mechanism.

The second debt rule applies to the states and prevents them from borrowing foreign debt. Notwithstanding, states may acquire debt through domestic institutions (including the federal government). Usually state debt is guaranteed with *participaciones*, although there are cases where debt can be guaranteed by other sorts of assured revenues, such as *aportaciones*. State borrowing must be authorised in advance by the state legislature. When *participaciones* are affected (the norm rather than the exception), they must be registered in the obligations and borrowings registry managed by the Ministry of Finance. The sub-national debt in Mexico is very small – only 2% of total outstanding public debt – although this figure does not include public-private partnerships entered into by the states.

The third fiscal rule is the balanced budget rule which was introduced under the 2006 Budget and Fiscal Responsibility Law (BFRL). This rule had the political support and endorsement of the major political parties. The rule requires that the budget be balanced according to the government's narrow measure of fiscal balance: that is, the financial balance that includes interest payments but excludes the cost of the banking sector rescue package and of public-private schemes and PIDIREGAS. Now the rule also excludes long-term PEMEX investment schemes, and the PIDIREGAS scheme is no longer available for PEMEX.

Box 2.1. Fiscal rules

An effective fiscal rule should promote long-term fiscal responsibility and sustainability and help achieve short-term macroeconomic stabilisation. Some required characteristics of an effective fiscal rule are that it is transparent, that the assumptions and estimations used for the forecasting are credible, that the rule is politically viable, and that it has enforcement mechanisms. The numerous existing fiscal rules can be divided into deficit-based rules, debt-based rules, and expenditure rules.

Deficit and debt rules

Deficit rules specify a numerical ceiling on the amount of the annual deficit, generally set as a percentage of GDP. Examples include the European Union's Stability and Growth Pact (SGP) and Chile's structural deficit rule. These examples are discussed below.

The SGP has both a deficit rule and a debt rule that state that: *i*) budgets must be close to balance or in surplus over the medium term; *ii*) in any given year, the budget deficit must not exceed 3% of GDP; and *iii*) government debt must not exceed 60% of GDP. The European Commission is in charge of budget surveillance to judge if the yearly updated fiscal plans submitted by each Member State are credible, consistent and in line with the EU policy objectives for fiscal policy, employment, and economic reform.

The council of EU finance ministers (ECOFIN) monitors the implementation of the submitted programmes, issuing an early warning when a country's deficit is approaching the 3% limit and even starting an "excessive deficit procedure" (EDP) if this limit has been exceeded. If a country that has exceeded the limit does not adopt the required measures to bring the deficit back under 3% during the four months following the start of an EDP, ECOFIN could impose sanctions such as requiring a non interest-bearing deposit of up to 0.5% of the country's GDP.

The fiscal rule under the SGP sets a rigid ceiling on the fiscal deficit that applies regardless of the stage of the economic cycle. Therefore, an important moral hazard issue arises because each government is encouraged to arbitrarily set its deficit close to the limit. This conduct jeopardises the regional monetary stability and increases considerably the impact of negative shocks on the country's economy.

The structural balance indicator used in Chile nets out the cyclical impact of the level of economic activity and the prices of copper and molybdenum.¹ Therefore, the structural balance reflects the financial results that the government would have shown if GDP had been at its trend level and copper and molybdenum prices had been running at their long-term level. The target for the annual structural surplus had originally been set by the authorities at 1% of GDP but has been reduced to 0.5% since 2008. Chile's six-year experience has been quite successful in: *i*) permitting the implementation of counter-cyclical policy to smooth the economy's fluctuations and to reduce uncertainty; *ii*) increasing public savings during growth periods, which has helped reduce pressures on currency appreciation and smooth the impact on the competitiveness of the export sector; *iii*) reducing interest rate volatility; *iv*) boosting the government's credibility, which has reduced risk premiums and improved access to international markets; *v*) ensuring financial sustainability of social policies; and *vi*) reducing the economy's need for foreign financing.

Box 2.1. Fiscal Rules (*cont.*)

Expenditure rules²

Avoiding the “contamination” of the budgetary policy with pro-cyclical elements can also be achieved by setting a ceiling on annually appropriated expenditures. In fact, expenditure rules – that aim to limit policy-induced increases in spending and reductions in taxes – can promote stronger fiscal discipline than deficit rules and can give guidance to policy makers under all budgetary conditions. Where deficit rules are inherently pro-cyclical, expenditure rules prohibit pro-cyclical spending during economic expansions but can permit counter-cyclical reductions in revenues and increases in automatic stabilisers during economic downturns. Moreover, a spending rule can enhance transparency and co-ordination with monetary policy and reduce controversies over the application of the rule.

Having an expenditure ceiling that covers as large a share of total expenditures as possible is essential for the efficacy of a spending rule. Nevertheless, when deciding what to include within expenditure ceilings different countries use heterogeneous criteria. In the United Kingdom, only discretionary spending is included, and expenditures determined by macroeconomic fluctuations such as social security are excluded. On the other hand, in countries like the Netherlands and Sweden, mandatory entitlement spending programmes such as for health care and education are included under the ceilings because they are not really affected by macroeconomic swings. In most countries, transfers to state and local governments are included, especially when – as would be the case for Mexico – local expenditure represents an important share of total government expenditure.

After having had the largest deficit among OECD countries, accompanied by a high increase in government debt, Sweden implemented a comprehensive and effective reform of the budget process that included an expenditure rule. Unlike in the Netherlands where a fixed, periodical framework is used, the budget formulation process in Sweden is defined by a fixed rule based on a three-year rolling framework.³ The objective is to articulate the Swedish government’s fiscal objectives at a macroeconomic level, stating a maximum level of expenditure based on several economic forecasts that give guidance on available resources for each of the 27 expenditure areas divided among the 13 spending ministries. However, after completing several stages of negotiations between the Ministry of Finance, the spending ministries and the Parliament, each minister in Sweden now has a high degree of autonomy in deciding the allocation of funds to the different appropriations within each expenditure area.

1. Revenues from copper and molybdenum (a by-product of copper) account for more than 25% of total fiscal revenues.

2. See Anderson and Minarik (2006).

3. See Box 2.2 for a more complete description of medium-term expenditure frameworks and a deeper analysis of the Netherlands case.

In addition to establishing the rule, the BFRL sets out disciplinary measures to be taken if there is an unexpected shortfall in the revenues so that the budget can still be balanced (see Chapter 4).

Under exceptional circumstances, the law allows the executive to run a deficit but only with the approval of Congress. In order to obtain congressional approval to run a deficit, the executive must first present to Congress the required amount of the deficit, the exceptional circumstances that justify it, what actions will be taken to clear the deficit and return to a balance budget, and how long this will take. The executive must also report on its progress to Congress in its quarterly reports.

This fiscal rule is an improvement on what has gone before; however, there are concerns that a balanced budget rule can lead to pro-cyclicality (more revenues mean more spending) and can make it more difficult to adopt counter-cyclical fiscal policies. In the future and in light of the experiences of the current financial crisis, the government may wish to consider adopting a more counter-cyclical rule.

As discussed in Chapter 1, since the passage of the Budget and Fiscal Responsibility Law (BFRL), Mexico has been successful in achieving a balanced budget in 2007 and a small deficit (0.1% of GDP) in 2008. For the 2009 budget, two factors made it possible to mitigate the effects of the declining oil prices and the financial crisis.

First, the Ministry of Finance successfully hedged the oil price for 2009. In the 2009 budget, the oil price is set at USD 70, namely the price at which the Ministry of Finance managed to sell in advance much of this year's output at nearly twice the market rate at the end of 2008. This policy is likely to generate savings of about MXN 118.4 billion¹, underscoring the importance of the ministry's ability to properly adjust the changing oil price for its overall fiscal stance.

Second, the government introduced an amendment to the budget which excluded the capital investments of PEMEX from the balanced budget rule and shifted the off-budget portions of PEMEX on budget. This action reduced budget expenditures by MXN 78 billion or about USD 5.5 billion and created a 13% increase within the budget for investment. Spending for administrative items was reduced by 2%, as were expenditures for personnel. These changes helped to address the problems for the 2009 budget, but a challenge remains for 2010.

In addition, should there be a need in the future, the government has four stabilisation funds. Three were created specifically to address shortfalls in revenue; the other fund aims to solve issues related to pensions. The funds could be used if financial circumstances do not improve for the second semester of 2009. Deposits and withdrawals from the funds are specifically regulated by the BFRL and other administrative rules to assure their permanence and purpose. By the end of March 2009, these funds amounted to USD 16.5 billion.

5. Economic assumptions and medium-term expenditure frameworks

5.1. Economic assumptions

The Ministry of Finance's Economic Planning Unit is responsible for developing economic forecasts and preparing the reports for the legislature on the economy. The unit prepares a preliminary report on the macroeconomic projections for the coming year which the government submits to Congress in April. This report includes sensitivity analyses considering the potential implications of alternative economic scenarios. In addition, the unit contributes to the macroeconomic framework presented in the *Paquete Económico*. The ministry also provides quarterly updates on the economy to the legislature. The quarterly reports disaggregate information by month and include information on the economy, public finances, and the debt.

In 2008, the ministry provided an update on the economy on 8 October, one month after the release of the *Paquete Económico* for 2009. This extra update was in response to the rapid changes in the economy over the preceding few months.

The macroeconomic framework submitted with the budget as part of the *Paquete Económico*, called “General Economic Policy Criteria for the Tax Law and Expenditure Budget”, provides a comprehensive overview of the economy and its impact on the fiscal policy of Mexico. The 2009 review drew upon analyses of the United States Department of Commerce, the Blue Chip financial forecasts, the United States Federal Reserve, Standard and Poors, the European Union, and other independent sources of economic analysis. The report also focuses on petroleum prices and other raw materials produced by Mexico, and particularly on the impact of future reduction in petroleum income on the Mexican budget. The report includes quarterly estimates for key indicators for the past four years. The fiscal policy sections include broad revenue and spending aggregates.

The framework document focused on economic policy issues that are critical to the performance of the Mexican economy and to its budget. The government has been rather careful in its economic assumptions. Notwithstanding the conservative bias, the economic outlook of the 2009 budget has proven to be too optimistic – which is of course true of most other public budgets in the world. The Mexican economic outlook is reviewed by the legislature's Center of Public Finance Studies, but the Center does not produce an independent forecast. The medium-term aspects could be given more emphasis in future reports. It would also be useful if future reports could include an assessment of deviations from previous forecasts.

5.2. The medium-term expenditure framework

The Mexican budget presents a ten-year macroeconomic framework: five years before the draft budget and five years after. This requirement was introduced under the 2006 BFRL; nevertheless, it was voluntarily fulfilled several years earlier. The macroeconomic framework includes economic projections of the Mexican economy for different key variables: GDP, inflation, the nominal interest rate and the current account for the next five years. It includes an overview of projections of public finances during the period 2010-14. These projections focus on two relevant elements: first, the implications of the formula-determined expected price trajectory of Mexican oil and, second, the pressures of expenditure on borrowing requirements. The ten-year estimates provided in the Mexican budget are at the aggregate level. The budget does not include multi-year projections by programme, organisation or economic classification. Most of the detail in the budget is presented on an annual basis.

Multi-year projections of revenues include estimates of oil and non-oil revenues. For oil revenues, the figures include: estimates of the Mexican oil price for the period 2010-14 using a formula established in the BFRL; an estimation of the production of oil provided by PEMEX that states the number of barrels expected to be produced per day in the period; and an estimation of oil revenues and their share of GDP. Non-oil revenues include forecasts for the amount of revenues expected from tax collection.

The net expenditure section includes projections of programmable expenditure such as expenditures for personnel services, pensions, subsidies and transfers, capital expenditures, and other operations. It also provides estimates of the transfers to sub-national governments and payments for social security and health care during the period 2010-14, as a percentage of GDP.

Finally, the section on public sector borrowing requirements includes estimates for the primary economic balance during 2010-14, and for the public sector net debt during 2004-14.

Overall, the Mexican budget makes very limited use of a medium-term expenditure framework. The macroeconomic material presented in the budget includes some graphs and tables that present estimates for the five years beyond the budget. The overview budget material includes a two-page summary explanation of the budget in the medium term.

Box 2.2. The medium-term expenditure framework

The development of a medium-term expenditure framework (MTEF) is a key factor for achieving sustainable public finances over the long term. Stability and credibility gains linked to the implementation of an MTEF are very important. Moreover, the adoption of an MTEF increases the effectiveness of the budget formulation process and reduces the degree of conflict during this period.

An effective MTEF requires the government to: *i)* clearly state its medium-term fiscal objectives in terms of high-level targets such as the level of aggregate revenue, expenditure, deficit/surplus and debt; *ii)* operationalise these targets by the implementation of budget constraints for individual ministries and/or programmes over a pre-defined multi-year period; and *iii)* use a baseline which draws upon objective, cautious and high-quality assumptions.

The MTEF can be flexible or fixed. The former, chosen by most OECD countries, allows a yearly adjustment of the overall ceilings in the light of the previous year's outcomes or if macroeconomic circumstances and/or political priorities are modified. Fixed frameworks present binding aggregates that can, nevertheless, be compensated between the different expenditure units and should be updated in light of inflation estimates. Fixed frameworks are split up into periodic (Netherlands) and rolling (Sweden). In a rolling framework, an additional year is added every year to the end of the sequence of annual ceilings. On the other hand, in a periodical framework, a new sequence of ceilings is drawn up at periodic intervals – for instance, at the beginning of every new cabinet period.

The Netherlands budget formulation process is divided into two phases. First, when a new government is created, it explicitly presents its overall budgetary policy objectives for its term of office in the “coalition agreement” document. An expenditure rule is applied on the basis of cautious assumptions made by the independent institution, the Central Planning Bureau. The coalition agreement establishes separate caps for the three sectors (the “core” budget sector, the health care sector, and the social security and labour market sector) and incorporates the multi-year expenditure projections for each ministry.

After the first and main phase, the Dutch government's overall budgetary policy is annually translated into operational terms. After several negotiations, each ministry receives a “letter of totals” showing the maximum level of expenditure that is allowed for the coming year. As in Sweden (see Box 2.1), each Dutch ministry must address any eventual overrun in its area, and transfers between ministries or adjustments to the spending caps are only rarely used.

Having an MTEF with pre-established ceilings and targets helps improve fiscal discipline. The multi-year control of spending in both flexible and fixed frameworks has proved to be effective, even if it seems stronger in fixed ones. In flexible frameworks, the previous year's ceilings are an important baseline used by the Ministry of Finance through negotiations with the expenditure units, while in a fixed framework, the overall ceiling cannot be altered and thus every increase in a ministerial ceiling has to be compensated by a reduction in another ministerial ceiling or by intra-ministry reductions.

Detailed tables for the investment programme do include the full costs of the project and annual estimates going forward five years. The government's National Development Plan and sectoral plans provide a policy context for the budget, but the budget does not provide explanations of the relationship between the budget and these planning documents. Virtually all budget decisions are made on an annual basis, and most budget materials do not present a medium-term perspective.

Although Mexico has focused on key medium-term issues such as planning for the downturn in oil revenues and for the growing costs of pensions, the budget would be strengthened by producing medium-term estimates for ministries and major programmes and by developing a more explicit bridge between planning documents and the medium-term budget planning. Incorporating performance in budgeting will also be more realistic in a medium-term context. Examples of programmes where providing medium-term estimates would have increased the public understanding of programmes and the budget would be to show the expenditure commitments for the cost of providing 1.9 million cement floors over the next four years, or for expanding internal security spending over the budget horizon.

5.3. Investment and infrastructure

The budget office (the SSE) has a separate unit of 68 people who are responsible for reviewing investment projects to consider the project design, cost estimates, and potential impact on investment programmes. Over the past year, 3 000 new projects were considered (including 875 new rural roads) and 1 500 projects were reviewed. Projects are considered in terms of socio-economic benefits, reduction of poverty, regional benefits, and cross-cutting benefits. Projects above MXN 150 million are required to have a full cost-benefit analysis considering the costs and benefits over the life of the project.

Smaller projects are subject to a simplified review. The project assessments are then ranked in terms of the overall impact of the cost-benefit review. Projects initiated by the legislature are subject to the same review requirements. This review does not result in budget decisions, but serves as an input to the budget policy process. Decisions on funding are considered in the context of the overall programme budget, rather than in allocations for operating expenditure *versus* investment. The budget presents a detailed table for each investment project organised by agency, providing a description of the project, its total cost, its prior costs, the current budget requirement, and future estimates for the next four years. It is not exactly clear how the allocation decisions are made nor to what extent the ministries use the results of the review process.

Mexico has budgeted for investment projects on an incremental basis, with funding for annual project segments decided on an annual basis. This funding approach has resulted in increased project costs and substantial numbers of unfinished projects. In 2007, the IFR introduced multi-year funding for investment programmes. Decision makers can use this new authority to engage in more multi-annual planning and funding for large investment programmes.

6. Long-term fiscal sustainability

All OECD countries are seeking to ensure the longer-term sustainability of their public finances. Transparency – particularly for long-term liabilities and other financial risks – is a vital ingredient in ensuring the health of public finances and macroeconomic stability over the medium and long term. For Mexico, given the declining oil revenues, long-term fiscal sustainability is a particularly important issue. Being transparent and having clear policies for addressing longer-term liabilities such as pensions and social security are important for sustainability, as are being transparent about other contingent liabilities and having clear rules with regard to off-budget expenditures.

6.1. Pensions and social security

One of the most critical areas of contingent liabilities is pensions and other social benefits. As discussed in Chapter 1, the 2007 reform to the federal employee pension scheme (ISSSTE) was an important step in strengthening the sustainability of Mexico's finances. This reform tightened eligibility rules and the level of benefits, and significantly reduced the federal government's pension liabilities. As a result of this reform, the net present value of contingent liabilities is expected to decline from 57% of GDP to around 35% (OECD, 2007c, p. 49).

The IMSS (Mexican Institute of Social Security) is in charge of managing the medical services and pensions and several other benefits for private sector workers. The IMSS is fully funded through the collection of contributions paid by both employers and employees, and by means of financial reserves. The contributions are the social security allotments established by law that have to be paid by the employer, employee, and other parties. Employers are obliged by law to calculate the contributions under their charge and to submit them to the IMSS. In addition, when an employer pays the wages to its workers, it must withhold the workers' contributions. The contributions are paid on a monthly basis, and the employer must calculate its amounts in the printed formats or using software

authorised by the IMSS. The obligations of IMSS are guaranteed by four reserve funds, funded by contributions to the IMSS and dedicated to cover operations, actuarial reserves, contingencies, and catastrophes.

6.2. Public entities and enterprises

There are several public entities and enterprises in Mexico which operate under different governance regimes. The five most important public enterprises are under what is termed “direct control” by the Mexican government. These are PEMEX (the national oil company), CFE (the Federal Commission of Electricity); LFC (the Central Light and Power Company), IMSS (the Mexican Institute of Social Security) and ISSSTE (the federal employee pension system). The finances for the directly controlled enterprises are included in the budget. The government has been working to establish performance agreements setting efficiency goals and savings targets for the managers of these entities. The government has also begun to develop and report on performance measures for these entities.

There are 120 “indirect control” enterprises. The difference between indirect and direct control enterprises is set out in the BFRL: the income of the direct control enterprises is totally included in the annual revenues law and their expenses are integrated in the net total expenditure; on the other hand, the indirect control enterprises are those whose own income is not included in the annual revenues law, and their expenses are not integrated in the net total expenditure but subsidies and transfers that they receive are included.

Guarantees: The Mexican central government does not usually grant direct loans. Priority productive activities rely upon the support of federally sponsored development banking institutions that receive guarantees from the central government as provided by law. Development bank funds are mainly focused on providing credit to persons, public and private enterprises, states, and municipalities. Development banks and funds are authorised a financial intermediate ceiling by the Congress. Development banks are subject to “Basel II” compliant requirements as if they were commercial banks.

Tax expenditures: Since 2002, the revenues law had included the provision which mandates the executive to include the tax expenditure budget. In addition to the revenues law, the BFRL also establishes a provision for inclusion of the tax expenditure budget, which is due on 30 June so that it can be used for the negotiation of the budget for the next fiscal year.

Off-budget expenditures: The Mexican budget includes most public expenditures, in particular a substantial portion of sub-national budgetary

activity funded through federal grants and transfers. Off-budget funds are used to cover expenditures not reported in the budget; these activities are public or are partially funded with taxes. However, they have to be approved by Congress, and the information regarding these items is included in quarterly reports. Some examples of off-budget items are as follows:

- Financial funds to pay for PIDIREGAS, projects financed and built by the private sector to be transferred later to the public sector. These projects are meant to produce their own source of financing, and their budgetary impact must be recorded at each occurrence.
- The Institute for Banking Savings Protection (IPAB, Mexico's deposit insurance). By law, its total financing is excluded from the financial balance; the financial balance only includes fiscal grants to cover the unfunded component of IPAB costs.
- Modifications of budgetary provisions such as virtual transactions: *i*) the inflationary component of a debt item; *ii*) revenues out of debt reacquisition; *iii*) revenues out of a balanced debt issue; and *iv*) actuarial reserves from IMSS and ISSSTE.
- Financial resources from the Trust of Support to Rescue Licensed Highways, created in 1997, by financial assets and liabilities of licensed highways.
- The programme of debtor's support, the final cost of which will be influenced by the results of audits directly related to the appropriate implementation of programmes carried out by the National Banking and Securities Commission with banks and the future behaviour of tangible interest rates.

Recent legislation has improved the transparency of long-term liabilities, especially the 2007 pension reform which should help Mexico to budget for what is one of the most important long-term liabilities. However, issues remain about the transparency of the contingent liabilities of some public enterprises and PIDIREGAS, which is off budget.²

7. Conclusion and recommendations

The Mexican budget formulation process works well. The Ministry of Finance oversees a strong, centrally controlled budget process that ensures that the spending and taxing policies of the government are reflected in budget decisions and allocations. Under the current administration, there has been a marked improvement in the balance between the Cabinet, the Ministry of Finance, and the Presidency. Under previous administrations, it

used to be possible for individual spending ministers to receive budget increases by requesting the President to override the ceilings previously set by the Ministry of Finance.

Within the *Subsecretaría de Egresos* (SSE, the “budget office”), the main day-to-day work on the budget is carried out by two Directorates General for Programming and Budgeting (DGPYP A and B), with strong involvement from the Budgetary Policy and Control Unit (UPCP). In all three units (as with Mexican public administration in general), many operational decisions are not made at the operational level, resulting in extreme workloads for top officials. In the case of the two DGPYPs, the workload problem is compounded by what seems to be a very high degree of detailed supervision over spending ministries on the part of budget analysts within the Ministry of Finance. In the short term, the proposal to create a third DGPYP to better distribute the workflow within the SSE would certainly help.

The creation of a separate evaluation unit will also help, although it is crucially important that this organisational change include a viable framework for getting budget analysts involved in the performance system. In the medium term, further steps will be necessary to enable budget analysts and their managers to focus on strategic issues and to delegate at least some of the detailed work either down the hierarchy or – better still – into spending ministries altogether.

Recent reforms have improved the transparency of budget documents and helped to provide a more comprehensive package of economic and budget information to the legislature and the public. Mexico has launched important reforms in the areas of a performance-oriented budget, creating programme review and programme evaluation capabilities, and enhancing the transparency of the budget. There are areas where the budget could be improved, including:

- **Developing a more comprehensive medium-term expenditure framework would lend greater stability to the government’s fiscal framework and would improve planning.** The first step in this process is to develop medium-term estimates for major programmes for the base year and at least three years out. These estimates should be tied to sectoral planning and to the National Development Plan within the context of budget constraints. The Ministry of Finance should develop and publish a current services baseline to act as a benchmark for considering out-year policy changes. In addition, consideration could be given to developing either a flexible or fixed medium-term expenditure framework.

- **Budget ceilings should specify limited constraints and, within these limits, provide ministries and programme managers with discretion to allocate resources wherever possible to strengthen programme performance.** For example, it may be appropriate to specify a budget ceiling for each ministry, an employment ceiling, and assumptions for a few selected programmes that are of high national significance. The allocation of the resources within these constraints – including the allocation of personnel – should be at the discretion of the ministries.
- Currently, the budget formulation process is heavily overloaded in the final two months before submission to the legislature. The Ministry of Finance seems to rely on its close relationship with budget staff in sector ministries to reduce the number of unresolved issues as they arise in the preceding months. It would be desirable for the budget negotiations between sector ministries and the Ministry of Finance to be rearranged so as to formalise the interactions taking place in spring and early summer. **This would include communicating the ceilings for each ministry well in advance, to give sector ministries enough time for proper policy deliberations on how best to use the fiscal space available.**
- **Developing and using longer-term estimates will contribute towards enhancing fiscal sustainability.** It would be beneficial for the Ministry of Finance to develop longer-term estimates for 20 to 30 years out. This would help plan for the longer-term fiscal policy issues which Mexico will be facing, namely the declining oil revenues and changing demographics.
- **Investment decision makers should consider funding large investment programmes on a multi-year basis.** Up until 2008, it was not possible to properly budget for multi-annual capital investments. The recent introduction of multi-year funding for investment programmes is a welcome improvement. Decision makers should use this new authority to engage in more multi-annual planning and funding for large investment programmes. The Investment Unit in the Ministry of Finance should do more *ex post* assessments of selected investment programmes to determine the accuracy of project plans and cost estimates.
- **Consideration should be given to improving budget presentation.** This could be done by reducing economic classification data that do not contribute to budget management and by expanding programme information. Budget documents should

include information about programme changes – both those that are proposed and those that have been implemented.

- **The efficiency of the budget formulation process has been improved by enhancing the co-ordination role of the Ministry of Finance. This should be continued.** Under the current administration, the budget formulation process has become more co-ordinated, both within the executive and in relations with Congress. The Ministry of Finance has played the leading role in co-ordinating the process. This centralisation has helped to enforce budget discipline by avoiding the situation of previous administrations when line ministers resorted to the President or the Congress to override the ceilings previously established by the Ministry of Finance.
- **Reorganisation of the budget office (*Subsecretaría de Egresos*) will help better manage workloads and increase the focus on performance initiatives.** The proposal to create a third Directorate General for Programming and Budgeting (DGPYP) and a separate evaluation unit is to be commended, although it is important that this organisational change include a viable framework for involving budget analysts in the performance system. Many operational decisions are delegated upwards, resulting in extreme workloads for top officials. In the case of the two existing DGPYPs, the workload problem is compounded by a high degree of detailed supervision over spending ministries. Reducing this level of detailed oversight and concentrating more on aspects of programme review and analysis will help reduce workload.

Notes

1. This figure assumes an average oil price of USD 44 per barrel for the year and an average exchange rate of 13.8 pesos to the dollar.
2. Due to the 2008 energy reform, multi-year investment projects (PIDIREGAS) no longer exist for PEMEX, but only for the Federal Commission of Electricity (CFE).

Chapter 3

Budget Approval: The Role of Congress

This chapter reviews the role of the Mexican legislature in the budget process. Over the past decade, the Mexican Chamber of Deputies has become a much more active participant in the budget process. This development reflects the changes in the political system and the nature of the legislative-executive relationship. On a number of occasions, the budget process has become the focal point of conflict between the two branches. Recent reforms to the legislative budget process have provided tools to strengthen legislative oversight and have helped to some extent to clarify the respective roles of the legislature and the executive. Combined with a growing cross-party willingness to co-operate on the budget and greater emphasis on fiscal responsibility, the legislative budget process has been greatly improved.

This chapter is divided into four sections. The first provides an overview of the political system and recent changes to this system; the second examines the legislative budget cycle; the third discusses the role of the audit office; and the fourth presents conclusions and recommendations.

1. Overview of the political system

Mexico is a presidential system in which the President is directly elected on a first-past-the-post or plurality basis for one six-year term. Re-election is not permitted. The Mexican Congress (*Congreso de la Unión*) is a bicameral legislature consisting of the Chamber of Deputies (*Cámara de Diputados*) and the Senate. Both houses are elected by a combination of proportional and direct representation. The Chamber of Deputies (the lower house) has 500 members, 300 of whom are elected directly in single-member districts by the first-past-the-post method with the remaining 200 elected on the proportion of the votes received by their parties. In the Senate, 96 seats represent the 31 states and the federal district directly; a further 32 are elected through proportional representation. Deputies serve for three years and senators for six years, with no consecutive re-election permitted.

The principle of no re-election has been an important aspect of Mexican political life since the time of the revolution in the early 20th century. This principle applies to nearly all public offices. As a result, public officials must move into a different position every term – for example, running for elective office at the state level after a term in the national legislature. Mobility between the executive and the legislature is quite common, and legislators also move into career bureaucratic positions after their term in

office. Some commentators have noted the adverse effect of this high fluctuation on lawmakers' expertise, especially given their short terms in the lower house. To some extent this problem is ameliorated by the fact that many legislators develop their expertise at different levels of government, and many eventually return to Congress after at least one term away. Several of the current leaders in Congress are in fact veteran legislators.

As discussed in Chapter 1, the Mexican political system was dominated by one party for most of the 20th century: the PRI, which led all branches of government (Costa-I-Font, Rodriguez-Oreggia *et al.*, 2003; Rocha Menocal, 2005). This dynamic changed quite profoundly as the country began to turn into a three-party system in the 1980s and 1990s. In 1997, the PRI lost its absolute majority in the Chamber of Deputies and had to adapt to the fact that the PRD (a centre-left party) and the PAN (a centre-right party) could block legislation. Since 2000, two candidates of the PAN have been elected to the Presidency.

These three parties have been the main actors in the legislature for the past decade, without any of them being able to achieve a clear majority or a stable coalition. As a result, the executive has to work with varying coalitions to achieve its legislative aims. Both the executive and the legislature are still in the process of adapting to this relatively new institutional setup, and although great progress has been made in the last few years, this process is not yet complete.

The first years of divided government were characterised by constant differences between the two branches, especially after the change in government in 2000. The President lacked a majority in the legislature and found it very difficult to achieve legislative approval for his reform initiatives, often leading to deadlock between the Presidency and the Congress. In this struggling environment, the budget was no exception; both branches sought to shape budgetary allocations according to their respective political preferences, while at the same time coming to terms with the new institutional reality of divided, democratic governance. The confrontation came to a head with the presidential veto of the budget for 2005, a conflict which had to be resolved by the Supreme Court.

Since 2005, actors on both the legislative and the executive side have shown a markedly increased willingness to develop new institutional rules for the budget process so that the inevitable political conflicts in a democratic polity do not jeopardise the orderly conduct of budgeting. As a result, major reforms of the budget process (2006), the Integral Fiscal Reform (2007), and reform of the accounting system (2008) and of federal audit (2008 and 2009) were passed with congressional support. Furthermore,

the annual budget for the last three years (2007-09 budgets) has been passed with overwhelming majorities from all three parties.

2. Legislative approval cycle

The outlines of the budgetary competences of Congress are defined in the Constitution; most details are covered by the 2006 BFRL. This law changed the budget process. Before submitting the budget, the executive presents two reports to Congress earlier in the year. The first report is in April, six months before submitting the budget: the executive provides Congress with a report containing the macroeconomic projections for the next fiscal year. The submission of this first report is in keeping with the “OECD Best Practices for Budget Transparency” (OECD, 2002, p. 9). The presentation of this information is intended to generate more informed debates between the executive and the Congress when discussing the approval of the budget. But although the information is made available in Mexico, it is not clear if it is actually debated in Congress.

In June, the executive submits the second report to Congress: the programme structure of the budget, including proposed new programmes. The legislative budget calendar (see Table 3.1) somewhat understates the degree of interaction between the legislature and the executive immediately before and after the submission of the budget to Congress. Officials from the Ministry of Finance and from the Office of the Presidency are in contact with party leaders from all congressional factions and even attend the sessions of the Budget Committee when the amendments are put to a vote. On the other hand, there is little evidence that the information submitted in April and June results in substantive discussion in the lower house.

The 2006 BFRL states that the executive’s proposed budget must be submitted to Congress by 8 September. The executive’s proposal consists of separate revenue and expenditure budgets, along with supplementary documentation (see Chapter 2). After the formal submission of the executive budget draft, the revenue budget is received, discussed and voted on by the Finance Committee of the Chamber of Deputies before being submitted to a plenary vote. Afterwards, the Senate follows the same procedure of committee vote followed by plenary vote to confirm or reject the vote of the Chamber. The revenues law must be approved by both houses to become effective; the lower house must approve it before 20 October, the upper house before 31 October.

Table 3.1. Congressional budget timetable

Date	Event
1 April	The executive submits preliminary macroeconomic projections for the next fiscal year.
30 June	The executive submits the programmatic structure of the budget, including proposed new programmes.
8 September	The executive submits the draft expenditure and revenue budgets to Congress. The Budget Committee in the Chamber of Deputies starts holding hearings on the expenditure budget.
20 October	The Chamber of Deputies approves the revenue budget.
31 October	The Senate approves the revenue budget. The Budget Committee receives comments from the sectoral committees of the lower house, votes on proposed amendments to the budget, and submits the budget to a full vote of the Chamber.
15 November	The Chamber of Deputies approves the expenditure budget.
1 January	The fiscal year begins.

The expenditure budget is technically not a law but a decree, as it only has to be approved by the Chamber of Deputies. For the expenditure side, the lower house first holds a general discussion of budget policy in plenary session after the initial submission of the executive budget. The Budget Committee then discusses the draft budget before forwarding the relevant sections to the respective sectoral committees; the Budget Committee later receives the comments of the sectoral committees.

The main forum for budget analysis and debate is the Budget Committee in the Chamber of Deputies. It has 34 members from all the parties represented in the legislature. Legislative deliberations of the budget are open to the public and covered by the media. The committee holds public hearings on the budget and hears evidence from a variety of sources, such as academic institutions, business groups, representatives of sub-national entities, line ministries, and the Ministry of Finance itself.

Under the current administration, co-ordination of executive testimony before congressional committees has improved: the procedure is that ministers and officials from line ministries should first co-ordinate with the Ministry of Finance before appearing before the Budget Committee and other committees. The Ministry of Finance representative can attend meetings of congressional committees with the relevant ministry. In practice under previous administrations, this co-ordination did not often take place, and line ministers would appear before committees and in some cases argue for increased funding for their programmes. Under the current

administration, this co-ordination is being enforced. As a result, there is a more coherent executive position in negotiations with the legislature.

Although, in general terms, the Chamber of Deputies has the power to amend the budget draft as it would do with other decrees promulgated by the legislature, some limitations are nevertheless in place. First, the Chamber cannot change the programmatic structure submitted by the executive in June. Second, the Chamber cannot deny funding for expenditures that the executive is legally or constitutionally compelled to make, such as federal transfers or entitlement spending. The Chamber of Deputies can increase expenditures only if additional sources of funding are identified. The Chamber can, however, amend income estimations and the oil price within the range of the formula established in the IFR to obtain additional revenues. Any change must be within the balanced budget rule.

In order to avoid cases where Congress passes a law that represents an unforeseen expenditure during the year, the budget framework law (BFRL) provides that any proposal that increases expenditure shall be accompanied by the corresponding revenue proposal (but not incurring debt and not reducing other items) that must be approved first. No payment can be made if it is not authorised in the budget or in a later law.

According to estimates from both the Ministry of Finance and the Budget Committee, the amendments made to the executive's budget proposal added up to 4.8% of the overall budget in recent years.¹ This figure is much lower in many parliamentary countries where, in the most extreme case, a government might fall if the budget is amended at all. However, comparable presidential countries like Argentina or Brazil see amendments of similar magnitude.² In the United States, congressionally earmarked spending amounted to about 2% of discretionary spending in 2008. In Mexico for the 2008 budget, the figure increased to approximately 6% of the overall budget. The high percentage in 2008 reflected the late upward revision to the executive's revenue estimates due to income expected from a new tax which had not been approved at the time of the executive's budget proposal. The variation between the executive's proposal and the approved budget was 4.9% in 2006 and 1.2% in 2007.

The Budget Committee of the lower house is also the main decision-making body for the amendment process. Any amendments to the budget are voted on separately in the Budget Committee before that committee votes to submit the whole budget to the full house for approval. The sectoral committees can only propose amendments to the Budget Committee. The budget is read and debated twice in plenary session before the final vote. The budget must be passed by 15 November, well ahead of the new fiscal year which starts on 1 January.

Before the constitutional reform³ of 2004, the deadline was 31 December and the budget was often passed only after lengthy last-minute negotiations stretching into the new budget year, thereby delaying budget execution in the first weeks of the new budget year. There is no formal provision in the event of a budget not being passed in time. Legally, the budget can only be in force for one calendar year. The need to safeguard against the country being without a valid budget was the main motivation for moving the approval deadline forward. Although there are still intense last-minute negotiations, moving the date for congressional approval of the budget six weeks earlier has improved the efficiency of the process. This change leaves less time for Congress to debate the budget. However, congressional deputies appeared satisfied with this reform in practice and voted heavily for it. In addition, they are now provided with more pre-budget information than under the previous system.

The 2006 BFRL introduced special provisions in the budget calendar for presidential elections, held every six years in early July. Since a president cannot be re-elected, a new administration inevitably takes office with each new presidential term. The outgoing administration has a legal obligation to co-operate with the new administration on the elaboration of its first budget. The 2006 budget framework law (BFRL) provides for a transition fund that supports the president-elect's transition team before he takes office on 1 December. The new administration then submits its budget to Congress on 15 December and both the expenditure and revenue budgets have to be passed by 31 December.

The 2006 BFRL and the 2007 IFR increased the volume of performance information presented to Congress by the executive. While both Congress and the Ministry of Finance agree on the importance of developing performance information, they have distinctly different interpretations of how the performance information would be used once it is fully operational, with legislators seeing it mostly as an instrument of control, not management.

To discuss budget reforms, one option would be to establish an informal advisory committee on budget reform as part of the wider public consultation exercise. This committee would have representatives from all political parties and would encourage the exchange of information on the reform process. An example can be found in Austria, where the Advisory Council for Budget Reform was established to exchange ideas on the extensive budget reform package that was introduced in Austria at the end of 2007 (Blöndal and Bergvall, 2007). Members of this council include persons from the Ministry of Finance and parliamentarians representing all political parties. This council continued to exist after the passage of the budget reform legislation, and keeps parliamentarians informed of the progress of

these reforms. The Austrians believe that this council has facilitated more technical exchanges of ideas and helped to ensure that the discussion of the reforms was not so politicised.

Box 3.1. The Center of Public Finance Studies

The Center of Public Finance Studies (*Centro de Estudios de las Finanzas Públicas*, CEFP) is the support unit of the Mexican Chamber of Deputies in budgetary affairs. The CEFP was created in 1998 after the legislature began to establish its new role as an independent branch of government; it is overseen by the Budget Committee of the Chamber of Deputies. It is designed to be an independent, nonpartisan office of technical experts who assist members of the lower house in both deliberation on the budget and legislative oversight during budget execution. Its director is appointed for a five-year term by a vote of the full house after an open, competitive application process. The Center has four divisions: revenue studies, budgetary and expenditure studies, IT studies, and macroeconomic and sectoral studies. Overall, it has a staff of about 50 persons.

The CEFP is charged with analysing: *i)* the executive's quarterly reports on budget execution and the state of public finances; *ii)* the annual report on the implementation of the National Development Plan; and *iii)* any laws and initiatives with fiscal implications that the executive submits to the legislature, including most importantly the annual draft revenue and expenditure budgets. The Center can further be asked by any member of the lower house and any other committee to provide expert advice on any public finance issue. Its research outputs are available publicly on its website. Since the introduction of the BFRL, all legislative proposals must be analysed for their fiscal implications. If a proposal originates in Congress, analysis is the task of the CEFP. When the executive proposes the draft laws, it is the Ministry of Finance who provides the analysis to Congress.

Given its role and legal mandate, the CEFP could play an important role in making performance and evaluation information available and accessible to members of Congress during budget deliberations. The quality of its outputs is high and it seems to have sufficient capacity to serve an important role. Compared to the situation in other OECD countries, the CEFP is a capable legislative budget office with a sound mandate. Members of the Budget Committee spoke highly of the quality of advice they receive from the CEFP.

2.1. Presidential veto

The President can veto proposed laws. All laws passed by Congress must be sent to the executive for official publication, which the executive may refuse if it has reservations. These reservations can be overridden by a vote of two-thirds majority of both houses of Congress, after which the executive must allow the law to go into effect. The legal framework does not provide for a specific procedure for the President to veto either the budget decree or specific amendments approved by Congress.

The first and only time the presidential veto has been evoked was by former President Fox in late 2004 regarding the budget for 2005, sparking a constitutional conflict that had to be resolved by the Mexican Supreme Court. Congress had modified some programmes and reduced the funding for a number of items in order to increase funding for both existing programmes and new items. The executive argued that, aside from the specific political priorities, Congress had no right to make such changes to the draft budget decree because it left mandatory commitments of the central government unfunded. The President invoked his power to veto laws. Congress disputed whether the President's general veto power included the right to veto the budget, because the budget is not a law but a decree. For the first five months of the 2005 fiscal year, some items of the budget remained frozen although this did not jeopardise the operation of the government.

The Supreme Court ruled in May 2005 that the President could veto the budget decree and that he could refuse to let the budget go into effect unless Congress addressed his specific observations. Congress could overrule the veto with a majority of two-thirds, as it could with any law. The Court did not, however, address the exact scope of the congressional amendment powers, the issue over which the conflict first arose. The legislature and the executive have since adhered to an understanding that Congress can only change the allocations between existing programmes but not create new programmes of its own.

3. The role of the external audit office

The Federal Supreme Audit Office (*Auditoría Superior de la Federación*, ASF) is the supreme audit institution of Mexico and was created by Congress. It has a staff of 1 950 persons, plus almost 400 temporary staff to audit states and municipalities. The institution is an independent external auditor in accordance with international standards as defined in the "Lima Declaration" of INTOSAI (1977). The mandate of the ASF is established in the Mexican Constitution and through the Federal Audit Act. The Supreme Auditor holds office for a term of eight years, renewable once. Candidates are chosen by the audit committee of the lower house of Congress and are elected by the full house by a two-thirds majority. The ASF is functionally independent from any branch of government; its budget is approved by Congress without the possibility for amendments and is considered sufficient to carry out its mandate.

The Federal Supreme Audit Office has legal powers to access data, books and documents related to federal public revenue or expenses, as well as any other information that might be helpful, with the sole restriction that it must explain the purposes and uses the information may serve. All internal

control offices (ICO) in public organisations shall aid the ASF in the review of the public accounts. Co-ordination is vital in order to guarantee information exchange.

The ASF undertakes approximately 800 audits per year and produces a single report that consists of 40 volumes and 25 000 pages which is submitted to the Chamber of Deputies. The main element of the report is the audit of the central government's final accounts. The most recent report contained 959 audits including 189 performance audits and 714 financial audits. All public spending, including sensitive areas such as defence, is subject to audit by the ASF. The main focus of its audit work is the regularity of public spending.

Since 2008, the ASF has been empowered to carry out performance audits and include them in the report on the final accounts. The audit office clearly has the technical capacity to do so, and has in the past conducted audits of the appropriateness of different performance monitoring instruments in use across the central government. However, since audit reports cannot be made public before the annual report is presented in the legislature, the timeliness of recommendations to the audited bodies is in doubt. It is necessary to increase co-operation between the audit office and the executive to strengthen the ability of the ASF to comment on indicators used by the executive agencies.

The lower house of Congress has a dedicated audit committee where the report of the ASF is presented and discussed. Findings and recommendations, once they are presented to Congress, are publicly available. Ministries and other relevant bodies are constitutionally required to respond to audit recommendations, and the ASF presents biannual follow-up reports to Congress. Constitutional modifications introduced in 2008 have changed the procedure for dealing with audit findings. The new procedure is as follows: ten days after the public account reviews are submitted to the Chamber of Deputies, the ASF sends its recommendations to spending ministries, who have 30 days to respond. In turn, the ASF has 120 working days to reply to the ministries' explanations. Twice a year, the ASF submits a report to the Chamber of Deputies on the status of the agencies' compliance with the recommendations.

4. Conclusion and recommendations

The legislative budget process has undergone a fundamental transformation as Mexico evolved from a single-party state to a modern presidential democracy. The last decade has been characterised by a sequence of changes, both confrontational and co-operative, aiming to

establish the Mexican Congress as an independent branch of government in the budget process. Congress now has both the technical capacity and the legal mandate to fulfil this role. Especially in the last three years since 2006, the congressional budget cycle functioned well and delivered timely budgets while maintaining the government's overall fiscal stance. Despite these important achievements, there are still some issues remaining:

- The introduction of performance budgeting and management will provide Congress with more information on programme performance. **It is important that Congress be engaged in this reform initiative and be encouraged to use performance results to follow up the performance of the relevant ministries and agencies and to use this information when discussing the draft budget.**
- **As part of the existing public consultation exercise for proposed reforms, it could be helpful to establish an informal advisory committee on budget reform.** The committee could serve as a sounding board or consultative body to obtain congressional views on proposed budget reform initiatives before reform bills are introduced in the legislature. This committee would consist of representatives from all legislative political parties and the Ministry of Finance.
- **When preparing and amending the draft budget, the executive and the Congress should abide by their respective constitutional limitations.** Differences may generate conflicts, such as the one brought before the Supreme Court in 2005.
- **The Federal Supreme Audit Office (ASF) should consider producing information in a more streamlined and easily accessible manner.** The ASF undertakes approximately 800 audits per year and produces a single report after the end of the fiscal year that consists of 40 volumes and 25 000 pages. Rather than generating one single large report, the audit institution should consider publishing summaries of individual reports and presenting them to the relevant congressional committee.
- **Audit reports and performance information should be provided to Congress in a timely manner.** It would be highly desirable for Congress, the Federal Supreme Audit Office and the executive to improve the organisation of their workloads so that performance reports and other relevant audit reports are effectively used in decision making and provided in a timely manner.

Notes

1. This percentage is the average of total net expenditure for the years 2006-09. Programmable expenditure varied 6.2% over the same period. Figures from the Ministry of Finance show that, for the 2008 budget, the overall amount of programmable spending in the executive proposal was MXN 1.777 trillion, while the approved budget amounted to MXN 1.899 trillion (an increase of about 6%).
2. According to data collected by the OECD for 2004 and 2005, changes amounted to around 3% in Argentina and around 4% in Brazil in those years. Changes in Mexico were somewhat lower than today at less than 1% (Curristine and Bas, 2007, p. 91).
3. The 2004 constitutional reform adjusted the deadline for the executive to submit the budget as well as the deadline for Congress to approve it. Previously, the budget draft was presented to Congress on 15 November and approved by 31 December. Now the draft is to be submitted by 8 September and approved by 15 November at the latest.

Chapter 4

Budget Execution and Financial Management

This chapter reviews the implementation and management of the Mexican budget. Financial management is in the midst of an ambitious agenda of reform with the overall goal of improving the quality of public service. The central concepts behind the reforms are to delegate management responsibility to programme managers and to focus greater attention on improving results. This chapter is divided into seven sections: the execution of the budget; cash management; public accounting; internal control and audit; human resource management; procurement; and the conclusion and recommendations.

1. Execution of the budget

The central executive government has 18 ministries. These ministries are organised into sub-agencies for various programme purposes or functions of the ministry. The federal executive has two types of arm's-length agency. The first type is composed of units that belong to spending ministries but enjoy independence in their decision-making process. From the budgetary perspective, these units are integrated in the budget of the corresponding ministry. The second type of arm's-length agency enjoys administrative and budgetary independence. Although they are arranged in sectors by ministry, they do not report to the minister and their budget is managed and determined by themselves within the ceiling previously authorised by the Ministry of Finance.

1.1. Budget execution

Within ten days of approval of the budget by the legislature, the Ministry of Finance issues guidance for the expenditures of each ministry. The agencies have 15 days after notification to complete their review of the guidance. The budget is then uploaded to a system called "Federal Integrated Financial Management System" (SIAFF). Each spending ministry appoints personnel to access the system and operate the budget. Income and expenditures are scheduled by month. The budget becomes available through the system according to the authorised calendar. Spending ministries access segments of their budget every month with the possibility of advancing expenditures for future months as long as they compensate the advances with resources from other items. The SIAFF is comprehensive enough to allow ministries to make internal reallocations of the budget, to request external reallocations from the Ministry of Finance, and to order

payments. The system is updated with each year's budget information, and active, as of the first working day of January.

Each spending ministry has a central administrative unit called *Oficialía Mayor* (OM) which co-ordinates the planning, programming, budgeting, spending and financial control of public expenditure in that ministry. This office reports directly to the corresponding minister and is considered the centre of all the administrative tasks of its ministry. The office is divided into different directorates-general, typically including IT, budget and organisation, human resources, material resources, procurement, and general services. An OM is linked with all the parts of its ministry by means of *coordinaciones administrativas* (CA). When, for example, the Directorate-General of Social Development needs to spend, it asks its CA to present a request to the OM of the Ministry for Social Development. Once granted by the OM, the Directorate-General is then obliged to follow the instructions of its OM.

Although the rules on payments do not expressly provide a mechanism of preventive control, the budget law states that no payment can be made without its corresponding documentation. In other words, for a payment to be ordered an obligation for a payment has to arise either from a contract, a law, or a supply request, and the invoice has to be submitted by the supplier. The office of payments in each ministry prepares the documentation and orders the payment. The Ministry of Finance does not apply any preventive control in the payment procedure because it is the responsibility of each ministry. The rules are set by the budget law. Failure to comply with the terms of the law may result in the application of administrative and criminal sanctions.

Ministries require the authorisation of the Ministry of Finance to exceed their chapter ceilings. Chapters in the budget are organised by ministry. There are rules that allow the Ministry of Finance to authorise overspending only if there are resources available from other chapters or windfall revenues. Spending ministries can incur overspending if they compensate it with windfall revenues they generated themselves. The Ministry of Finance must include in the quarterly reports every authorisation for overspending that equals or exceeds 5% of a given chapter.

Starting in 1998, Mexico has established measures to handle unexpected shortfalls in the revenue estimates of the fiscal year. The Oil Revenues Stabilisation Fund was created in 2000 and since then has been available for compensating some income shortfalls up to the limit allowed by its operating rules. When there is an income shortfall, the first action is to compensate the decrease of a revenue item established in the revenues law of any given fiscal year with the increase of another revenue item in that

law. For instance, if the VAT revenue rate decreases, it could be compensated with an increase of the income tax rate or any other tax set forth in the revenues law. Another scenario is a decrease in the price of a barrel of Mexican oil, which could be compensated with the resources of the Oil Revenues Stabilisation Fund.

Then, when revenue items or stabilisation funds are insufficient, offsets will be found from: *i*) expenses on social communication; *ii*) administrative expenses not directly connected to population needs; *iii*) expenses on personnel services, without affecting the priority extraordinary benefits; and *iv*) budgetary savings and economies established in accordance with the authorised calendars of ministries and agencies. If still not sufficient, other adjustments can be made while still trying not to affect social programmes.

1.2. Structure of appropriations and budget flexibility

The budget is structured by organisation, programme (function), and economic classification. Budget chapters are organised by ministry. The line items within the budget are very detailed: for example, 6 500 codes in education and 9 000 codes for transport. Strict controls are applied to personnel expenditure, to the numbers of employees, and to the organisation of government.

The law opens the possibility for reallocation of resources without further congressional authorisation during the budget year. According to the law, reallocating resources can only take place when they contribute to a better achievement of the goals set for the corresponding programmes. There are two types of reallocations: internal and external. Internal reallocations of resources are those that ministries and agencies may apply without authorisation from the Ministry of Finance. There is a wide legal margin for internal reallocation, and these reallocations are very common. In contrast, external reallocations of resources are those that need the authorisation of the Ministry of Finance (*e.g.* reallocations from investment to current expenditure). External reallocations are those that, due to the magnitude of their impact on the public finances, need to be authorised by the Ministry of Finance.

While the Mexican government appears to have significant flexibility to modify the budget within the ministries, the budget documents are extremely detailed – as demonstrated by the 6 500 budget codes for education. This level of detail requires a substantial amount of administrative action to move funding from one code to another. Shifting to a programme structure will substantially reduce the number of line items and should shift the focus from administrative detail to programme allocations. As the transition to the programme structure and a results focus

progresses, it should be possible to reduce the amount of detail in the budget, reduce the number of budget codes, and provide greater flexibility to programme managers on the use of budget resources.

2. Financial reporting and cash management

Budgetary operations are executed through a computer system that enables the Ministry of Finance to keep track of the development of the expenditure by spending ministries. The Ministry of Finance often requires information from the spending ministries to comply with the quarterly reports that the executive sends to the legislature. The authorised personnel from every ministry log into the SIAFF system to request payments. Each request travels through the system to the *Tesorería* (a branch of the Ministry of Finance) which reviews the requests and orders the Central Bank to pay. There are other situations where there are no direct payments from the Central Bank. Instead, the Central Bank transfers resources to the accounts that spending ministries hold with commercial banks. The authorised personnel from the given spending ministry ask the commercial bank to make the payments.

In Mexico, the budget and part of the federal revenue have been managed through approximately 5 000 bank accounts by public sector agencies. As a result of the proliferation of accounts, the Treasury did not have accurate or up-to-date information about the balances of those accounts.

Having a single treasury account is a common practice within OECD countries and helps to generate efficiencies and savings. The 2007 modifications to the budget law stipulated the creation of a single treasury account (STA) as of 2008. Use of the STA will be mandatory for the central government and its agencies. Work towards achieving this objective has begun. There are currently around 80 accounts centrally operated by the Ministry of Finance. Those accounts reside in the Central Bank.

However, the federal government, through the spending ministries, owns a large number of accounts in commercial banks. Under the single treasury account, agencies will continue to be responsible for payment decisions. The Treasury will execute the payments from a single account. This reform is expected to improve the tracking of public expenditure, avoid idle balances, minimise public borrowing requirements, and promote the use of electronic payments. It is also hoped that the reform will create greater transparency in the operation of public finances.

Direct payment from the STA to 600 000 employees of the central government will be mandatory. Many of the remaining approximately two

million employees of the government and beneficiaries of government transfer programmes are not currently paid through any bank. The STA will support Treasury efforts to expand the use of electronic transfers to the non-bank recipients of federal payments.

The executive, via the Ministry of Finance, sends information to Congress on a monthly and quarterly basis. Monthly reports focus on debt. The quarterly reports must be sent within 30 days after each quarter; they contain information on economic assumptions, public finances, and public debt. Quarterly reports are disaggregated by month and include information on performance evaluations, goals and objectives, and their social impact.

3. Accounting: integrated federal accounting system

Accounting in Mexico has been on a cash basis with a capital account. Nevertheless, since 2006, some modifications have been introduced to shift to accrual accounting. In December 2008, the Congress enacted the Governmental Accounting Law to harmonise the accounting systems of the federation, the states and the municipalities. Accounting reports will be required to include information on the results of programmes. The new law created a national council to oversee the implementation of the new accounting law, with representatives of the federal government, the states, and the municipalities. All three levels of government are required to use standard accounting structures and standards. Each entity is to establish registries of goods and real estate.

The goal is to create an accrual accounting system that will allow real-time reports of financial information. The move to accrual accounting is to be completed by 2012. This accounting system must be designed and managed to facilitate registration and control of assets, liabilities, costs and expenses. Some public entities such as PEMEX and the *Comisión Federal de Electricidad* (CFE) already use accrual accounting. The new public accounting law intends that all levels of government, including all public entities, must use the accrual accounting basis, thus allowing their key actors to use the real-time financial tools to improve the administration of financial resources.

In recent years, many OECD countries have adopted accrual accounting. This technique allows governments to obtain better cost information and on a real-time basis. It enables governments to better plan and estimate the cost of longer-term liabilities like pensions for government employees. Accrual accounting can help to support wider government reforms such as performance budgeting and the delegation of financial and managerial flexibilities.

Shifting from cash to accruals, however, can be a difficult and costly process. It requires hiring trained accountants in accruals and retraining those who only have experience of cash-based systems. It also requires a major investment in IT equipment.¹ Moreover, it is important to improve communication to ensure that all the agents directly or indirectly related to the accounting system understand the accruals methodology and to enhance transparency towards the media and the general public.

Given the complexity of accounting on a consistent basis at the federal, state and municipal levels, reaching the goal of having an integrated accrual accounting system within three years will represent a very significant challenge. There is clearly an issue about the capacity of some states – and especially municipalities – to implement this reform. The capacity and expertise of states and municipalities vary significantly. Some states are equipped to implement results-oriented budgeting, internal controls and accounting reforms, but others do not have the ability. Similarly, larger municipalities may have the human resources to support the reforms, but many of the smaller municipalities will have problems. There are also issues with having to introduce all of these reforms at the same time. This urgency can strain the capacity of even the most resourced states and municipalities.

Moreover, adopting a uniform chart of accounts and consistent accounting standards, and developing timely integrated reports, will present major challenges. Implementation of full accrual accounting requires the valuation of assets and the selection of appropriate depreciation schedules. The treatment of specific assets such as military, heritage and infrastructure assets, and liabilities such as social insurance programmes is generally a very contentious issue when implementing accrual accounting. The tasks are very complex, and at a minimum there needs to be a register of assets before engaging in valuation.

The first goal should be to have accurate, consistent and timely cash accounting. The second goal should be to develop a register of assets. In some unitary small OECD countries, this task has taken a few years. For Mexico – given that it is a large federal country – it will take longer. Once the register has been developed, accruals should be introduced in such a way that the added work of accounting on an accruals basis will produce more accurate financial information that will be useful to financial decision makers.

3.1. Current accounting timetable

The accounting timetable is set by the Constitution and the Federal Audit Act. The fiscal year matches the calendar year. The public accounts timetable is as follows:

- The public accounts are presented by the executive to the lower house of Congress not later than 30 April of the year that follows the reported year – namely four months after the end of the reported fiscal year.
- The Federal Supreme Audit Office submits its report on the review of the public accounts to the lower house of Congress no later than 20 February of the year that follows the year in which the accounts were presented – namely almost 10 months after the accounts were presented and almost 14 months after the end of the reported fiscal year.
- The lower house of Congress completes its review of the public accounts no later than 30 September of the year that follows the year in which the accounts were presented – namely 16 months after the accounts were presented and 20 months after the end of the reported fiscal year.
- The executive, legislative and judicial powers present the “Report of Financial Management Progress” to the Federal Supreme Audit Office no later than 31 August of the fiscal year in progress.

The public accounts include financial information from federal public entities and are intended to demonstrate that federal income and expenses were properly used in accordance with applicable rules and for the specific goals contained in federal programmes.

The current schedule allows so much time that the reports may lose their policy relevance. The Federal Supreme Audit Office (ASF) should improve the timing of the submission of its report on the review of the public accounts. The ASF review is presented to Congress almost 14 months after the end of the fiscal year. The “OECD Best Practices for Budget Transparency” (OECD, 2002) recommends that a supreme audit institution’s opinion and audit of the public accounts should be released within six months of the end of the fiscal year.

4. Internal control and audit

Each ministry or agency of the federal administration has an internal control office (ICO), an operational extension of the Ministry of Public Administration (*Secretaría de la Función Pública*, SFP). The SFP appoints the head of the ICOs inside the other agencies to preserve the independence of these offices.

Each ICO has three branches: an Office of Responsibilities, an Office of Audits, and an Office of Complaints. ICOs have the power to: organise and co-ordinate the system of governmental control and evaluation; inspect federal public expenses and their consistency with the federal budget; and establish the general basis for performing audits in the agencies and entities of the federal public administration. The head of each ICO receives complaints against public servants and evaluates preliminary reports of responsibilities submitted by ministries, the Attorney General's Office, and the Treasury. The head of the ICO also orders and performs all kind of audits and investigations, and informs the Ministry of Public Administration about the status of actions that have been taken.

One of problems with the Mexican bureaucracy is that it has layers of rules and regulations that have been expanding during recent years. There are currently around 4 200 procedures controlled by regulation and an estimated 18 175 rules and norms to be followed. There are 1 002 SFP controllers who devote a considerable amount of their time and resources to reviewing government employees' compliance with these procedures and norms.

The internal control functions of the SFP have traditionally been viewed as the internal enforcer of public service rules whose main function is to identify and punish public employees for wrongdoing. The SFP has a mandate from the 2003 Professional Public Service Law (PPSL) to undertake a programme for the improvement of public management. The goals of this initiative are to promote performance-based recruitment, review, and management. The SFP intends to convert the individual ICOs into catalysts for improving performance management. But there is a major issue with reengineering the workforce and transforming this function from enforcement to management improvement.

In addition to the internal control function, external audit also plays a role (see also Chapter 3). The Federal Supreme Audit Office (ASF) concentrates on applying sanctions to individual civil servants for violation of rules. If the ASF find that a breach of the law has resulted in a monetary loss, it can initiate a procedure against the civil servant who is presumed responsible. Hearings will be held, during which the official will have the opportunity to plead his/her case. The ASF evaluates the evidence submitted and can decide to request reimbursement of the missing amounts. This procedure is in addition to any action taken through internal control, and other sanctions such as criminal sanctions can apply if the official has violated the law.

The current system of administrative responsibilities and sanctions of public servants lacks the necessary clarity to give public servants the

certainty needed to perform their duties. The executive has recently prepared a draft to modify the “Law of Administrative Responsibility of Public Servants” (*Ley Federal de Responsabilidades Administrativas de los Servidores Públicos*) to introduce a certain degree of flexibility concerning minor irregularities such as errors or mistaken decisions. This proposed modification would allow corrective measures without sanctions, thus avoiding excessive rigidity. On the other hand, the draft aims to impose the most severe sanctions on public servants who commit more serious offenses.

5. Human resource management

The Mexican government reported having 2 586 213 public employees in 2008, out of a population of 107 million. The employees of the federal government are divided into two different categories: unionised affiliation (*base*) and free appointment (*confianza*). While unionised affiliation – generally reserved for administrative personnel – implies an important level of stability, free appointment refers mostly to higher positions with shorter-term contracts. The 2003 Professional Public Service Law (PPSL) initiated a career-based civil service. This law established procedures for the SFP to implement performance-based recruitment, training and review for personnel.

Recruitment: Under the PPSL, existing employees (*confianza*) can be appointed to the civil service by winning a competitive contest or by improving their capabilities and demonstrating their ability through their performance evaluations. All new external applicants are required to win a competition and to demonstrate knowledge, skills and experience. All candidates for civil service appointment (both existing employees and new external applicants) are considered by committees consisting of the selecting official, the HR general director, and an internal control office representative of the SFP.

After five years of implementing the new structure, 36 000 positions have been reclassified using the principles of the PPSL, but only 9 000 individuals have been selected under that law. There is an important difference regarding the level of professionalisation, performance and bureaucratic culture between the two categories of public employees, *base* and *confianza*. Unionised workers generally perform more administrative tasks and have weaker levels of professionalisation. Moreover, the career-based civil service is undeveloped in the decentralised institutions and at a sub-national level: only a few administrations at the state level have implemented it, and even less at the municipal level.

Training: Training is divided into optional courses and mandatory courses. Public servants take optional courses to prepare them for higher positions, or mandatory courses to maintain their qualifications for their current positions. Employees who fail twice in mandatory training can be removed from the public service.

Pay: Compensation based on performance is just beginning to be implemented in Mexico. The salary of unionised personnel is fixed in accordance with the performed activity. In addition to the benefits stipulated by law, each union negotiates benefits with the ministries or entities of the federal public administration through an agreement that is named “General Working Conditions”. These working conditions are revised every three years. The benefits include supplementary payments for incentives and overtime, and other criteria. The agreements do not apply to the free appointment personnel (*confianza*).

The salary of free appointment personnel is set in accordance with the minimum and maximum limits that the federal executive branch proposes in the annual federal budget draft for the corresponding fiscal year. The Chamber of Deputies approves the limits. Once the limits are approved, the federal executive branch will publish the applicable rules.

Although the implementation of the PPSL has been an important improvement to the general functioning of the Mexican public service, a lot of work still needs to be done. As mentioned in several academic publications,² the application and selection systems have been the object of criticism regarding their objectivity, legitimacy and efficacy, and consistency with the legal framework. The main criticisms of the PPSL are: *i*) the management of the system could be less centralised and its mechanisms for certifying competences could be shorter, clearer and more convincing; *ii*) the system is often questioned due to the risks of politicisation; and *iii*) there has not been an evaluation of the results of the PPSL implementation, whereas such an evaluation could help to highlight and address its limitations.

6. Procurement

Since the early 1990s, the Mexican government has adopted private financing and construction of public sector energy projects, including oil and power. The legal framework was established in 1995 for the so-called PIDIREGAS. Under this scheme, the construction and, in principle, the financing of the facilities are the responsibility of a private entity. The expected revenues of all PIDIREGAS projects should entirely cover the

investment and operating costs, requiring no additional public expenditure. There are two types of PIDIREGAS:

- Directly financed investment projects: build-lease-transfer (BLT), build-operate-transfer (BOT), and public works privately financed schemes.
- Conditionally financed investment projects.

In both cases, a long-term contract is signed.

Under the “public works privately financed scheme”, the Mexican government purchases an asset built by a private investor once the construction is completed according to the requirements of the public entity. The private investor bears the financial risk during the construction period, while the public entity bears the risk related to the operation of the asset. The market risk and the financial risk related to the repayment of the asset are borne by the public entity.

The conditionally financed type establishes a fixed payment and a variable payment to the private investor. The fixed payment corresponds to an availability concept, whereas the variable payment depends on the production of energy. The asset is private property and is built under the technical specifications of the public entity. However, the government is obliged to acquire the asset in the case of government default or for extraordinary reasons. The private investor bears the financial risk during the construction and operation period, as well as the risk related to the operation of the asset. The market risk is borne by the public entity.

The Mexican Constitution provides that all government purchases shall result from public tenders. The compulsory requirements for all spending ministries to follow when purchasing goods and services are set out in two laws: the *Ley de Adquisiciones* (procurement law) and the *Ley de Obras Públicas y Servicios Relacionados con las Mismas* (law concerning procedures for expenditures in infrastructure projects). The public tender is administered through an online electronic system of government procurement that is named COMPRANET. The objective of this system is to simplify and improve the transparency of the procedures for contracting goods and services. COMPRANET performs the electronic tendering procedures. All the federal and local government public tenders are published on the COMPRANET website, in the link named “tenders in force”. A supplier or contractor can consult the public tender conditions on the COMPRANET website free of charge. Modern security systems have been used to design the system for the submission of a bid electronically. Such systems include the electronic signature, cryptography and international standards for electronic interchange of documents to secure the

confidentiality of data. Finally, the link named “tenders follow-up” enables consultation of information produced during the tender process up to the formalisation of the contracts. In summary, COMPRANET allows greater transparency and rapidity in the government’s tender processes.

The executive intends to modify both procurement laws (*Ley de Adquisiciones* and *Ley de Obras Públicas*) to create a common procurement policy throughout the federal government, and to harmonise the internal rules of each ministry and agency to allow faster procedures and, for example, the elimination of unnecessary authorisations.

7. Conclusion and recommendations

Mexico is in the process of implementing a broad agenda of reform to strengthen and modernise its public service, including: performance budgeting and performance management, strengthening internal control, and establishing consistent accounting for federal, state and municipal governments. All of these reforms should contribute to improvements in public sector management and the efficiency of programme delivery to the public. The goals of these reforms are ambitious. It will be important to provide realistic implementation schedules and to ensure that the reform efforts are co-ordinated to the maximum extent possible.

The central theme of these initiatives is to improve public management. Such improvement is facilitated by giving programme managers greater responsibilities while still holding them to account. Systems are being revised to emphasise performance measurement and results.

- **It would be desirable for the budget execution functions to be reviewed, to enhance the discretion and flexibility of programme managers and budget officials.** Within the budget office, budget analysis should focus more on programme review with less emphasis on *ex ante* budget controls. Staff mobility within the budget office should be encouraged, to minimise programme advocacy and to strengthen analytical skills. Agency programme managers should be given greater control over details of budget management and reallocation of resources within their programmes.
- **To manage the implementation process for the accounting reforms, it is important to generate realistic expectations about the timelines and challenges ahead. The focus should be on getting the basics right.** The initiative to harmonise accounting systems for the Mexican central government, the states and the municipalities and to shift to an accrual-based financial reporting

system has a challenging time frame. The task is highly complex and requires patience and adequate time to implement. The primary emphasis should be placed on getting a correct cash system and on establishing a register of assets, before adopting accrual measures.

- **The Federal Supreme Audit Office (ASF) should improve the timing of the submission to Congress of its report on the review of the public accounts.** The “OECD Best Practices for Budget Transparency” (OECD, 2002) recommends that a supreme audit institution submit its opinion on the audited public accounts to the legislature no later than six months after the end of the fiscal year. The current period in Mexico is 14 months.
- The Ministry of Public Administration has internal control offices within each ministry. In the past, these offices have focused on enforcing government regulations and resolving complaints against public servants. While these functions are necessary, **the internal control offices should shift more towards programme improvement rather than performing legal compliance audits that may result in the sanction of public servants but not in the improvement of public services.**
- The 2003 Professional Public Service Law (PPSL) has now been in place for over five years. **The implementation and results of this law to date should be externally evaluated and reviewed in order to provide recommendations for improvements.** The introduction of the PPSL was an important advance on what had gone before; however, there are many areas in which it can be improved.
- **Strengthening performance management should be emphasised in the personnel, procurement and regulation functions of government:**
 - Expand the performance-based personnel recruitment, review and compensation, using performance-based incentives wherever possible.
 - Simplify procurement rules and regulations and shift more to e-procurement and common service procurement. Focus procurement review on larger-scale, longer-term projects.
 - Reduce regulation and administrative paperwork and expand the use of e-government to reduce the bureaucracy of the system.

Notes

1. For further information concerning accruals, see Robinson (2009) and Blöndal (2003 and 2004).
2. From the beginning, the process has seemed quite rigid and too dependent on basic technologies such as informatics or the Internet – the only way of applying for a job vacancy is through the site *www.trabajaen.gob.mx* – which is not universally available in Mexico. Moreover, the subjectivity of the final decision has also been criticised, and several contradictions between the PPSL and the Mexican Constitution have been highlighted (Sánchez Tamborel, 2007; Guerrero Orozco, 2007).

Chapter 5

Improving Accountability for Results: Performance Budgeting and Management Reforms

Mexico, like most OECD countries, is under pressure to enhance the efficiency and effectiveness of public spending. An important step in this process is to obtain objective information on the performance of programmes and agencies. Performance information allows governments to measure progress towards achieving their goals and to know what programmes and policies are working and those that are not. The majority of OECD countries are seeking to improve the development and use of performance information through performance management and budgeting reforms. These reforms aim to shift the emphasis of budgeting and management away from a focus on controlling inputs and following rules and regulations towards a focus on results.

This chapter examines the Mexican government's latest performance budgeting and management reforms. The Performance Evaluation System (*Sistema de Evaluación del Desempeño* or SED) is the main component of this reform package. The overall objectives of this initiative are to improve public sector efficiency and effectiveness at both federal and state levels and to enhance accountability to citizens and to the legislature.

This latest reform has a strong imperative and is being driven by a number of factors, including the need to improve the performance of key services such as health and education, which are seen as vital for alleviating poverty and enhancing economic growth. Recent OECD experience demonstrates that giving more funds to key services does not necessarily generate improved results. Enhancing performance involves monitoring and evaluating the results produced with funds, and using this information to implement changes in organisations, administrative capacity and programmes that will support a focus on, and achievement of, results. In addition, in Mexico providing more information on public sector performance to citizens and the legislature is part of efforts to increase trust in public institutions and to meet the demands for greater accountability generated by a stronger legislature and enhanced political party competition. Furthermore, as the government increases its tax base it becomes increasingly important to demonstrate to citizens what is being achieved with their taxes.

In the first year of implementation, this reform has made good progress. It is necessary to keep the momentum going and to push forward with implementation and address the challenges, if the reforms are to achieve their objectives. Furthermore, the current crisis gives greater imperative to

the government's efforts to achieve better value for money and improve efficiency and effectiveness.

This chapter is divided into six sections. The first section provides a brief summary of the history of performance reforms in Mexico. The second section gives an overview of recent reform initiatives and describes the Performance Evaluation System known as SED. The third section describes the implementation of SED to date and the progress made. The fourth section draws on OECD country experiences and examines different approaches for addressing the challenges ahead. The fifth section discusses possible next steps. The sixth section presents conclusions and recommendations.

1. Historical context

In Mexico, efforts to improve the efficiency and effectiveness of public expenditure have been ongoing for over 15 years. Reforming the public sector has been a recurring theme of several presidential administrations. But, in fact, new initiatives were often introduced without regard to what had gone before and without following through on actual implementation. The result has been a “start/ stop” nature of many reform efforts.

The first incarnation of performance budgeting in Mexico was in the 1970s. The 1976 Budget, Accounting and Public Federal Expenditures Law introduced programme budgeting and required that objectives and goals be defined for each programme. The programme budgeting classification was implemented, but the traditional economic and other budget classifications were also maintained. There was no significant development or use of performance information resulting from this initiative.

More recent efforts at improving public sector efficiency and effectiveness took place under the presidency of Ernesto Zedillo (1994-2000). The *Programa para la Modernización de la Administración Pública* or PROMAP (Programme for the Modernisation of Public Administration 1995-2000)¹ began by setting out the failures and deficiencies of previous reforms. These deficiencies included: the limited capacity of the public administration to satisfy increasing demands of citizens; the lack of a professional public service; over-centralisation within the administration; and poor procedures and lack of interest in measuring and evaluating government performance. Another deficiency was overemphasis on compliance with juridical and administrative rules and regulations.

PROMAP sought to address these problems by establishing a wide-reaching reform programme. One aspect of this programme aimed to strengthen accountability mechanisms by developing a modern system for

control and performance evaluation. This reform required the establishment of clear, quantifiable objectives and performance indicators for federal programmes. By 1997, agencies had to submit a specific set of performance indicators to SECODAM (now called the Ministry of Public Administration) and to the Ministry of Finance, and negotiate for their acceptance. Agencies had to demonstrate the impact of their programmes on clients and society and show that proposed institutional goals were achieved. In addition, in 1998 the budget framework incorporated a chapter on evaluation which stated that social programmes (like *Progres*a, currently called *Oportunidades*²) should be evaluated.

In addition, the National Programme of Finance Development (PRONAFIDE 1996-2000), sought to introduce a new programmatic structure (NEP), foster a strategic planning approach to budgeting, and improve the evaluating and monitoring of programmes. PRONAFIDE set objectives and performance indicators for government institutions and activities. The NEP aimed at closer co-operation of the budgetary authorities with the personnel in charge of public expenditure and with the people responsible for the execution of public policies.

Although the reforms continued under President Vicente Fox (2001-06), they were not a high priority. President Fox's administration introduced its own reform and established the Presidential Targets System (SIMEP). Each member of cabinet was required to commit (to the President) to achieve measurable results in his/her area of responsibility. SIMEP also established a system to follow up and monitor the achievement of results.

The reform efforts of the 1990s and early 2000s made some progress, although not as much as expected. These initiatives encountered problems with implementation, including excessive paperwork, lack of political interest, and a failure to engage line ministries in the reform efforts. By 2005, there was no regular or systematic evaluation of performance in the federal administration. While indicators were included in the budget and in the operational rules of the federal programmes, they were overwhelmingly process indicators. They did not measure outputs, outcomes or impact on the population. Impact evaluations were only conducted for some social programmes. The performance indicators and evaluations generated were barely used in decision making.

2. Overview of recent reform initiatives

In 2006, the Mexican government launched a new system of performance budgeting and management. This initiative sought to build on the positive aspects of previous reforms; however, it differs from them in

several ways. First, the details of the reforms have been enacted in legislation. Given the legalistic nature of Mexican public administration, this is an important step. Second, these initiatives seek to reform not just the federal government but also state governments. Mexico is the only OECD country to seek to introduce performance budgeting simultaneously at the federal and state levels (see Annex E). Third, these reforms have political support at the highest levels. President Felipe Calderon Hinojosa's fiscal policy aims to maintain stable public finances while increasing investment in social and economic development and infrastructure which are necessary for economic growth. He has announced that these reforms are an important part of his policy, and that evaluating the results of programmes will help to improve expenditure allocation by giving priority to sectors and programmes that are working and achieving results.

As discussed in Chapter 1, these reforms have been introduced mainly through the 2006 BFRL and the 2007 IFR legislative package. The 2006 BFRL states that spending institutions are responsible for management by results and are required to establish goals and objectives for their programmes and to evaluate results. The law has a special chapter³ about how evaluations should be managed and conducted, including the requirement that evaluations be conducted by external experts, as well as a set of rules and principles to assure that investment projects are properly evaluated (see Annex C).

The IFR reform package, which was approved in September 2007, required the creation of an Annual Evaluation Programme. The reform package elaborated on the overall framework for performance budgeting and management. It also called for the creation of a federal programme known as the Management Improvement Programme (PMG) which aims to improve the efficiency and effectiveness of public sector management. The PMG aims to monitor and evaluate the management processes and the quality of public service delivery.

At a federal level, the current system of performance budgeting and management is complex and has several components. The overarching framework of the performance budgeting and management initiative is called the Performance Evaluation System or SED and is described below.

2.1. Performance Evaluation System (SED)

Mexico has implemented budgeting for results through the creation of the Performance Evaluation System (SED). The development of the SED began in 2007. The SED has two main components:

- The first component is the evaluation of budgetary programmes and policies. This involves the development of performance indicators, known as strategic indicators, to measure programme outputs and outcomes. In addition, it involves conducting different types of programme and policy evaluations. The programme evaluations are carried out as part of the government's Annual Evaluation Programme.
- The second component is the evaluation of management processes and public services. This focuses on improving the management processes within the public sector and the quality of service delivery. This involves the development of performance indicators, known as management indicators, to measure and evaluate management processes and public services. This activity is conducted through the Management Improvement Programme (PMG).

In addition to producing the performance information described above, the SED seeks to link planning, budgeting, and reporting. The aim is to ensure that the performance information generated by SED is used in planning and budgetary decision making.

To support this alignment of budgeting and planning, the Ministry of Finance issued guidelines in 2007 for a new budgetary classification by programme. Such a classification would reinforce the Budgeting for Results initiative and the alignment of budget programmes with the National Development Plan. Budgetary programmes were arranged in different groups and types. Programmes that had grant subsidies and operational rules in place were required to develop performance indicators using the Logical Framework Methodology (see Box 5.1).

This new programme classification, combined with the Logical Framework Methodology, aims to allow a greater linkage between the goals in the national and sectoral plans, the objectives of budgetary programmes, and the performance indicators developed for these programmes. In theory, the design of the SED should allow follow-up of the goals of the National Development Plan. The relationship of the SED to Budgeting for Results and the National Development Plan is represented in Figure 5.1.

Box 5.1. Logical Framework Methodology (Matrix of Indicators for Results, MIR)

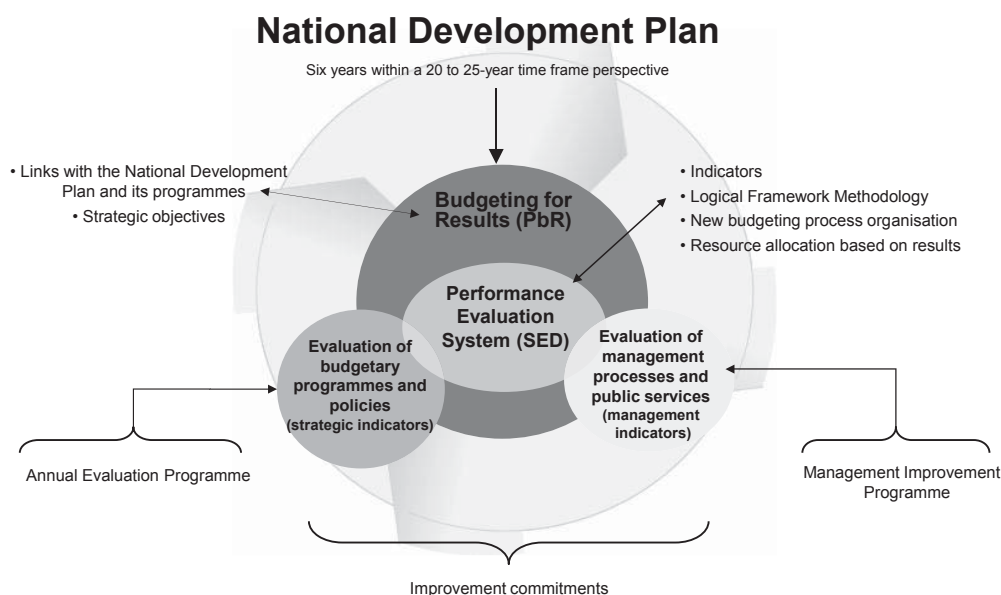
The Logical Framework Methodology, which in the Mexican case is called the Matrix of Indicators for Results (*Matriz de Indicadores de Resultados*, MIR), is also used in countries like Chile and Colombia as a tool in the evaluation of results of public programmes and indicators. The MIR underpins the development of programme evaluations and also the development of performance indicators to be included in the budget.

The matrix is a structured way of presenting information about the objectives of a programme, how the achievement of these objectives is going to be evaluated, and the risks to be faced during programme execution. The four-by-four version of the matrix was adopted in Mexico. The four rows (top to bottom) are: goal, purpose, components, and activities (*fin, propósito, componentes, actividades*). The four columns (left to right) are: objectives, indicators, means of verification, and risk scenarios (*objetivos, indicadores, medios de verificación, supuestos*). The indicators column is divided into three parts to register the name of the indicator, the formula for calculating it, and the frequency with which the indicator will be measured. The matrix is presented under a template that identifies the budgetary programme, and the alignment of the programme with institutional, sectoral and national development objectives.

The matrix is complemented by a form to record detailed information about every indicator included in the matrix. The form includes data that identify the programme(s) to which the indicator belongs, information about the indicator and its characteristics, goals set for the indicator, information about the variables that enter into the calculation of the indicator, and additional references. Completing the form is a cumbersome task, especially considering that a matrix may have 50 or more indicators. The one-to-one linkage between budgetary programmes and a matrix in some cases is difficult to achieve in practice because funding for some programmes comes from several ministries and budgetary programmes. Also, a single “budgetary programme” can assign resources for pursuing different goals and thus more than one matrix is needed. In practice, the introduction and implementation of MIRs proved challenging, as expertise in this methodology did not exist in Mexico. In order to implement the methodology, an extensive training programme involving external international experts had to be organised. However, MIRs create a sound process for defining indicators and goals, and they are an important contribution to the usefulness of the evaluation component of the SED.

Objective of the public administration policy of the National Development Plan (sectoral, institutional, special or regional objective):						
Strategic objective of the ministry or agency:						
Budgetary programme:						
	Objectives	Indicators			Means of verification	Risk scenarios
		Name of the indicator	Formula	Measurement frequency		
Goal						
Purpose						
Components						
Activities						

Figure 5.1. Budgeting for Results (PbR) integral outline



Source: *Secretaría de Hacienda y Crédito Público*.

Although the Ministry of Finance has overall responsibility for the SED, currently three institutions have a role in administering this initiative: CONEVAL, the Ministry of Finance, and the Ministry of Public Administration.

The first component of SED (the evaluation of budgetary programmes) takes place as part of an Annual Evaluation Programme for which the Ministry of Finance and CONEVAL are responsible (CONEVAL for social programmes and the Ministry of Finance for other programmes). The second component (the evaluation of management processes) is implemented through the Management Improvement Programme (PMG, *Programa de Mejoramiento de la Gestión*) and is the responsibility of the Ministry of Public Administration.

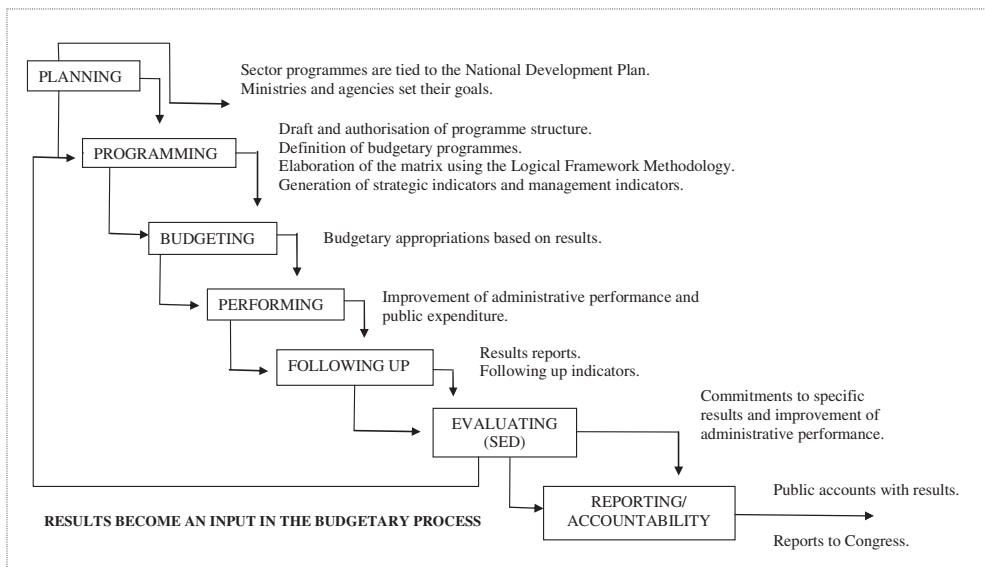
In sum, line agencies and ministries establish programme objectives and develop performance indicators. Two types of performance indicators are included in the annual budget: strategic indicators and management indicators. In addition, ministries are responsible for co-ordinating evaluations.

The Ministry of Finance and CONEVAL published guidelines for line ministries on the evaluation of federal programmes (*Lineamientos Generales para la Evaluación de los Programas Federales de la Administración Pública Federal*). These guidelines established in great detail the type of evaluations to be conducted and specified the methodology approach to be taken. The guidelines require the use of the Logical Framework Methodology or, as it became known in Mexico, the Matrix of Indicators for Results (MIR). This methodology underpins not only evaluations but also the development of performance indicators for the budget.

Each year, the Ministry of Finance, the Ministry of Public Administration and CONEVAL prepare and publish the Annual Evaluation Programme.⁴ This programme establishes the type of evaluations to be conducted and which programmes and policies will be evaluated.

In theory, the results of strategic and management indicators and the results of programme evaluations should inform budgetary decisions for the following fiscal year. The entire Budgeting for Results annual cycle is described in Figure 5.2.

Figure 5.2. The Budgeting for Results annual cycle



Note: SED = Performance Evaluation System.

Source: *Secretaría de Hacienda y Crédito Público*, March 2008.

3. Implementing the Performance Evaluation System

Since the SED began in 2007, progress has been very rapid, specifically in the evaluation of budgetary programmes. Work on the second component (the evaluation of management processes, through the PMG) is still in the initial stages. This section largely concentrates on the first component of the SED (the evaluation of budgetary programmes) and discusses the development of evaluation guidelines for line ministries, the training of line ministries, and the presentation of results.

3.1. Developing guidelines for line ministries

The Ministry of Finance and CONEVAL have the leading role in handling the evaluation component of the SED. Before 2007, evaluations of federal programmes had no common approach. Different aspects of a programme were analysed in different years. Therefore, no follow-up could be conducted on the implementation of recommendations or on assessing improvements in the results of programmes. Moreover, the quality of the evaluations was not uniform.

To solve this problem, in March 2007, the Ministry of Finance and CONEVAL published general guidelines for the evaluation of federal programmes, which established the Logical Framework Methodology as the common approach to be applied. The guidelines include details of seven different types of performance evaluation which can be divided into two groups: evaluations of policies, programmes and institutions, and evaluations of social and economic impact.

The first group of evaluations includes:

- Evaluation of consistency and results (design and overall performance of programmes).⁵
- Evaluation of indicators (suitability of indicators to achieve objectives).
- Evaluation of processes (outputs and productive efficiency).
- Specific evaluations (intended to improve programmes).
- Additional evaluations (any additional aspect).

The second group of evaluations consists of:

- Impact evaluations.
- Strategic evaluations (alignment between objectives and results).

Not all of these evaluations are conducted on the same programme simultaneously; rather, the decision about what type of evaluation to conduct and on which programmes is taken when the Annual Evaluation Programme is established. Different criteria are used to select programmes for evaluation. For example, consistency and results evaluations were carried out on programmes that were in their first year of implementation or that had undergone significant changes in design and/or management. The evaluations in 2008 concentrated particularly on ten programmes in the agricultural and social sectors.

All evaluations are conducted by external experts appointed by the relevant line ministry. The completed evaluations are sent to CONEVAL and the Ministry of Finance by the institutions responsible for the programmes.

3.2. Training line ministries

In implementing the SED in the first year, reformers encountered two major challenges. First, the Logical Framework Methodology (Matrix of Indicators for Results) was barely known in the Mexican public sector before this reform. An extensive training programme, with the help of international consultants, was needed to inform and train government officials. Second, implementation had to be very rapid because the Matrix of Indicators for Results had to be ready for the 2008 budget.

Given the lack of knowledge about the Logical Framework Methodology, an ambitious training and technical assistance programme was developed. By the end of March 2007, the Ministry of Finance and CONEVAL, with the help of the Economic Commission for Latin America and the Caribbean (ECLAC) and the Inter-American Development Bank (IADB), started a series of executive seminars for directors of ministries and programmes. The objective of these seminars was to inform participants of the procedures and methodology for evaluating programmes during fiscal year 2008. Approximately 600 directors attended these seminars, and 280 more came to a second round in June 2007. The Ministry of Finance also received technical assistance and a grant from the PRODEV programme of the IADB (Programme to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness) to help with the development and training for this reform (for more details, see Marcel, 2007).

Training on how to build a Matrix of Indicators for Results (MIR) was given to civil servants from all the 120 programmes that were required to develop matrices (subsidy programmes and subsidy programmes with operating rules). The MIRs were mostly ready on time for the 2008 budget;

however, problems arose because some of the external consultants hired to teach the methodology did not have the necessary skills and because different approaches to building the matrices were taught by different consultants. In addition, there were some inconsistencies in the guidelines issued by central agencies.

During August and September 2007, around 200 external evaluators were trained on how to analyse the MIRs. In October, those evaluators did a first analysis of the MIR design of the 120 federal programmes. The results of these evaluations were summarised by CONEVAL and used to give the programmes a grade as part of the “traffic light” system discussed below. In late 2007, technical assistance was provided to improve programme MIRs. Between April and June 2008, these MIRs were reviewed, and suggestions for improvement were sent to the programmes through the evaluation units of the federal ministries. This very extensive training programme was undertaken rapidly and completed within 15 months.

During the last months of 2008, training on MIRs was extended to the sub-national level, specifically to state governments. The IADB and the World Bank provided training to officials at the state level on how to develop indicators and matrices. Also, specific training on how to build good indicators was provided to directors of federal ministries and programmes.

3.3. Presenting the results of evaluations: the “traffic light” system

For the first time in 2008, CONEVAL prepared a summary of evaluations for government programmes in the social sectors using a relatively simple grading system: a traffic light – red, yellow, green – was assigned to each programme. This grading was largely based on the results of consistency evaluations. In 2007, evaluations of consistency and results were the most common type of evaluation. In total, 116 evaluations were conducted for subsidy programmes.

In an exercise similar to the United States “Program Assessment Rating Tool” (PART⁶), CONEVAL prepared a set of 100 questions to conduct these evaluations. The questions aim at analysing programme design, strategic planning, programme coverage and targeting, operation, perceptions of the target population, and results. However, unlike the PART system where questions are answered by the relevant agency and the Office of Management and Budget, in this exercise external evaluators answered the questions based on reviews of the agencies’ MIRs. Most questions required binary answers (yes or no) which were justified by the evaluator. The requirement of a binary answer imposes rigidity on the analysis. A programme that almost complies in a given aspect can be assigned a “No”

answer, thereby underestimating design quality or results. Consideration could be given to developing a one-to-five scale for answering most questions.

The binary answers are registered in a worksheet, and a total score for the programme is calculated by assigning weights to the different subjects analysed and to each question. Based on this score, and applying a decision rule that establishes total score ranges and minimum scores for some sections (subjects), a traffic light is assigned to the programme. For example, to contribute to the wider goal of improving the nutritional level of poor children and pregnant women, there is a programme to provide beneficiaries with access to fortified milk. This programme received an overall grade of a green light, indicating that its design and operation enabled it to achieve the desired results. Children that consume fortified milk present less anaemia risk compared to the control group (10.7% *versus* 15.6%) and the children's height is half a centimetre taller compared to the control group.

Results of all evaluations of federal programmes are published by the secretary of state in charge of the programme and by CONEVAL on their websites. CONEVAL also prepares summary reports using the “traffic light” system to summarise the final conclusion of the evaluation regarding the design of the programme. These summaries are sent to the Ministry of Finance, the Presidency, and Congress.

3.4. Progress to date

Rapid progress has been made with implementing these reforms, particularly in terms of developing performance information. Although the situation varies extensively with stakeholders, there have also been signs of progress in using performance information in the decision-making process.

3.4.1. Developing performance information

Extensive efforts have been made to develop additional performance evaluations and to streamline and improve the quality of performance indicators. The 2009 budget contained a total of 246 indicators (184 strategic indicators and 62 management indicators). This is a significant reduction compared to the 2007 budget which included 649 indicators. Also, through using MIRs, efforts have been made to move away from process indicators and towards outputs and outcomes. Table 5.1 summarises the evaluations performed in 2007 and 2008 and programmed for 2009.

The Annual Evaluation Programme for 2009 includes 193 evaluations of 136 budgetary programmes. Hence, 32.2% of budgetary programmes are under evaluation in 2009.

For the 2009 budget period, 70% of the federal programmes will have their own MIR, including all programmes that provide goods, services or subsidies (representing 70% of total expenditures of the federal agencies and ministries that operate those programmes). Half of those programmes will be evaluated by external consultants who will follow up on the recommendations made in the internal evaluations.

Table 5.1. Evaluations completed in 2007 and 2008 and planned for 2009

Type of evaluation	Applied to	2007	2008	Programmed for 2009
Consistency and results	Subsidy programmes	116	34	22
Processes	Subsidy programmes with operational rules	0	0	5
Impact	Subsidy programmes	2	6	4
Strategic	Different policies (such as nutrition, health, microcredit, gender) and "Ramo 33" (earmarked transfers to sub-national governments)	2	1	7
Specific	Different programmes	6	151	155
Total		126	192	193

Source: *Secretaría de Hacienda y Crédito Público*, Mexico.

Despite some initial problems, enormous progress has been made in disseminating the use of the Logical Framework Methodology and the general concepts of evaluation and of results-based budgeting. In almost every Mexican institution at the federal level, and increasingly at the state level, civil servants in the planning and budgeting units of the OMs are aware of the importance of evaluating programme results (not only process indicators, as was customary until 2007) and of the methodology to be applied.

3.4.2. Using performance information in decision making

The main purpose of generating performance information is to use it to improve decision making. Across OECD countries, a key issue is ensuring the use of performance information by key stakeholders because a large

quantity of performance information is developed but never used (Curristine, 2005b). As noted in Section 1 above, the Mexican government has been producing performance information for a number of years, although there was a wide variation in the volume and quality of information developed. A problem with previous reforms was that, for a variety of reasons, key stakeholders did not use the information – the reasons including poor quality, a lack of relevant information, and no motivating interest in the reforms.

When compared with previous initiatives, these reforms have received high-level political attention from many quarters including the President. Given that these reforms – at the time of writing – had only completed the first 18 months of implementation, the effects are not yet evident. However, it is possible to make some preliminary assessments about the use of performance information to date by key decision makers in the Ministry of Finance, line ministries, the Presidency, and Congress.

3.4.3. The Ministry of Finance: performance information in the budget process

With previous reforms, little use was made of performance indicators and evaluations in the budgetary process. In 2007 and 2008, the Ministry of Finance and CONEVAL made a concerted effort to systematically improve the development of performance information through the establishment of guidelines and training. For the 2009 budget, the current administration began to use performance information to align budget decisions and policy priorities in budget formulation.

Driven by strong leadership from the Ministry of Finance, there has been an intense effort to improve the discussion on performance information in the budget process. Building on the development of logical frameworks, the relevant budget analysts from the DGPyPs discussed with their counterparts in line ministries the progress made on the previous year's strategic indicators and proposed indicators and targets for the following year. This information was combined with the self-assessment from ministries and the "traffic light" system developed by CONEVAL to create a summary picture of the performance of programmes and ministries.

The aim of this summary was to give high-level decision makers accessible performance information. When the top political officials of the Ministry of Finance met with the Presidency to discuss the ceilings for each ministry, they not only discussed information on proposed allocations and ceilings but also some summary performance information. Officials pointed out that the performance data were a formal input for these negotiations.

Although it is impossible to ascertain their precise impact on allocation decisions, anecdotal evidence suggests that a few programmes received additional resources for performing very well, under the assumption that these additional resources would be well spent and would help achieve high-level goals. Previously, performance data and impact evaluations demonstrated that replacing dirt floors in low-income houses had a high impact in terms of improving children's health and quality of life. The government thus decided to drastically expand an existing programme for the provision of cement floors in rural regions and established a goal to eradicate dirt floors by the end of 2012 (see Annex D).

In addition, evaluations also highlighted overlaps in some programmes' objectives and roles. Four smaller programmes were merged as a result of recommendations from evaluations. For example, the programme for the efficient use of water and electricity and the programme aiming for full use of hydro-agricultural infrastructure have been merged into one programme because they served the same target group and had similar components.

In this budget round, it appears that performance information played a role in informing a few budgetary decisions, which is good progress for this early stage of the reform process. However, as is the norm in other OECD countries, performance information is used with other information on fiscal priorities. During the last budget round, the government had very pressing priorities, namely to substantially increase spending on internal security. While the Ministry of Finance and the Office of the Presidency took great care to emphasise performance considerations as the security budget expanded to ensure that additional resources would be spent meaningfully and would produce results, such major allocation decisions between sectors are political and are not based on performance data.

If the interest in and use of performance information are to be sustained and increased, it is important that the current efforts continue and that performance information is more formally integrated into different stages of the budget process.

3.4.4. Line ministries

In Mexico in the past 18 months, good progress has been made in raising the awareness of professional civil servants in line ministries regarding these reforms and the importance of measuring and achieving results. As discussed in the previous section, there has been extensive training for civil servants, and several national workshops and an international conference have been held to discuss performance budgeting. The largest international conference, with over 1 000 people, included several ministers, civil servants from line ministries and the states, experts

from OECD countries, and experts from international organisations (the IADB, the OECD, and the World Bank).

Engaging line ministries in this process and getting them to use performance information in decision making involves cultural and behavioural change which takes time to achieve. While most ministries are fulfilling the requirements of the law and developing performance information, to date the extent of use of performance information among line ministries varies widely. The agencies that have been developing performance information for the longest time have made the most progress (for example, SEDESOL). Other ministries have not yet recognised the opportunities that the use of performance information would provide for improving the management of their programmes. It is normal in any reform process to have leaders and laggards. In this case, it is important to: create incentives for the laggard ministries to engage in the reform process; communicate the goals of these reforms and the benefits for line ministries; and address fears over increases in requirements for information and paperwork.

3.4.5. *The Presidency*

The current President has demonstrated a high level of interest in improving the performance of the public sector and in measuring results. Since the passage of the IFR, there has been increased emphasis on achieving results. Performance information has been presented to the Presidency during the budget formulation process. The presidential focus, however, is on achieving high-level political goals contained in the National Development Plan and in *Mexican Vision 2030* (www.vision2030.gob.mx).

At cabinet meetings, the President has emphasised the importance of improving performance and achieving key goals. Within the Office of the Presidency, there is a unit that monitors the performance of ministries in key areas. The focus is on the achievement of 30 high-level outcome indicators. Secretaries of state have a commitment with the President to achieve progress on some indicators that contribute to the goals in *Mexican Vision 2030*. These commitments are not related to the budget.

In addition, the unit follows up on the 260 high-priority indicators set out in the National Development Plan and its programmes, which in theory are related to the strategic indicators in the budget via logical frameworks. Progress on these indicators is reported to the Office of the Presidency every three months. This information is summarised and provided to the President. The current President asks questions about the performance and progress of some programmes. He appears particularly interested in Mexico's progress and ranking in international comparative indicators such as the OECD PISA

study (“Programme for International Student Assessment”) and the World Bank’s “Ease of Doing Business”. He has pressured ministers to improve performance in these areas.

Within Latin America, the current Mexican President is not alone in taking an interest in performance: the Colombian President has developed an extensive system for monitoring performance and a similar system exists in Chile. In addition, the cases of Korea and Mexico demonstrate that a presidential system with a one-term limit creates strong incentives to achieve visible results by the end of the term. However, whether performance information is developed and used as a tool depends on the interest and aptitude of each presidential administration.

A common problem for many presidential systems of government is that a separate set of indicators is developed at the presidential level which is not linked with the indicators published in the budget. Failure to make this connection can lead to multiple indicators, creating heavy information requirements on line ministries. While in Mexico there have been efforts to avoid these problems and to link the national plans with sectoral plans and budget programmes, more work could be done in this area, especially in providing the information and plans in a timely manner that would allow such alignment.

3.4.6. Congress

The Mexican Congress has demonstrated interest in performance issues for almost a decade. For example, a congressional requirement that all social spending be evaluated every year was written into the social development law in 1998. Between 2001 and 2006, SEDESOL sent 82 external evaluations of 30 social programmes to Congress. For a variety of reasons, these evaluations have not often been used by Congress. Some evaluations were of poor quality or contained too much information which was often too technical for policy makers to understand. Obtaining good quality evaluations was difficult, given that there were few academic institutions with the correct level of technical skills to perform these evaluations.

Despite this problem, and in comparison with OECD countries, there is a fairly high awareness of the various monitoring systems. Members of Congress in the Budget Committee and the Audit Committee of the lower house have taken note of some performance data provided by the executive. This general engagement has not been translated into a system in which performance information would regularly be used to inform budgetary decisions. Within OECD countries, this is not unusual, as only 8% of politicians in legislative budget committees often use performance information in decision making (OECD, 2005b). Instead, selected pieces of

information are used in political discussions. This political use of performance information appears to be more prevalent in presidential systems with divided government than in parliamentary systems (Robinson, 2007). For congressmen, paying attention to the pressing day-to-day political issues often outweighs the more mundane examination of performance information.

Within Mexico, while selected congressmen agree on the importance of developing performance information, the role that Congress will play in this initiative has yet to be fully realised. Congress can play an active role in holding line ministries accountable for their performance and in using this information to inform budget decisions. The information should be seen as a means of pushing for improvements in performance to benefit citizens rather than as an instrument for controlling the executive.

Unusually for a performance budgeting initiative, this reform has generated a great deal of interest from key institutional players. While the key actors agree with the general objectives of the reforms, their motivations for supporting the initiative differ as, in some cases, does their ultimate expectation of the use of the information. While there has been progress compared to previous initiatives, it is clear that there need to be continuous efforts to push forward to ensure use, especially by line ministries and Congress. The current progress has benefited from strong political leadership and the support of key actors. To sustain these improvements, this support needs to continue and, over the longer term, it will be necessary to institutionalise some of the current practices and to integrate performance information more into the decision-making processes.

4. Addressing the challenges ahead

The majority of OECD countries have encountered challenges with implementing different aspects of performance budgeting and management reforms. These challenges include improving the quality of performance information, developing the institutional capacity of central and spending ministries, and changing the culture and behaviour of civil servants and politicians so that they focus on performance.

Like in most countries, the Mexican government faces challenges with implementing these initiatives. Some challenges are similar to other OECD countries, while some are unique to the Mexican context. This section examines these key challenges and suggests ways to address them. The challenges include: improving institutional co-ordination and co-operation; improving the quality of performance information; integrating performance information into the budget process; engaging line ministries in the reform

process; and shifting from compliance to a performance culture by changing government-wide accountability and incentive structures.

4.1. Improving institutional co-ordination and co-operation

Mexico is unusual among OECD countries in having three institutions with overlapping roles and responsibilities for these reforms: the Ministry of Finance, the Ministry of Public Administration, and CONEVAL. The Ministry of Finance and CONEVAL are responsible for the first component of the SED (evaluation of budgetary programmes). The Ministry of Public Administration is responsible for the second component (evaluation of management processes). Both the Ministry of Finance and the Ministry of Public Administration are establishing evaluation units to support the implementation of these reforms.

In most OECD countries, only one institution has the lead responsibility, although that institution varies by country. In centralised public administration systems, it is generally the Ministry of Finance that is responsible for performance budgeting initiatives, as is the case, for example, in Chile and France. There are some exceptions, such as Poland and the United Kingdom, where responsibility for these initiatives has oscillated between the Prime Minister's Office and the Ministry of Finance.

A key challenge facing the Mexican government is improving institutional co-ordination and co-operation. In practice, the fragmented institutional responsibility for different components of the reform is a potential source of co-ordination problems. Earlier efforts were made to address this issue. In March 2007, a proposal by the Ministry of Finance was presented to Congress⁷ to assign the evaluation of the results of all federal programmes to CONEVAL, and the evaluation of public management processes to the Ministry of Finance and the Ministry of Public Administration. However, it was defeated in Congress, leaving the Ministry of Finance as the main institution responsible for implementing the SED. Co-ordination among institutions needs to be improved, especially between the Ministry of Finance and the Ministry of Public Administration.

Currently efforts are under way to address the problem through proposals to create a co-ordinating council or working group and to more clearly define the role and responsibilities of each institution. The proposal is that the co-ordinating council be headed by the Ministry of Finance and also include the Office of the Presidency, the Ministry of Public Administration, and CONEVAL. The main functions of this permanent co-ordinating council would be to serve as a link between the four key institutional actors that are part of the performance reforms and to act as a place where line ministries can bring up enquiries and receive assistance in

implementing and improving their performance management and budgeting initiatives.

The role of the Ministry of Finance would be to focus on the results-oriented budget process and on developing strategic indicators and performance-informed budgeting.⁸ Within the Ministry of Finance, the Unit for Budgetary Evaluations, established to implement the reforms, will have 25 officials. It will chair the co-ordinating council and lead the co-ordination of the whole budgetary and management performance evaluation process. It will formulate regulations related to the SED and its systems and produce quarterly reports with the information. This unit, together with the Budgetary Policy and Control Unit and the DGPYPs, will co-ordinate the follow-up of evaluations and of the strategic indicators. It will also collaborate with CONEVAL on managing the national register of external evaluators.

The role of the Ministry of Public Administration would be to operate the budgeting and management for results initiative, together with the Ministry of Finance. The evaluation unit in the Ministry of Public Administration known as the Unit for Management Evaluation on Government Performance will have a staff of 25 officials. This unit will work on the Management Improvement Programme (PMG), validate management indicators, and assist the line ministries in management issues related to the SED. In addition, the unit will operate the Council for the Government Evaluation System.

The role of CONEVAL would be to work on result-oriented evaluations of social development programmes and to participate in the co-ordinating council on developing methodologies for designing and building indicators and measuring performance, especially for social programmes. CONEVAL will work with the Ministry of Finance and the Ministry of Public Administration to validate those indicators so that they can be included in the SED.

The role of the Office of the Presidency would be to oversee and monitor the correct alignment between the National Development Plan and budgetary programmes and to follow up on key indicators that are of interest to the President.

This co-ordinating council is a necessary institutional feature to facilitate co-operation and co-ordination between the key actors in this reform initiative. It is important that this group be created and that the exact status of the group and the formal procedures are clearly defined. Previous attempts in 2007 by the Office of the Presidency to create an informal co-ordination committee to discuss the reforms, including the SFP and the SHCP, did not work, as all parties did not continue to participate in the

meetings. It is important that the key institutional players co-operate if this initiative is to succeed. Additionally, it is important that the co-ordinating council be on a formal institutional footing.

4.2. Improving the quality and meaningfulness of performance information

A key challenge facing governments is improving the quality of performance information. While nearly all OECD countries develop performance information, it remains difficult in many areas to measure government activities and to improve information quality. It takes a number of years to develop good quality and meaningful performance information. It is important that all countries, including Mexico, be realistic about the time involved.

Over two-thirds of OECD countries develop evaluations and/or performance measures. In 2007, 24 out of the 30 OECD countries reported developing a combination of output and outcome performance measures (Lonti and Woods, 2008). In addition to developing performance measures, governments include performance targets in budget documents but the number varies extensively across OECD countries, from the United States with over 3 000 performance targets to Korea with around 1 000 and Sweden with only 48 performance targets included in the budget.

While there is no optimal number, countries continue to struggle with the number and level at which targets should be set. Too many targets can create information overload and make prioritisation more complex; too few may not provide enough information and can create distorting effects (Curristine, 2005a). For example, staff and management might concentrate only on a few targets that are the most achievable or saleable, at the expense of the overall objectives of the programme. In extreme cases, agencies under pressure to meet targets may deliberately present misleading information.

There are also problems with setting targets too low or too high. When targets are set too low, agencies are not challenged to improve performance (for more detailed information, see OECD, 2007i, p. 68). When they are set too high, they can motivate agencies to achieve goals, but they can also create unrealistic expectations and situations in which agencies can fail. It takes time to get both the level right and sufficient comparative data to ascertain if targets are set at too high or too low a level (OECD, 2007i, p. 68).

When starting out on performance budgeting reforms, there is a tendency for countries to use a large number of performance measures and/or targets. For example, the United Kingdom started with

600 performance targets in 1998 and reduced this number to 30 outcome targets in 2009.

Starting with a large number of targets can reflect the perception that a programme must have a target so as to be considered relevant. In addition, there is a tendency to measure everything and to provide all the performance information to all stakeholders rather than tailoring information to users' needs. The information that managers need in order to manage their programmes is not the same as that needed by central agencies or by politicians. Congress and the President are interested in outcomes and in whether policy goals are being achieved.

OECD country experiences highlight a number of general lessons to help improve the quality and meaningfulness of performance information. In developing performance information, it is best to be simple and to use a common sense approach rather than spending time trying to develop the perfect system. It is important to avoid starting out with an unmanageable amount of indicators. The end users must be kept in mind, and how the information will be used and tailored to meet their needs.

If targets are set, they should be the product of a strategic planning process, and there should be a baseline measurement and reliable information sources for monitoring. Good targets should be SMART (specific, measurable, achievable, relevant, and timely) and jointly outlined and agreed with those delivering the service (OECD, 2008b). Also, countries should seek to develop a formal quality control process.

In many countries, reform efforts initially concentrate on quantity as opposed to quality and on outputs as opposed to outcomes. Previous Mexican reforms have concentrated on quantity to the neglect of quality. The poor quality of evaluations and performance indicators has been a factor in explaining the failure of key actors to use this information.

Under the recent reform initiative, there has been a reduction in the number of performance indicators in the budget. The 2009 budget included 246 indicators, a big reduction from more than 1 000 indicators nearly ten years ago. There have been clear efforts to improve the quality of performance indicators and these efforts are continuing. There should be clear guidelines for developing indicators, which should take account of the lessons learned from other country experiences. Ideally, one common set of guidelines should be agreed by central agencies and issued. Preparing such guidelines could be a role for the proposed co-ordinating council.

More training and guidelines could aid line ministries in developing higher quality measures, including outcome measures, and in understanding the relationship of outputs to outcomes. More medium-term outcome

measures could help to more closely align the performance information in the budget with the National Development Plan, the presidential priorities and, if it is developed, with a medium-term expenditure framework.

These reforms have also sought to improve the quality of evaluations by issuing common guidelines and methodologies for all ministries, requiring the use of external evaluators, and providing training to line ministries. In developing these guidelines, the reforms have benefited from the expertise of CONEVAL. However, in general within Mexico, the evaluation expertise needs to be expanded along with the number of external evaluators. Also, measures need to be implemented to minimise the possibility of conflict of interests among external consultants that are paid by the institution whose actions are being evaluated.

The presence of CONEVAL and the creation of two new evaluation units will help the development of expertise in evaluations in the central agencies. The current proposal is to create a national register of external evaluators and to produce guidelines on contracting external evaluators for line ministries. It would be helpful to have a system for line ministries which would allow them to receive feedback on the quality of their evaluations and also facilitate follow-up on the recommendations. However, more needs to be done to develop a local market for external evaluators, by encouraging either CONEVAL or universities that have the expertise to conduct capacity building or training on evaluations.

The Federal Supreme Audit Office (ASF) has a role to play in examining performance information, to help improve the indicators and the quality of the evaluations. The ASF will report to the legislature on the implementation of its recommendations. However, it is important that sanctions should not be applied to individuals or organisations as is the case with financial audits. Performance information is not the same as financial information. Applying sanctions in a similar manner creates the danger that the reforms will merely involve compliance instead of performance. It is important to take account of the fact that building good quality data and performance measures takes time.

4.3. Integrating performance information into the budget process

An important issue facing OECD countries is integrating performance information into the budget process in a systematic manner. Countries integrate performance information into their budget by changing their budget structures and using performance information as part of discussions on budget formulation at different levels, including negotiations between the central budget authority and line ministries and between line ministries and their agencies.

In 2007, almost two-thirds of OECD countries reported using performance against targets and evaluation reports as part of the budget discussions and negotiations between the central budget authority and ministries. In some countries, however, discretion is given to ministries concerning the inclusion of performance information in their budget submissions. In Denmark and Sweden, ministries have discretion over whether to provide such information; in contrast, in Korea and the United Kingdom, performance information is required.

While performance information is used, its application is not necessarily systematic and its impact on allocations varies greatly according to the country and organisation. For example, in Sweden the central budget authority used performance information regarding less than 20% of organisations to inform its budgetary decisions. This situation contrasts with Korea where the central budget authority used performance information to determine budgetary allocations for over 80% of government organisations. Korea is very unusual in its use of performance information to determine budget allocations.

The majority of OECD countries that use performance information engage in performance-informed budgeting. In this case, performance information is used to inform budget decisions along with other information pertaining to macro restrictions on fiscal policy and political and policy priorities. There is, however, no automatic or mechanical linkage between past or proposed future performance and funding. Performance information is important but does not have a predefined weight in the decisions. The final weightings will depend on the particular policy context.

Countries have taken different approaches to institutionalise the use of performance information in budget negotiations. Some countries have created special evaluation units which supply performance information to budget examiners who negotiate with the line ministries. In some cases, these units participate in budget discussions with the line ministries. Chile is an example of this approach.

In other countries, the responsibility for this issue has oscillated between budget examiners and special units. In France, the situation is more complex. To implement the 2001 *Loi organique relative aux lois de Finances* (LOLF, organic budget law), a special Budgetary Reform Directorate was established in early 2003. With the change of government in 2005, it was decided to combine the responsibility for public administration reform with the existing Budgetary Reform Directorate, resulting in the creation of one general directorate of public sector modernisation to implement the LOLF and other public sector reforms. With the completion of the implementation of the LOLF, and its integration into the budget, the

responsibility for performance information has transferred to the Directorate for the Budget which is responsible for budget formulation.

In the United States Office of Management and Budget (OMB), management and performance issues were the responsibility of a separate division. However, it was felt that, due to time pressures, performance issues were being neglected in the budget negotiations. This is one of the reasons why responsibility for the Program Assessment Rating Tool (PART) was given to the budget examiners, leading to a greater awareness and use of performance information in the budgetary process.

Countries have taken different approaches adapted to their individual circumstances. However, experience highlights that while it is important to have the expertise of a special unit, it is also vital that the budget examiners be involved if this information is to form a real part of budgetary discussions and negotiations.

In the case of Mexico, the DGPyPs were heavily involved in the first year of implementation, and negotiated the performance measures and targets with the line ministries. This involvement has worked very well. As discussed above, a special unit with expertise in performance information is being created in the Ministry of Finance. It is important that this unit and the DGPyPs work closely together. Their co-operation could include the exchange of information and participation in negotiations with line ministries as part of the budget process. It could also include secondments of personnel so that staff in the evaluation unit will obtain budgeting experience and *vice versa*.

The integration of performance information into the budget formulation process can take place in three stages. First, internally within the Ministry of Finance, there could be meetings between the evaluation unit, the DGPyPs and the Budgetary Policy and Control Unit to discuss the performance of individual programmes. This discussion would be based on information supplied by line ministers and information gathered throughout the year from the co-ordinating council and SED. This information and the discussions could result in summary information on the performance of individual programmes for discussion with ministries.

Second, in budget negotiations with line ministries, staff from the evaluation unit could also be present along with the DGPyPs to assist in discussions about the past and future performance of programmes. These discussions should include follow-up on evaluation recommendations and agreement on the following year's targets, the ministries' proposals, and the resources needed to achieve these targets. It is important that these discussions be an exchange between the Ministry of Finance and the line ministries. The targets should be agreed rather than imposed, and line

ministries should have the opportunity to discuss the issues and challenges facing them in achieving targets.

Third, in higher-level negotiations between the Ministry of Finance and spending ministers when discussing each ministry's expenditure ceilings, the summary performance results and proposed performance for the following year should play a role. As mentioned earlier, in the 2009 budget process discussions with the Presidency included performance information on each ministry. This practice of presenting concise key performance information along with proposals for funding to the Presidency should be continued.

When the agreed expenditure ceilings are sent to the ministers, they could include headline targets and the main proposed improvements to implement recommendations from evaluations for the upcoming year. These high-level targets could reflect the priorities of the President for the upcoming year and be linked to his agreement with ministers.

The key objective of integrating performance information into the budget process is to shift the emphasis of all actors in the budget process away from concentrating on how much money they get towards addressing the question of what is being achieved with this money. As finances become tighter, this question will become more pressing. While this shift requires and has received strong support of the top leadership, it also needs changes in process to help institutionalise the reforms (discussed above). Ultimately, however, to sustain reform requires a change in culture and behaviour which is a more long-term process.

4.4. Engaging line ministries

This section concentrates on how to engage line ministries and civil servants in the reform process and how to shift them towards focusing on results. For line ministries to take part in the reform, they must have the capacity to participate and must see the benefits of doing so. In Mexico, previous reforms have failed to take root because of a lack of engagement of high-level officials and line ministries.

4.4.1. Building capacity

It is important to build up the capacity of line ministries to implement reforms and achieve results. Over the past 18 months, there have been extensive efforts to improve capacity by providing training on the Logical Framework Methodology, performance indicators, and evaluations. As discussed in the previous section, training on developing and improving performance information will continue. Building capacity is also about

developing systems and tools that line ministries can use to integrate performance information into management, planning and budgeting processes. Guidelines and training could also be provided for ministries in this area.

In order to promote the use of this information in decision making, the current budgeting and planning processes within line ministries need to be changed. In some ministries (for example, SEDESOL and the health ministry), this change appears to be happening already. In addition to training, secondments of personnel from line ministries' budgeting and planning units (in the OMs) to the new evaluation units of the central agencies and CONEVAL could also help develop expertise.

Building capacity is an evolving and ongoing exercise. Even in countries that have been working on performance for many years, capacity can vary with individual ministries, and a universally applied reform may not capture or address underlying problems in individual ministries. In the United Kingdom, the government has recently conducted "capacity reviews" of individual ministries to see if they have the necessary financial, personnel and management systems in place to achieve goals. The reviews also examine if these systems are aligned to support a focus on results.

4.4.2. Promoting reform ownership

In addition to training and changing processes, it is also important to identify individuals within the ministries who are responsible for co-ordinating reform implementation and promoting the reforms. In Poland, individual reform co-ordinators at a high level in each ministry are responsible for implementing the reform in their ministry. In Portugal, there is a similar proposal to have a high-level reform co-ordinator report to the minister or his/her representative (Currstine *et al.*, 2008). In France, an individual programme manager is responsible for the performance of the programme and, if requested, must answer questions before the legislature.¹⁰

Within the Mexican government, one suggestion to help engage line ministries is to create a performance co-ordinator in the *Oficialía Mayor* in each line ministry. This person could report to the minister and be the reform champion in the ministry. Also, there could be a working group of government co-ordinators including all performance co-ordinators, which could meet to exchange ideas and experiences.

Establishing formal or informal networks with representatives from line ministries can help ensure the exchange of ideas and best practices. These networks do not have to be only for performance co-ordinators but could also be for more technical level or higher-level staff.

4.4.3. Learning by doing

The best way to promote ownership of performance information is for managers to see how using the information helps them to better manage their programmes and achieve results. In OECD countries, this approach appears to be effective, as line ministries and managers are reported to be the most frequent users of performance information (OECD, 2007k), although within countries the extent of use will vary among ministries and agencies. Those that do use performance information use it for a wide variety of activities, including managing programmes and agencies, setting targets for the following year, justifying expenditure, reallocating expenditure, and pushing and compelling change in programmes. However, to improve performance, agencies need the freedom to implement changes.

4.4.4. Managing reporting requirements

Even an organisation with high-level capacity can be stretched by extensive information and reporting requirements. Creating what can be perceived as excessive information demands discourages line ministries from participating in reforms. In most OECD countries, line ministries work in a context which involves dealing with the demands of several central agencies and specific legislative requirements governing their area. Therefore, they will always face multiple information demands. In Mexico, while the number of indicators included in the budget has been reduced, other legislative initiatives and reforms have introduced more requirements for different programme indicators for planning, budgeting, evaluations, and audit functions. There should be a clear indication of the purpose and use of each measure or category of indicator.

In a few OECD countries (mainly the United Kingdom), critics have argued that performance reforms have increased the rules and the information requirements, creating a compliance exercise as opposed to improving performance.

The volume of performance reporting required of ministries should be manageable. A guiding principle could be that for every indicator added, one is removed. Other factors which can help are automated reporting and connected IT systems: information is collected and collated once but may then be used often. Enhanced technology also facilitates sharing information across central agencies and avoiding duplication of information requirements. The SED system can also help in this regard. Reporting requirements should concentrate on the relevant and important indicators, and the frequency of reporting should be less than that of financial information. In addition, ministries should try to avoid imposing their

internal performance regulations on top of those coming from central agencies.

4.5. Shifting from a compliance focus to a focus on performance: changing culture and behaviour

One of the most difficult challenges facing OECD countries is creating a performance culture within organisations and throughout government. Factors which influence the ease with which this shift can be made are the existing institutional structures and administrative capacity, the prevailing culture of the public administration and individual organisations, and government-wide accountability and incentive structures.

Introducing performance information into budgeting and management processes, in theory, should be accompanied by a relaxation of controls over inputs and by giving agencies increased financial and/or managerial flexibility in the areas of spending and staffing. In sum, managers and agency heads are given flexibility to improve the efficiency and effectiveness of their programmes and are held accountable for the results achieved. These reforms are not just about changing the budget process but about changing the way government does business. This shift requires changes in the government-wide incentive structures and systems of accountability within which all government actors operate, in order to change their culture and behaviour and shift the focus towards performance.

For all countries, moving towards a performance-based system is a challenging process. It is especially the case for public administration systems with a strong legalistic tradition and hierarchical administrative culture which concentrate mostly on detailed control of inputs and on the legality and regularity of public expenditure. This has traditionally been the case in many countries, for example Greece, Mexico, Portugal, and Spain.

The Mexican public service comes from a strong legalistic tradition that stresses adhering to rules and regulations and punishing individuals that fail to do so. Moving from this system to one that stresses performance is a large cultural shift and a long-term process. To help with this shift, there need to be streamlining of the current internal rules and regulations, an increased flexibility in budget execution and in management and personnel issues, and changes in the incentive structures.

4.5.1. Streamlining rules and regulations

The reforms are seeking to move towards a system of performance-based accountability. Accountability for performance will coexist alongside

other traditional mechanisms. The issue is not about completely replacing input controls with outputs/outcomes; it is more about finding the desired mix of mechanisms within a system.

As discussed in Chapter 4, the current system in Mexico has a large number of internal rules and regulations that apply to procurement and to personnel and financial management. These rules are in place in order to ensure probity in the use of public funds and to prevent corruption. Corruption erodes trust in public institutions and has to be seriously addressed; officials who are found guilty of corruption must be punished.

However, having a large number of internal rules does not necessarily achieve this goal. Instead, the implementation and effectiveness of the rules are more important than their number. The current system has evolved over time with new rules imposed on top of old – every new case or management problem elicited a new rule. This accumulation has taken place without an examination of the necessity or effectiveness of these rules or the impact of this approach on the overall culture and system of public administration.

The current system has many rules and norms which focus on applying sanctions for minor errors or mistakes. The result is a culture of fear among civil servants. There are strong incentives for civil servants to concentrate on compliance and avoiding errors as opposed to improving programmes or service quality. This culture also contributes to extensive paperwork and form filling, to a lack of initiative or innovation among civil servants, and to a lack of incentives to improve performance.

Rules become ends in themselves, and the accountability mechanisms stress compliance over performance. The pendulum has swung so far in favour of control and compliance that it is contributing to rigidities which impede efficiency and effectiveness. Other OECD countries also experience similar conflicts. In the United States, rules have been an ongoing problem which reformers have tried to address. For example, former Vice President Al Gore's "Reinventing Government" movement sought to remove unnecessary rules and regulations in the procurement and personnel area and focus on performance.

While having effective systems to prevent and catch corruption is essential, it is also important to balance them with the need to be accountable to citizens for performance. The effectiveness of rules should be reviewed and their numbers streamlined so that the system can concentrate on implementing important rules that work and removing those that are unnecessary, that inhibit efficiency and that contribute towards a culture of fear.

The Mexican government has recently introduced an initiative which proposes to address this issue and reduce the number of rules and remove sanctions for minor errors but more severely punish serious offenses. This proposal is a first step. It takes time to get the balance right and to change the culture.

4.5.2. Increasing managerial and financial flexibility

A performance-based approach, along with reducing rules and input controls, calls for increasing managerial and financial flexibility. Across the OECD, there is no uniform pattern of countries reducing input controls and increasing flexibility. The approach is strongly influenced by historical factors and a country's existing budgeting and public management systems. Countries have different starting points – for example, the Nordic countries have historically decentralised systems of public administration in which service delivery agencies have extensive freedoms. This situation contrasts with the traditionally more centralised and legalistic public administration systems of continental Europe.

OECD countries have taken different approaches to increasing financial and managerial flexibilities for line ministries and agencies. The first approach is a universal approach. Generally as part of wider public sector reforms, central financial or personnel rules are changed to devolve greater responsibilities to all ministries or agencies. This action can also be part of reforms to change government organisational structures, such as the creation of “Next Steps” agencies in the United Kingdom.

A second approach links an increase in flexibility to performance. Flexibilities are earned, not given. Agencies that achieve their performance targets or receive favourable evaluations will be given exemptions from central rules or reporting requirements and/or greater flexibility in spending. Using increased flexibilities or exemptions from reporting requirements as incentives to improve performance is not a widespread approach across OECD countries. The approach has been used in the United States as part of the Government Performance and Results Act of 1993 (GPRA). A pilot phase of this Act allowed agencies to claim exemptions from rules and reporting requirements if they achieved results. This aspect of the reform was not included in the full implementation of the Act because, in practice, it proved difficult for the OMB to grant these exemptions. Many of the regulations from which agencies sought exemption were legislative requirements or were imposed by other central agencies or by the internal regulations of their own line ministry. These constraints in the United States context do not mean that such an approach would not work in other country contexts. What is more common in OECD countries is that underperforming

agencies have increased monitoring and reporting requirements imposed on them. OECD surveys highlight that the most common consequences of poor performance are increased monitoring of the programme and publicising the results (OECD, 2007k).

The third approach is that decisions about delegating responsibility to line ministries are taken on a case-by-case basis as opposed to making across-the-board changes. In this approach, agencies can apply to be granted greater financial and managerial flexibilities; however, the decision to grant these flexibilities is taken on the basis of a number of criteria that go beyond just performance. These decisions can be based on a combination of factors, including: the strength of the agency's internal financial and managerial controls; a risk assessment of the agency; its history in terms of performance; compliance with regulations; and avoidance of corruption, waste, and mismanagement.

A few OECD countries have introduced points or credit systems where agencies are required to meet set criteria in order to have certain exemptions or freedoms. Agencies are assessed and rated and given points or credits based on the extent to which they meet these predetermined criteria. This assessment determines whether they receive certain freedoms or not.

A case-by-case approach could be appropriate for Mexico, as it would allow a gradual devolution of financial and managerial responsibilities to ministries that meet the set criteria while ensuring that necessary safeguards are in place. This approach, combined with the removal of unnecessary central regulations, would encourage increased managerial flexibility to improve performance.

Regardless of the approach taken, one important precondition for devolving resource control to the operational level is that the line ministries and agencies have the necessary modernised financial and managerial control systems in place. Before granting new financial freedom, it is often necessary to modernise and strengthen internal control systems. Systems must be in place to allow agencies to adequately track and control the costs of operations and the performance information required to measure results. New IT platforms could be needed.

Other factors which can influence the success of efforts to delegate managerial and financial responsibilities include: *i*) the willingness of central ministries to relax controls and delegate responsibilities; *ii*) the willingness of individual line ministries to pass on these delegations to their agencies and civil servants and to avoid imposing additional controls (Greer, 1994, pp. 49-50; Hogwood *et al.*, 1999); and *iii*) incentives for civil servants to use the new flexibilities and their willingness to do so.

4.5.3. Changing incentive structures

In order to change behaviour, it is important to understand how the current incentive structures can be altered to motivate civil servants and organisations to focus on performance. It is vital to create the right mix of incentives. Table 5.2 describes potential mechanisms that can be used to motivate agencies to improve performance. These mechanisms can be used not only by the Ministry of Finance or other central agencies, but also within line ministries to motivate agencies and units. These mechanisms are divided into: *i*) financial rewards or sanctions; *ii*) increasing or decreasing managerial flexibilities; and *iii*) public recognition. Managerial flexibilities have already been discussed; this section will discuss the other two mechanisms.

Table 5.2. Potential mechanisms to motivate performance

	Rewards	Sanctions
Funding	Increase (or maintain) agency funding.	Reduce (or eliminate) agency funding.
	Increase staff budget.	Reduce staff budget.
Managerial rewards	Provide remuneration bonuses.	Cut salary of management / head of agency.
	Enhance career opportunities.	Restrict career opportunity of management / head of agency.
Public recognition	Publicly recognise agency achievements.	Publicly criticise agency performance.

Source: OECD (2007), *Performance Budgeting in OECD Countries*, OECD Publishing, Paris.

4.5.4. Financial rewards and sanctions

OECD surveys highlight that automatic or mechanical increases or decreases of funding based on performance results is not a widespread practice across the OECD. Only in Korea is there an automatic 10% cut of the funding of agencies that are ranked as ineffective. There are a number of political, technical and incentive reasons why this type of mechanical approach is not widespread (for more details, see OECD, 2007i), including that performance measures do not explain the underlying causes of poor performance. An approach that automatically cuts funding without understanding the causes of poor performance (which could be based on lack of funding) could make the situation worse and condemn badly performing agencies to continue to underperform.

Most OECD countries are engaged in performance-informed budgeting in which it is important that performance plays a role in budgetary decisions and that this message is communicated to line agencies and ministries. While the influence on funding decisions is not automatic or mechanical, performance can have an effect on funding decisions, and this does happen on a case-by-case basis in some countries. For example, at different time periods in Canada and the United States, performance information has been used along with other information to cut, increase or reallocate expenditures.

However, performance information is more often used to push for changes and improvements in programmes or for their reorganisation or restructuring. In general, poor performance against targets and in evaluations is most likely to result in systematic closer monitoring of programmes. Performance information acts as a signalling device that highlights when there are problems with programmes and agencies. Performance information is also a tool for line ministries in their internal budget process. The information is more often used by line ministries to allocate resources between and within programmes.

For the Mexican government, it is important to communicate to line ministries that performance information can and will play a role in funding decisions – not on an automatic basis but on a case-by-case basis. In addition, the government should give clear examples and highlight cases where this information has been used to influence funding decisions. It is also important to communicate to ministries that this information is useful for them in their internal budget, planning and management processes.

4.5.5. Staff and managerial financial rewards and sanctions

Two-thirds of OECD countries have introduced a system of performance-related pay for government employees for at least part of their civil service. OECD experience highlights that having a system to assess the performance of employees is an important contribution to creating a performance culture. Currently in Mexico, there are efforts under way to reform the personnel system to focus it more on performance.

In moving forward with this initiative, consideration should be given to wider OECD experiences. They highlight that performance-related pay (PRP) can help improve performance if it is applied in the right managerial context – that is, under conditions of transparency, clear promotion mechanisms, and trust in top and middle management (OECD, 2005c). Improvements, however, have less to do with the financial rewards given, which tend to be small in the public sector, than with the changes in the organisation of work and management that are needed to implement PRP. PRP gives managers incentives to fully endorse and establish a goal-setting

approach and a performance appraisal system. Often this approach goes hand in hand with delegated human resource management. OECD research indicates that staff is less motivated than might be expected by the prospect of more pay for better performance. Most public sector employees consider basic pay and how it compares to the wider job market as far more important than supplementary increases for performance. Performance rewards are often very limited in the public sector, and job content and career development prospects have been found to be the strongest incentives for public employees.

Countries also highlight the importance of considering how non-financial rewards can be used to motivate staff. In some countries, these non-financial rewards include giving extra holidays or leave to staff that have performed well, or encouraging staff development through career training and/or sabbatical leave to study.

4.5.6. Public recognition

Across the OECD, some of the main motivations for adopting these reforms are to improve accountability to the public and to demonstrate what is being achieved with taxpayers' money. Countries have taken several approaches in using public recognition to improve performance, including the "name and shame" approach such as publishing league tables. The United Kingdom has adopted this approach to compare the performance of hospitals, schools, and local authorities. In Australia, the performance of the states/territories in key areas is compared and published. These performance comparisons can generate competition among service delivery agencies and motivate them to improve performance.

While information on performance can be made publicly available, it is important that this information is actually used in decision making. Politicians in the legislature can play an important role by examining the reports on programme performance and using this information to hold agencies to account. Having clear, simple, easily understandable and well-presented documents helps this process. The "traffic light" system adopted by CONEVAL could be used when presenting performance information to the Mexican Congress. The media can also play a role in putting pressure on agencies to improve performance.

It is important to see this approach as an opportunity not just to punish but also to reward. In a few countries, public awards are presented by the president/prime minister or the relevant minister to the best-performing agencies or individuals. For example, in the United States during the Clinton era, Vice President Al Gore presented Hammer Awards to organisations that demonstrated excellence or innovation in the delivery of their services. This

approach can also be applied within line ministries where the best-performing units or employees are publicly recognised by the minister.

This section discussed different OECD country approaches to changing accountability and incentive structures. For Mexico, in moving ahead it would be helpful to consider how changes can be introduced in the wider government accountability and incentives structures to support these performance reforms. Also, consideration could be given to the right mix of incentives in the Mexican context that could help to change behaviour and culture and move the public sector towards a greater focus on performance.

5. Next steps

To date, these reforms have made good progress. It is important to build on this success and to consider the next steps and their pacing and sequencing. Moving forward, these reforms need to demonstrate success in the short run and plan for the longer term. The people engaged in the reform process need to see changes and proof that the reforms are having an impact and that the information is being used. There need to be “quick wins” and clear messages that the reforms will continue; otherwise people can become sceptical.

In the current circumstances, with the financial crisis and other pressing issues, there is a clear danger that the reforms will be forgotten as other priorities take over. Alternatively, crises can act as a stimulus for change and for pushing reforms forward. The fundamental issue remains of improving the efficiency and effectiveness of public expenditure. Implementation of these reforms offers an opportunity which can produce long-term benefits in this area.

Building on short-term results and highlighting the success of implementation can help to sell the reforms at later stages. In planning for the longer term, it is important to sequence the reforms and to decide on the most effective order in which to introduce changes based on the relationship and interdependence of different reform components. Mexico has already made progress in the area of developing a programme budget and performance information and in efforts to integrate it into the budget process. Moving ahead, a staged and sequenced approach could be helpful. An implementation plan should be developed, with defined timetables, stages, actions to be taken, and milestones to be achieved. The following describes some potential next stages and sequencing of the reforms:

- Improving the quality of performance information and IT support systems, and further integrating performance information into the budget process and other planning and management processes.
- Strengthening and modernising financial management in line ministries. This stage includes a manageable timetable for the implementation of accrual accounting reforms in line ministries and for the development of cost information.
- Changing the government-wide accountability systems and incentive structures. One aspect could be the use of a pilot scheme to test the delegation of financial and managerial responsibilities to line agencies on a case-by-case basis.

OECD experience highlights that these reforms are a long-term process which involves cultural and behavioural change. Having a realistic long-term timeline with stages and goals can help maintain the interest in these initiatives over the longer period.

6. Conclusion and recommendations

The latest performance budgeting and management initiative is part of a reform effort that has been ongoing for over 15 years. In its first year of implementation, the initiative made important progress. Mexican public officials at all levels appear to be aware of this latest initiative. However, in moving ahead, efforts must be made to ensure its continued implementation:

- **Co-ordination among institutions needs to improve significantly.** The roles and responsibilities of the key institutions and ministries – the Ministry of Finance, the Ministry of Public Administration, and CONEVAL – have to be clearly defined and implemented in practice.
- **A co-ordinating council or working group should be established to ensure co-operation among the offices of the different organisations and to prevent duplication of efforts.** This council should include high-level representatives from the Ministry of Finance, the Ministry of Public Administration, CONEVAL, and the Office of the Presidency. The current proposal is that this council be headed by the Ministry of Finance as part of its legal remit to co-ordinate the Performance Evaluation System (SED).
- The new evaluation unit within the Ministry of Finance, which is responsible for operating the Performance Evaluation System

(SED), **should be active in producing reports and information in a timely manner for key decision makers.**

- **Consideration should be given to the continuation and wider application of the “traffic light” system used by CONEVAL for evaluating performance results.** Also, it would be helpful to adopt its proposed timetable for producing performance evaluation reports in time for key decision making in the budget process.
- **There should be clear guidelines on the development and use of indicators.** Recent initiatives have resulted in an array of requirements to produce programme indicators for planning, budgeting, evaluation, programme management, and audit functions. There should be a clear indication of the purpose and use of each measure or category of indicator. To avoid redundancies and confusion, one institution should be clearly in charge of developing guidelines and standards for the development and use of performance indicators.
- **To engage line ministries more in the reform process, the position of performance co-ordinator or manager should be created in the *Oficialía Mayor* in each line ministry.** This person would report directly to the minister and serve as a reform champion in that ministry. To date, it is clear that most ministries have fulfilled the requirements of the law to provide indicators; however, more needs to be done to engage them in the reform process and to encourage them to use performance information to improve the management of their programmes.
- **The initial efforts to include performance information in the budget formulation process are to be commended. If progress is to continue, it is important to institutionalise some of the current practices and to integrate performance information more into the decision-making processes.** For this to be successful, it is important that the new evaluation unit, the DGPyPs, and the Budgetary Policy and Control Unit work closely together.
- **The incentive structure needs to change to reflect this new performance approach.** The current system strongly stresses compliance rather than performance. Moving to a performance-focused approach requires: *i*) the creation of new incentive structures; *ii*) streamlining and eliminating the current excessive internal rules and regulations; and *iii*) increasing flexibility in budget execution and in management and personnel issues.

- **To move ahead, a staged and sequenced approach would be helpful.** An implementation plan should be developed, with defined timetables and stages, actions to be taken, and milestones to be achieved. Potential stages and sequencing could be:
 - First, improving the quality of performance information and IT support systems, and further integrating performance information into the budget process and other planning and management processes.
 - Second, strengthening and modernising financial management in line ministries. This stage includes a manageable timetable for the implementation of accrual accounting reforms in line ministries and for the development of cost information.
 - Third, changing the government-wide accountability systems and incentive structures. One aspect could be the use of a pilot scheme to test the delegation of financial and managerial responsibilities to line agencies on a case-by-case basis.

Notes

1. Refer to http://zedillo.presidencia.gob.mx/welcome/pages/library/od_publicadmon.html.
2. *Oportunidades* (known as *Progres*a until 2002) is the most important anti-poverty programme of the Mexican government. It focuses on helping poor families in rural and urban communities improve the education, health, and nutrition of their children by providing cash transfers to households conditional to regular school attendance and health controls.
3. *Ley Federal de Presupuesto y Responsabilidad Hacendaria, título sexto: De la Información, Transparencia y Evaluación, capítulo II: De la Evaluación.*
4. Refer to www.coneval.gob.mx/coneval2/htmls/evaluacion_monitoreo/HomeEvalMonitoreo.jsp?categorias=EVAL_MON,EVAL_MON-prog_anual_eval#.

5. Using the Logical Framework Methodology, an evaluation is done of a programme's design, activities and components to see if they are consistent and aligned with the achievement of stated outcomes.
6. For a description of PART, see OECD (2007i), Chapter 13.
7. "Sistema de Evaluación del Desempeño, Propuesta a la Cámara de Diputados", Secretaría de Hacienda y Crédito Público, March 2007, available at www.fondodeculturaeconomica.com/Normateca/Reunion_indicadores_resultados/Propuesta_Camara_Diputados.pdf.
8. For an explanation of performance-informed budgeting, see page 21 of OECD, 2007i.
9. Australia and France are exceptions: they began by concentrating mainly on outcomes.
10. This situation refers to programmes in the budget which are more broadly defined than the standard programme.

Annex A ***Programa de Mediano Plazo (PMP,*** ***the Medium-Term Programme)***

The PMP is the tool created to comply with the obligation established by the 2007 reform (the Integral Fiscal Reform, IFR) to achieve 20% savings by the end of the current administration, at a rate of 5% per year. It is a programme for reducing administrative expenses and energy costs.

The PMP requires the executive to reduce its public spending on administrative activities, as well as improve the provision of public services.

The PMP is linked to performance budgeting (Budgeting for Results), the Performance Evaluation System (SED), and the Management Improvement Programme (PMG), in order to achieve a thorough scheme of indicators and results.

Ministries and agencies under the framework of the PMP are required to produce the following information: *i*) policies, strategies and actions to improve the quality of expenditure and public management; *ii*) performance indicators; *iii*) performance agreements; and *iv*) austerity measures.

The PMP binds ministries and agencies to follow austerity rules in the following areas:

- **Salaries and related expenses:** The creation of new posts is restricted to specific cases, and spending on representation of the federal government at the level of sub-national governments and in other countries is to be reduced. Liaison offices are allowed only when they are justified by a more efficient management of human and material resources.

- **Government procurement:** Consolidated purchases and best practices in government procurement are to be used to produce savings and reduce costs.
- **Information technologies:** The use of IT is to be maximised without incurring further expenditure, and technological platforms that represent mid-term net savings are to be implemented.
- **Administrative expenses:** A reduction is in place for expenses related to the conservation and maintenance of property, including real estate, as well as for academic and cultural events.
- **Other savings:** Food, travel and mobile communication expenses are to be reduced.

Ministries and agencies must prepare quantifiable and specific indicators to measure the results of expenditure policies and strategies, including at least one indicator that reports the savings resulting from the application of PMP austerity measures.

Annex B

Oil Revenue Management

Oil prices have been rising significantly since 2002, reaching a high of USD 145 per barrel in July 2008.¹ The huge flows of revenues present an excellent opportunity for large oil exporters, providing access to fresh capital inflows that could be allocated to savings, investment, or external debt cancellation. However, oil price volatility and inefficient management of oil revenues can also generate non-desired effects. Some of the symptoms of the so-called “Dutch disease” include overheating the economy, reducing incentives to improve the tax system, and increasing pressure for exchange rate appreciation or exchange rate volatility.

The following case studies of three large oil producers (Mexico, Russia and Norway) show the different systems for managing oil revenues.

Mexico

After the 1995 Mexican peso crisis, the aim of the Central Bank of Mexico was to accumulate foreign reserves, mainly through the sterilisation of oil revenues coming in through PEMEX. This strategy raised the reserve level from USD 50 billion at the beginning of 2003 to USD 75 billion in March 2007. The increased confidence in the Mexican economy allowed a more favourable access to international financial markets for the public and the private sectors. However, the cost of sterilising foreign currency inflows to avoid appreciation pressure on the local currency was considerable, as the government paid higher interest rates for its liabilities than those received for the investment of the international reserves in foreign markets.

Therefore, in 2003 the government changed its strategy by implementing an efficient non-discretionary mechanism to avoid the non desirable effects of the reserves' accumulation. Through a daily auction mechanism, the government sold part of the inflows that came into Mexico, letting the reserves increase up to a certain level but without generating pressure for the exchange rate appreciation and diminishing its volatility.²

The fiscal rules and mechanisms introduced by the 2006 Budget and Fiscal Responsibility Law (BFRL) are very important for improving the efficient use of the accumulated international reserves, reducing excess discretionary spending in the domestic economy, and preventing the domestic economy from potentially overheating. Surplus oil revenues are first used to offset any budgetary shortfalls arising from the difference between the actual budget and budgetary estimates. Second, surplus oil revenues are distributed to several stabilisation funds in accordance with the rules set out in the BFRL.

Moreover, an important share of these reserves had been used to reduce external debt. In 2008, the government introduced reforms to strengthen the governance structure and transparency of the oil company PEMEX. These reforms aimed to increase the company's flexibility and resources on the condition that it met its modernisation goals. The reform allows PEMEX to use the resources in the stabilisation fund for infrastructure expenditures. It is hoped that these reforms will give the company more flexibility and resources and help to foster capital investments, which are needed to increase production capacity. The reforms also modified the fiscal rule to exclude the long-term PEMEX investment schemes from the balanced budget requirement.

Russia

Since 2008, the main objectives of the Russian Oil Stabilisation Fund have been to insure the federal budget against oil price volatility and to generate future income in order to reduce structural budget deficits. Therefore, the Fund was split into the Reserves Fund and the Prosperity Fund. The latter fulfils the new intergenerational equity function and the former focuses on the original objective – *i.e.* fiscal stabilisation across the oil price cycle. The legislation estimates a minimum of RUB 500 billion and a cap of 10% of GDP for the operation of the Reserves Fund. All revenues exceeding this cap are transferred to the Prosperity Fund.

A number of recent changes have sought to improve the accountability and transparency of the Fund's management. These changes comprise: the inclusion of intergenerational allocation of revenues, the widening of the tax base of the Funds, and the modification of the switch mechanism for the oil

and gas revenue flows between the budget and the Funds (now a nominal transfer defined on a three-year basis according to the budget law). For instance, it was stated that, after reaching a threshold based on a cut-off price, the government could use the surplus revenues for “other purposes” such as repaying foreign debt or covering the Pension Fund deficit. These changes have reduced concerns about discretionary allocations of potential surplus.

Norway

During the past three decades, Norway has experienced a period of extraordinarily stable economic performance. Some of the achievements observed during this period include a low unemployment rate, an increase in GDP per capita from 90% to 150% of the OECD average, a considerable increase in the government’s financial assets, and the cancellation of the debt.

Due to the efficient management of the oil revenue inflows and the petroleum sector in general, the Norwegian economy seems to be more isolated from real oil revenue fluctuations. Norway has managed to avoid the so-called Dutch disease: it prevented massive domestic public spending, avoided periods of excess demand in the economy that could have resulted in exchange rate disadvantages, and prevented the crowding out of other productive economic sectors. That is why the main objective of the Norwegian Government Pension Fund – unlike Mexico’s and Russia’s funds – is to ensure that future generations also profit from the exploitation of non-renewable resources.³

In Norway, predictability and transparency are the pillars of the system. The Fund’s investment strategy is prudently defined by the Ministry of Finance and managed by the Norges Bank Investment Management in order to achieve high returns subject to moderate risk. There are, of course, regulations governing the management of the Fund. For instance, only the investment income (a portion of the Norwegian fund reflecting a notional rate of return of 4% per annum) is allocated to cover the non-oil deficit, and the maximum share that can be taken in any company is fixed at 5%.

Notes

1. As mentioned before, an important reversal has occurred since mid 2008, reducing oil prices.
2. On 25 July 2008, the mechanism to reduce the speed of international reserves accumulation was cancelled. After the cancellation, a more discretionary mechanism was implemented. Since October 2008, because of the uncertainty and the lack of liquidity, the Exchange Commission announced a daily auction of USD 400 million and several extraordinary auctions for a total of USD 8 000 million at a minimum exchange rate 2% higher than that of the previous working day.
3. The Pension Fund Act defines the fund's objective as follows: "The GPF shall support central government saving to finance the National Insurance Scheme's expenditure on pensions and safeguard long-term interests through the use of the central government's petroleum revenues."

Annex C

Public Investment Evaluation System

The 2006 Budget and Fiscal Responsibility Law required the establishment of rules to ensure that investment projects are properly evaluated. The Ministry of Finance (SHCP), through its Investment Unit, manages the public investment system which is an important element for achieving better results from investment projects undertaken by the public sector. Every year the Investment Unit publishes guidelines for the preparation and presentation of the cost-benefit analysis of programmes and investment projects (*Lineamientos para la elaboración y presentación de los análisis costo y beneficio de los programas y proyectos de inversión*).

Following these guidelines, institutions must register in the public investment system the following kind of initiatives:

- Investment programmes and projects (PPI) undertaken by federal public administration institutions.
- Projects whose objective is provision of services.
- PPI supported by special public funds (*fideicomisos públicos*).
- Other investment expenditures as determined by the SHCP.

Registration in the public investment system must be supported by a cost-benefit analysis of each programme or project. Depending on the investment cost of the initiative, the requested cost-benefit studies can be:

- a simple economic justification;
- a cost-efficiency analysis;

- a simplified cost-benefit analysis;
- a pre-feasibility cost-benefit analysis.

Each study is reviewed by the Investment Unit and, if no objections are made, the programme or project is registered in the public investment system.

Annex D

Impact Evaluation of the Social Development Programme on Cement Floors

The programme *Piso Firme* (solid or cement floor)

Between 2000 and 2005, the Mexican State of Coahuila implemented the social programme called *Piso Firme*. Its main objective was to replace mud floors with cement ones to improve the quality of life of vulnerable households living in marginal areas. Because the programme was so successful with 34 000 beneficiaries in Coahuila, it was extended to the national level to cover more than 300 000 households. Its success even generated the implementation of a national strategic goal: the eradication of dirt floors by the end of 2012.

An important impact evaluation and field research were carried out in the metropolitan area of La Laguna to assess the impact of the programme. This urban area is shared by the States of Coahuila and Durango, thus allowing a comparison between households that were part of the State of Coahuila where the programme was implemented and households that were part of the State of Durango where the programme had not been implemented. The main objective of the evaluation was to analyse the impact of the programme on the quality of life of the beneficiaries, with particular attention to health issues. The variables used to assess the programme's impact were divided into five main categories: *i*) prevalence of cement floors; *ii*) satisfaction indicators; *iii*) health indicators for children

between 0 and 5 years of age; *iv*) cognitive development of children and their mothers' mental health; and *v*) economic and demographic indicators.

The results are indisputable: the programme *Piso Firme* had a positive and significant impact on the quality of life of the recipient households; this is reflected in almost all the indicators.¹ One of the strongest *ex ante* hypotheses was corroborated: a positive and significant impact on the different health indicators concerning children. The reduction in diarrhea (by 49%), anemia (by 81%) and parasite cases (by 78%) was striking in comparison with the improvements observed in the control group (only a drop of around 20% for each of the three diseases). The programme showed important improvements in the global satisfaction level of the members of the households, in the mental health of the mothers, and in the cognitive level of the children.

The results concerning economic and demographic indicators were less impressive. In fact, no significant impact was detected regarding migration flows, labour income or the variation of the internal structures of the household (*i.e.* the number of economically dependent members). The variable which did show an improvement was the rate of school attendance for children between 6 and 17 years of age, which increased 7% compared to the control group.

The use of this programme's impact evaluation by key actors highlights how performance information can be used to improve policy making. The impact evaluation also shows how associating specific expected goals with the budget process can allow a better linkage between the allocation of resources and the outcomes of social programmes. Furthermore, because of the important amount of resources invested in these kinds of programmes,² the number of projects subject to evaluations in general should be increased.

Notes

1. In 2007, the number of households benefiting from the programme *Piso Firme* was 94 800 and the goal is to increase this number to 1.9 million for 2012.
2. Funding for the Programme *Piso Firme* in 2009 rose to MXN 4 530 240 000.

Annex E

Requirements on Sub-National Governments as a Result of the Recent Fiscal Reforms

Strengthening local auditing: The technical capability and independence of state legislature audit organs is to be strengthened (head audit officers are to be appointed by a majority of two-thirds of legislators and for seven-year terms). State audit organs are also bound by principles of impartiality and legality (Mexican Constitution, Articles 116 and 122).

Harmonisation of governmental accounting: The Congress passed a law that establishes the basic principles for harmonising accounting systems across three levels of government (federation, states and municipalities) and a shift to accrual-based accounting (Mexican Constitution, Article 73-XXVIII).

Indicators on federal transfers: Since 2008, the executive and the states have to agree on the setting of indicators to measure the results of federal transfers.

Evaluation of results: The three levels of government must evaluate the results obtained with public funds through independent technical expertise (Mexican Constitution, Article 134). Evaluations must be made public: the reports will be made publicly available and accessible via the Internet. Reports will also be sent to the Federal Congress and the state legislatures (Budget and Fiscal Responsibility Law, Article 85).

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