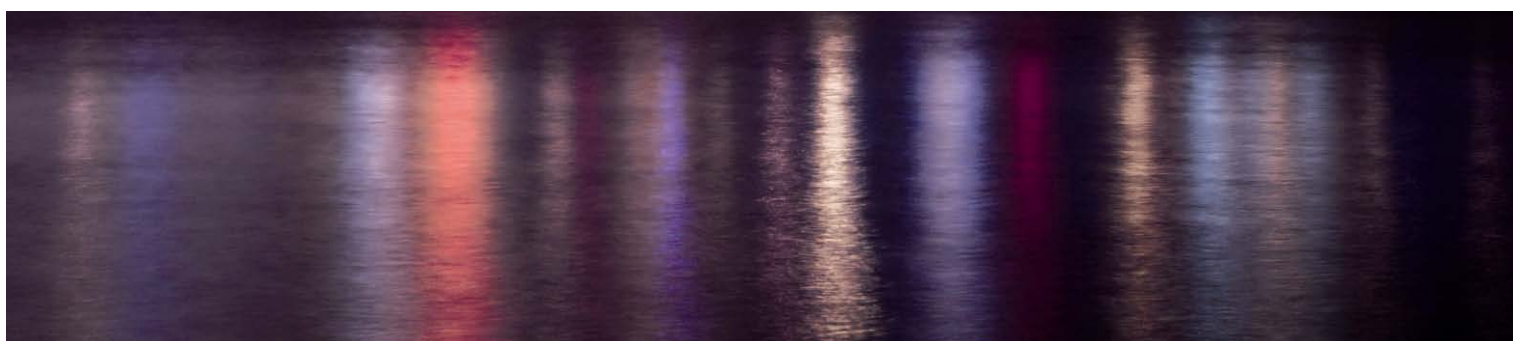




OECD Economic Surveys MEXICO

MAY 2011

OVERVIEW



Summary

Following a deep recession associated with a strong global downturn, Mexico is experiencing a robust recovery, with GDP growth of 5½ per cent in 2010 and 4½ per cent in 2011. Export growth is expected to slow after the exceptional rebound of 2010, but stronger domestic demand should keep the recovery on track. Several labour market indicators have improved, although unemployment is decreasing only slowly. Mexico has already started to withdraw the fiscal stimulus of 2009 and increased taxes to calm market worries about fiscal trends. If the recovery unfolds as expected, the government should fully implement its plans to lower the budget deficit further through spending restraint. Since inflation has come down, monetary policy can support the recovery by keeping rates low in the near term.

Mexico was able to implement countercyclical policies in the recession thanks to significant reforms of the macroeconomic policy framework. However, it should continue to strengthen its policy framework to better withstand shocks. Amending the fiscal rule to accumulate more financial assets during periods of high oil prices and economic growth would give the government additional room to support the economy when confronting large shocks. Taking measures to lower price stickiness related to administrative tariffs and uncompetitive markets would give monetary policy more room for manoeuvre and, most importantly, would contribute to a better allocation of resources. Enhancing competition and lowering market entry barriers would also promote the development of more stable consumer-related services, attenuating the effects of shocks.

Mexico needs to maintain growth-enhancing investments and social policies to catch up with average OECD living standards and reduce poverty. Therefore, the significant effort that has taken place in recent years to strengthen tax revenues should continue, particularly with a view of attaining a more efficient tax system with higher independence from oil revenues. There is also a great potential to increase revenues at the subnational level. This would make sure that Mexico can confront future spending pressures. The Mexican government has made significant efforts to close tax loopholes in recent years, mainly through the adoption of an alternative minimum tax on business income (*Impuesto Empresarial a Tasa Unica, IETU*). Yet, further efforts to remove inefficient tax expenditures would broaden the tax base, increase revenues and make the tax system simpler, thus reducing opportunities for tax avoidance and evasion. Mexico is in the process of increasing fossil-fuel prices, but this should be accelerated to eliminate subsidies and the associated negative effects on the environment. A targeted cash benefit would be more efficient to protect the poor.

Mexico's informal sector, which is large by OECD standards, is a drag on productivity growth. Firms in the informal sector lack access to credit, training and legal protection – so they do not innovate and remain small. Better education, enhanced regulation, and improved incentives to formalise are key reforms to combat informality, as will be stronger enforcement of labour and tax laws. The government should continue its efforts to reduce costs of starting and running a business and of employing workers formally. It should strengthen the value of the mandatory social security package for low-wage workers, while limiting its costs through efforts to raise efficiency.

Weak competition in many sectors and deficiencies in education have been a further brake on productivity. The OECD has co-operated with Mexico in all of these areas to develop a reform agenda. The competition law reform, which has now been passed in Congress, is an important step towards reducing market power of incumbents across all industries, as it will greatly strengthen cartel law enforcement. The quality of teaching could be further improved through stronger performance standards, better teacher training as well as more professional recruitment and school management.

Assessment and recommendations

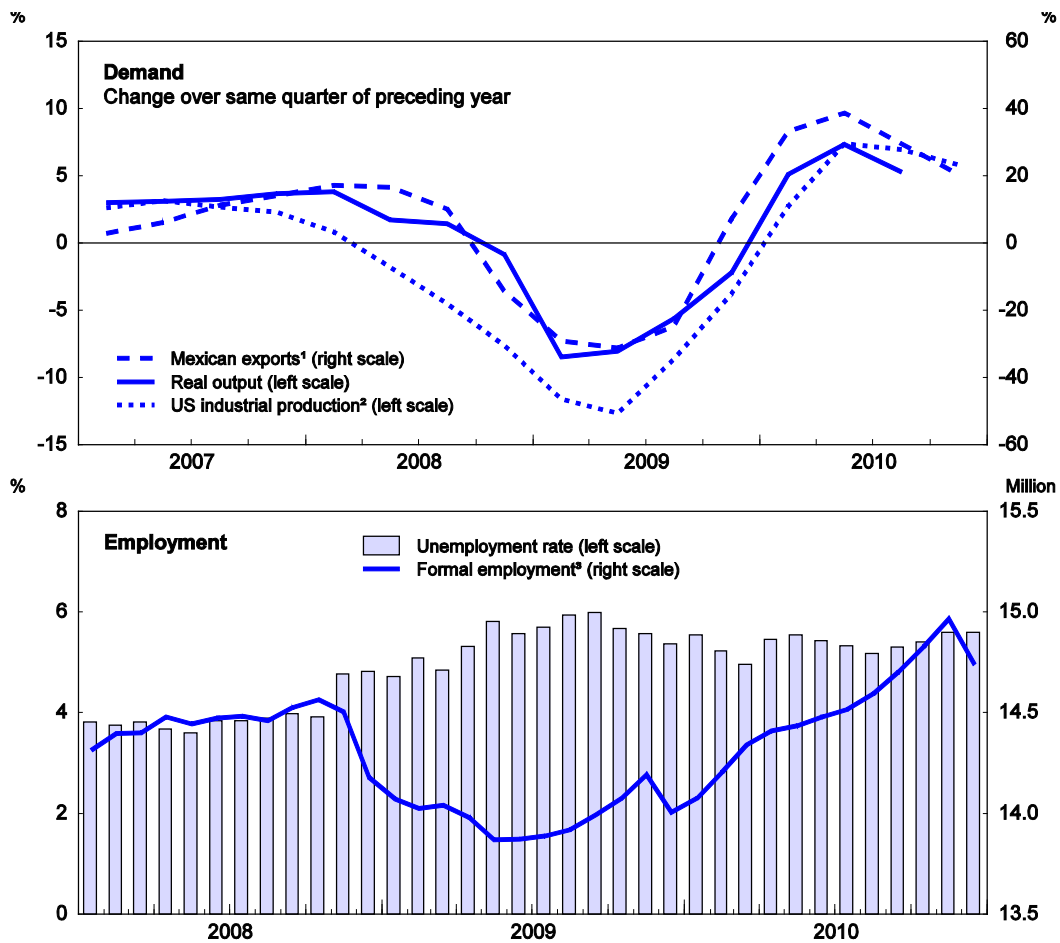
Thanks to past improvements in the macroeconomic policy framework and financial supervision, Mexico weathered the global recession of 2008-09 without fiscal or financial crises – a major improvement compared to previous episodes. The economic recovery has so far unfolded at a robust pace. Nevertheless, the recession was deep. There is thus a need for Mexico to continue preparing itself to confront future shocks through macroeconomic and structural policy measures. Oil revenues, which account for around one third of budgetary receipts, are highly volatile, especially due to price movements, and the prospects for production are uncertain, even though less so than in previous years. Reforms to have stronger fiscal buffers, increase non-oil tax revenues and enhance the efficiency of government spending are therefore important. Mexico's weak potential growth performance and slow convergence towards average OECD living standards highlight the need for structural reforms to raise productivity, especially in a context where Mexico faces pressures due to the integration of other economies with labour-intensive factor endowments into the world economy. Structural reforms should address macroeconomic volatility, limited competition in a number of sectors and remaining weaknesses within the education system.

A robust recovery is underway

After a sharp recession in 2009, Mexico has embarked on a strong recovery. Real GDP increased by 5½ per cent in 2010, after a fall of 6% in 2009. The upswing was initially led by booming Mexican exports, in particular to the United States, where Mexico gained market share. Private consumption and investment recovered with some lag, but are now growing more strongly as both business and consumer confidence have started to recover.

The unemployment rate, which had jumped to 6% in 2009, has been falling only slowly and remains well above pre-crisis levels. The underemployment rate, on the other hand, has been coming down steadily. Employment growth has increased, including in the formal sector (Figure 1), but the crisis has come with some decline in job quality, as employment growth was concentrated on the lower-paid jobs, especially in the early stages of the recovery, and the employment share of the informal sector has increased, which is typical for recessions. However, it is now back to pre-crisis levels. The increase in labour force participation has slowed the decline in the unemployment rate, which is expected to return to pre-crisis levels only by 2012. As the impact of the sharp recession on overall employment was rather mild and transitory, labour productivity declined substantially.

Figure 1. The recovery is robust



1. Export data is expressed in USD.
2. Excluding construction.
3. Workers affiliated with Instituto Mexicano del Seguro Social.

Source: OECD Analytical Database; Bank of Mexico; INEGI.

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After increasing strongly in 2010, reflecting the exit from the recession, output growth is projected to slow down somewhat to a more sustainable pace. Domestic demand should strengthen further in the course, but this may not fully compensate for lower export growth. GDP growth is expected to reach 4½ per cent in 2011 and 3.8% in 2012. Mainly due to swiftly growing imports, the current account deficit is projected to widen moderately, in spite of recovering remittances from Mexican workers abroad.

Core inflation declined almost continuously in 2010, while headline inflation has been slightly more volatile, mainly owing to food prices. It is now within the variability interval of +/-1 percentage points around the central bank's target of 3%. The value of the Mexican peso in terms of the US dollar, which weakened sharply in the wake of the financial crisis, reflecting large capital outflows, strengthened once again throughout 2010, although without returning fully to its pre-crisis level. The recent exchange-rate appreciation has helped to contain inflationary pressures.

Table 1. Demand, output and prices

	2007	2008	2009	2010	2011	2012
	Current prices MXN billion	Percentage changes, volume (2003 prices)				
GDP	11 313	1.5	-6.1	5.5	4.4	3.8
Private consumption	7 317.8	1.8	-7.1	5.3	4.7	4.1
Government consumption	1 182.1	1.1	3.5	2.8	0.6	1.5
Gross fixed capital formation	2 391.7	5.9	-11.2	2.3	8.6	8.3
Final domestic demand	10 891.6	2.6	-7.0	4.2	5.1	4.7
Stockbuilding ¹	598.7	-0.3	-1.1	1.0	-0.4	0.0
Total domestic demand	11 490.3	2.3	-8.0	5.2	4.7	4.7
Exports of goods and services	3 159.7	0.7	-14.0	24.5	4.9	8.6
Imports of goods and services	3 336.7	3.2	-19.0	22.3	5.6	11.1
Net exports ¹	- 177.0	-0.9	2.2	0.2	-0.3	-1.0
<i>Memorandum items</i>						
GDP deflator	—	6.2	4.1	4.4	4.0	4.1
Consumer price index	—	5.1	5.3	4.2	4.3	3.7
Private consumption deflator	—	5.5	7.2	3.0	3.0	3.7
Unemployment rate ²	—	4.0	5.5	5.3	4.6	3.9
Public sector borrowing requirement ^{3,4}	—	-1.1	-5.2	-4.3	-2.9	-2.6
Public debt	-	33.3	36.7	36.8	36.6	36.3
Current account balance ⁴	—	-1.5	-0.7	-0.5	-1.3	-2.1

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. Based on National Employment Survey.
3. Central government and public enterprises.
4. As a percentage of GDP.

Source: OECD, OECD interim projections

*Further fiscal consolidation can be facilitated by
supportive monetary policy*

Fiscal consolidation is already underway. After conducting a fiscal stimulus in 2009, the government is in the process of tightening its fiscal policy stance, raising taxes and containing expenditure growth. This reduced the public sector net borrowing requirement, a measure of the combined deficit of the federal government and its public enterprises, from around 5% of GDP in 2009 to 4½ per cent of GDP in 2010. The government intends to limit spending growth and reduce its public sector borrowing requirement to around 3 per cent of GDP in 2011 and 2½ per cent in 2012. This would translate into a closing of the deficit in 2012 based on the government's definition, which excludes PEMEX investment but includes a number of financial operations. If the recovery unfolds as projected, the government should implement its consolidation plans in full to avoid eroding market confidence in Mexico's fiscal policy.

In the longer term, further tax and oil sector reform will be needed to make the budget less dependent on oil revenues and their volatility, while securing fiscal sustainability. Even though oil production has stabilised since mid-2009, maintaining current production levels beyond 10 years would require continued substantial investments in high-cost exploration and new discoveries. Mexico launched a reform in 2008 to improve the governance of the state-owned oil company, PEMEX, which has stepped up its exploration of new oil fields. The government has taken initial steps to provide more flexibility to PEMEX's contracting mechanisms in order to enable it to work

more like its peers. But the outlook remains uncertain and therefore a strategy to strengthen non-oil tax revenues is needed.

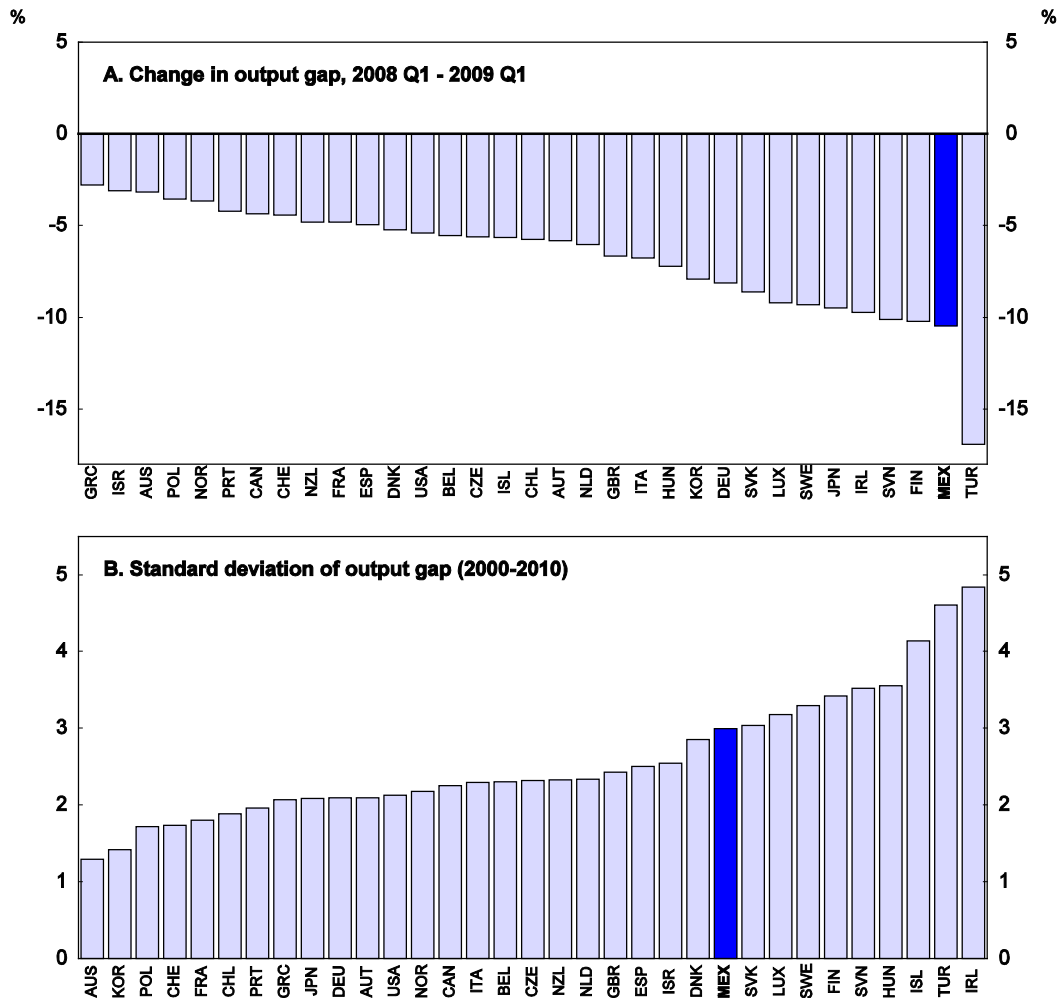
Current low interest rates are helpful to support the recovery in domestic demand in the context of a withdrawal of the fiscal stimulus. Medium-term inflation expectations now seem reasonably well anchored, although in the upper half of the central bank's variability interval around the inflation target of 3%. Given still substantial unused production capacity, inflation is projected to remain within the variability interval around the inflation target in 2012. However, vigilance is needed as some inflationary risks have re-emerged as the economic recovery gains strength even faster than expected and international commodity prices are rising. Provided that higher commodity prices and the strong recovery do not continue to translate into higher inflation expectations, the central bank can wait to raise its policy rates until at least mid-2011, when the recovery of domestic demand is expected to become more firmly established.

Macroeconomic and structural policy enhancements could further stabilise the economy

Thanks to an improved macroeconomic policy framework combined with prudent regulation and supervision of the financial system, Mexico escaped the fiscal or financial crises experienced in some other countries. After the "Tequila" crisis of the mid-1990s, Mexico started to strengthen its macroeconomic framework. Banking supervision was strengthened and the dependence on foreign financing was reduced. An inflation-targeting framework was introduced in 2001, bringing inflation from double-digit rates in the 1990s down to an average of around 4½ per cent over the period 2003-09, with a floating exchange rate acting as a shock absorber. The balanced budget rule was introduced in 2006 to keep net government debt at a low level by OECD standards (around 31% of GDP in December 2010).

Nonetheless, output volatility has been higher in Mexico than in most other OECD countries, including during the recent recession (Figure 2). The output gap widened by 10 percentage points from the first quarter of 2008 to the first quarter of 2009 and real GDP fell by 6% in 2009 against an OECD average of 3½ per cent. In Mexico domestic factors may have contributed to output volatility, which can have large costs for individuals and for long-term economic growth. Temporary disruptions in output tend to be accompanied by falls in consumption, in particular in countries like Mexico, where a large share of the population is credit constrained and the social safety net is weak. This generates costs for individuals who tend to prefer a smooth path of consumption and are averse to spells of unemployment or poverty (Reis, 2009). Moreover, the literature suggests that high output volatility can have adverse effects on long-term economic growth through hysteresis effects or higher uncertainty (Ramey and Ramey, 1995; Fatás, 2002; Aghion *et al.*, 2010).

Figure 2. The output gap widened sharply during the recession



Source: OECD, National Accounts Database.

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Output volatility could be reduced by further improving the fiscal policy framework. Even though there was an adequate fiscal stimulus in 2009, Mexico could strengthen its fiscal buffers by setting aside a larger amount of fiscal resources during economic upturns and periods of high oil prices in order to respond to large negative shocks. Accumulating a financial buffer would also help to prepare for the ageing of Mexico's population, which will increase health expenditures of the social security institutes (IMSS and ISSSTE) and the tax-financed healthcare scheme for workers who are not covered by social security, *Seguro Popular*. The government could consider adopting a structural balance rule netting out cyclical tax and oil revenues, as Chile does. In addition, the government should present the government accounts according to national accounts standards to enhance comparability, while the efforts to improve the quality and timeliness of local government fiscal accounts should proceed as planned.

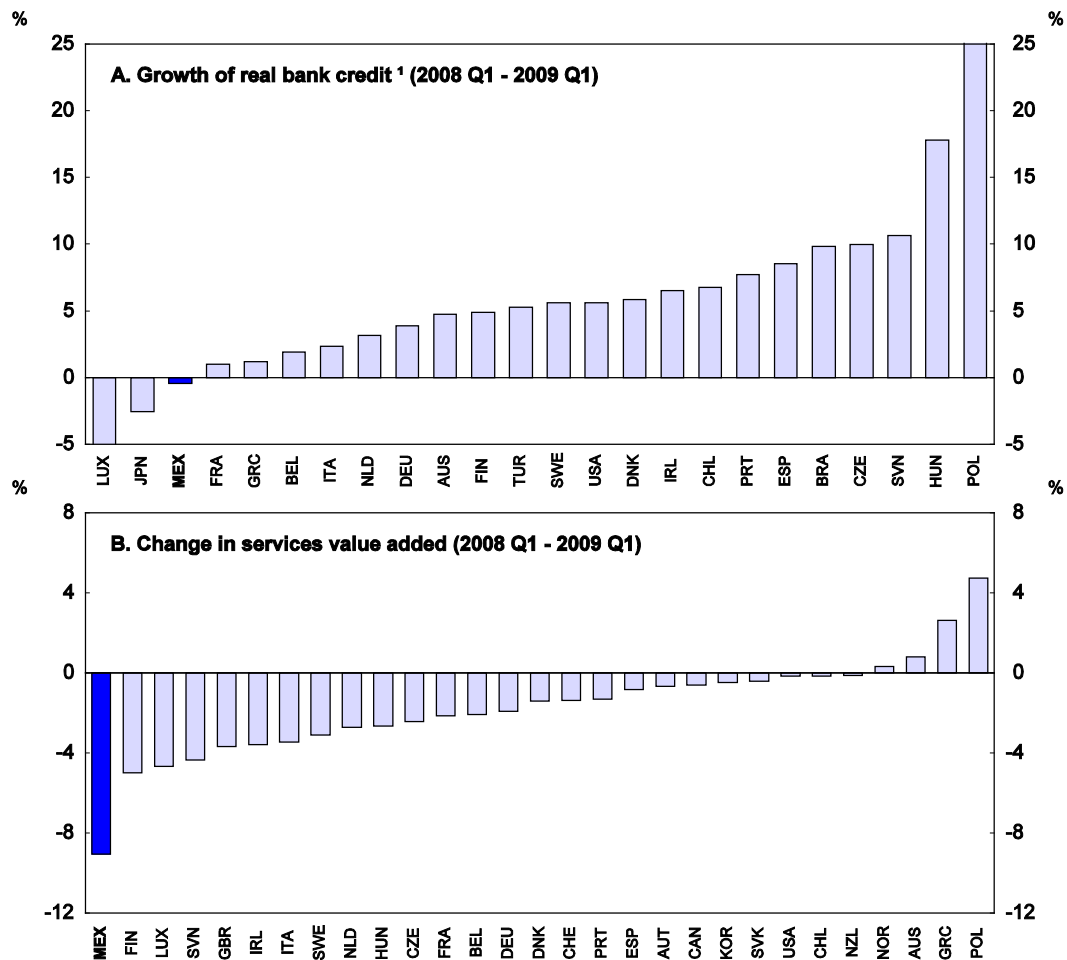
The budget surpluses accruing during economic upswings or periods of high oil prices should be accumulated in a stabilisation fund. With simple and transparent rules on savings and withdrawals, this would enhance the transparency of oil revenue management. While a system of revenue stabilisation funds already exists in Mexico, the rules on savings and withdrawals are

complex and the ceilings imposed on these funds are low, which resulted in the accumulation of less than 2% of GDP at the end of 2008 despite high oil prices. As a first step towards the establishment of a full-fledged economic stabilisation fund, the temporary lifting of the limits on accumulated assets in the oil stabilisation funds in 2010 and 2011 should be made permanent.

Monetary policy would have more room for manoeuvre if reforms were introduced to reduce inflation persistence. Higher foreign exchange assets would also have increased the flexibility for macroeconomic policies. In contrast to other countries, the recession of 2008-09 only had a minor downward effect on inflation in Mexico, where inflation remained above the central bank's target and expectations receded only slowly. By itself, a greater fall of inflation following the economic downturn would have facilitated the recovery by boosting the real income of consumers and improving the external competitiveness of Mexican firms. To some extent, the high inflation of 2008-09 can be explained by the large exchange-rate depreciation, which was partly passed through to prices. However, rigidities in product and labour markets may also have played a role. Moreover, during the financial crisis of 2009 the market sentiment towards Mexico appears to have been affected by the low level of foreign exchange assets relative to other emerging markets, thus reducing flexibility for the macroeconomic policy response. The authorities are increasing the central bank's foreign exchange assets through a rules-based mechanism and expanded the one-year precautionary USD 47 billion Flexible Credit Line (FCL) agreement with the IMF to a two-year USD 73 billion agreement approved in January 2011. Both self-insurance through reserve accumulation and multilateral insurance through international agreements bolster investor confidence in times of crises and should be continued as planned.

Further reforms of financial supervision would also contribute to macroeconomic stability. (Figure 3). Pro-cyclical loan loss provisioning requirements fuelled a boom in consumer credit prior to the recession, with real consumer credit growing 35% annually between 2002 and 2007, and underwriting standards deteriorating steadily. Banks sharply reduced consumer credit even before the recession, thus contributing to weaker household demand. The authorities have already taken measures to make loan-loss provisioning requirements for consumer lending less pro-cyclical and are planning to extend the new approach to other lending segments. The authorities should also take appropriate measures to reduce the pro-cyclicality of the financial system by moving towards macro-prudential regulation and supervision. The establishment of a Financial System Stability Council is a welcome step towards closer co-operation between financial authorities, which may facilitate the early identification and prevention of systemic risks. The government should complement the establishment of the Council by introducing counter-cyclical capital ratios as planned.

Figure 3. Bank credit and services value added contracted sharply



1. Deflated by CPI. Claims of depository corporations (excluding central bank) on all domestic sectors (including financial corporations, state and local government, public non-financial corporations and private sector).

Source: OECD, National Accounts Database; and IFS, Monetary Statistics Database.

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The development banks provided a counter-cyclical impulse to credit during the crisis, but the government now needs to consider retreating from this exceptional state-directed lending. Stepped up direct lending through public development banks may distort competition in non-crisis situations. The explicit state guarantee gives public development banks a funding advantage over private banks and is a contingent liability to the public finances. In particular, direct lending to market segments with access to private credit in non-crisis situations, such as the automotive, tourism and transport sectors, should be terminated. Instead, in non-crisis situations, public development banks should focus on co-financing arrangements with the private sector, for instance through credit guarantees. This would limit the risks to the public finances and enhance financial development through the dissemination of development bank expertise to the private sector, for instance in the area of long-term infrastructure finance (Armendáriz de Aghion, 1999; Levy Yeyati *et al.*, 2004). An effort to reduce direct lending by development banks is already taking place as lending by private banks recovers. This should be continued.

Modernising the services sector to reduce its dependence on manufacturing will be key to reduce macroeconomic volatility. Activity is normally more stable in the services sector than in manufacturing, but not in Mexico, in part reflecting strong links to manufacturing. The share of services directly linked to manufacturing, such as transport and wholesale trade, is high by international standards, reflecting high entry barriers into more stable consumer-oriented activities, such as telecommunications, passenger transport and retail banking. Several actions to reduce entry barriers in these sectors have already taken place, but the proposals discussed below would further support the expansion of a modern consumer-oriented services sector.

Greater geographical and product diversification of exports would reduce Mexico's exposure to sudden changes in US economic conditions. According to the WTO, Mexico is already one of the countries with the largest number of bilateral free trade agreements, and at the end of 2008 Mexico announced an ambitious unilateral import tariff reduction over the period 2009-13. By enhancing competition from abroad and reducing the cost of intermediate goods, the unilateral tariff reduction will help to improve the competitiveness of Mexican exports. The increasing number of bilateral free trade agreements and, more recently, unilateral tariff reductions have contributed to a process of trade diversification during this decade, but this process can be enhanced by further easing the access of Mexican exporters to additional foreign markets, including by negotiating free trade agreements at the regional level. At the global level, regional free trade agreements are a second-best option to multilateral trade liberalisation, as trade is diverted to some extent from non-member to member countries. But for Mexican firms, regional free trade agreements would put more export destinations on an equal footing with Mexico's partner countries in NAFTA, which would tend to reduce any remaining diversion of Mexican exports to North American partners. In terms of diversifying risk, the ongoing negotiations with Brazil and Korea are particularly relevant, as they present two fast-growing economies whose business cycles are becoming increasingly synchronised with China and more independent of the United States. To minimise trade diversion the government could also consider the option of negotiating regional instead of bilateral trade agreements.

Box 1. Main recommendations for supporting the recovery and further stabilising the economy

- Implement the fiscal consolidation plan in full, unless growth underperforms significantly.
- Provided that inflation expectations remain well anchored, wait to raise policy interest rates at least until mid-year 2011.
- Consider a structural fiscal balance rule, adjusting revenues for the business and the oil price cycles.
- Present fiscal data and budget projections according to national accounts standards on a regular basis.
- Make the temporary lifting of the limits on accumulated assets in the oil stabilisation funds permanent.
- Continue the build-up of foreign exchange assets through a rules-based mechanism as planned.
- In financial markets, move towards macro-prudential regulation and supervision.
- Introduce counter-cyclical capital ratios as planned.
- Continue retreating from exceptional state-directed lending through development banks.
- Promote additional export diversification, including through multilateral and regional trade agreements.

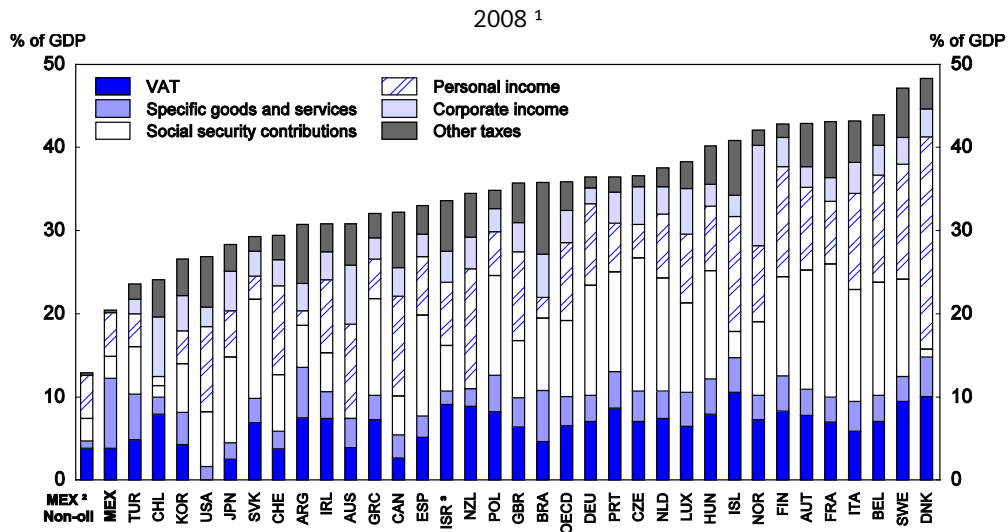
Important spending needs as well as volatility and an uncertain outlook for oil revenues require higher tax revenues

Mexico has substantial financing needs. With low growth and high inequality Mexico needs to invest in infrastructure and education to strengthen its growth potential and in social policies to alleviate poverty and inequality. Mexico has a well-targeted conditional cash transfer programme, *Oportunidades*, which helps the poor invest in their human capital. This has been very successful. However, over time it will be desirable to strengthen the social assistance system to complement *Oportunidades*, which would protect Mexican households and the economy better against shocks. Moreover, Mexico is rapidly extending health insurance coverage to workers not covered by social security through a largely tax-financed scheme, *Seguro Popular*.

There are also longer-term fiscal sustainability challenges related to population ageing and the associated increase in costs for the states' defined benefit pension systems and for healthcare programmes of the federal social security institutes (IMSS and ISSSTE). IMSS is currently drawing down its financial reserves to cover operational deficits of its health accounts, even though some of its schemes are running surpluses which could potentially make up for some of this. Addressing these challenges will require in-depth reforms, such as converting the remaining defined benefit pension systems to defined contribution systems, adopting a stronger focus on prevention in healthcare and taking measures to make the social security agencies more efficient. Yet, stronger revenues are needed, as well.

Mexico should further pursue its significant efforts to increase tax revenues. At only 20%, Mexico's tax-to-GDP ratio is low by international standards (Figure 4). In addition, more than one third of these revenues depend on oil, covering a large part of budget expenditure, as evidenced by the non-oil budget balance (Figure 5). Oil introduces volatility and is subject to an uncertain outlook. To secure medium-term sustainability of public finances, the budget needs to become more independent from oil revenues. There is potential to improve expenditure efficiency, in particular to improve poverty alleviation, which Mexico should not leave untapped. At the same time, spending needs will remain. Mexico thus needs to find ways to further strengthen its tax revenues, building on recent tax reforms, and improve the efficiency of its tax system, which would limit the distortions that can result from high tax rates.

Figure 4. Tax revenue from different sources across selected countries



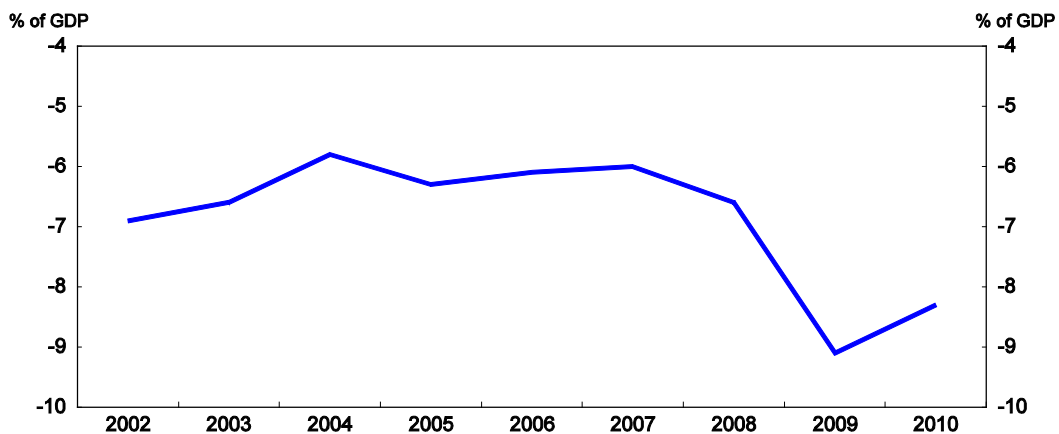
1. 2007 for Australia, Belgium, Chile, Greece, Iceland, Israel, Ireland, Japan, Netherlands, Poland and OECD average. Personal income tax collections include revenue from taxes on corporate income/profits in Mexico.
2. Excluding oil revenues.
3. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD, Revenue Statistics Database; Ministry of Finance for Chile and Brazil; Ministry of Economy and Production for Argentina; Central Bureau of Statistics for Israel.

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Figure 5. Non-oil budget balance¹

Public Sector Borrowing Requirement



1. Central government and public enterprises. Non-oil revenue minus non-oil expenditure.

Source: Ministry of Finance.

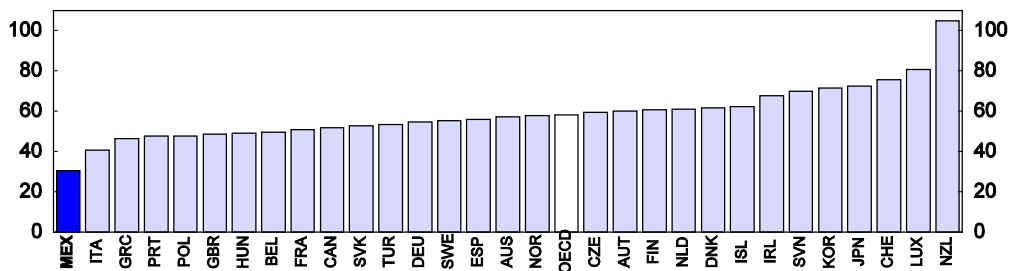
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The main reason for such low revenues is the narrow tax base. According to government estimates, tax expenditures account for around 4% of GDP, around 20% of actual government revenues. In addition to revenue losses, tax expenditures complicate the tax system, leaving ample room for tax planning and even evasion, e.g. through false declaration of income under categories that receive favourable treatment. Eliminating inefficient tax expenditures would broaden the tax base and make the system simpler to administer and more transparent. Also, there needs to be continued improvement in tax enforcement and tackling informality, including education and training to help low-productivity workers and enterprises succeed in the formal economy. Continued efforts to reduce the costs of formality, while enhancing its benefits through higher quality government services, are also needed.

Tax expenditures and special regimes should be re-assessed...

The costs of tax expenditures in the VAT system are particularly high. There are zero rates for food and medicines, exemptions, such as for education and medical services, and reduced rates at the border. Altogether this lowers tax revenues by a bit less than 2% of GDP. The large size of tax expenditures is also evidenced by the VAT revenue ratio, which measures actual VAT revenues as a percentage of potential revenues that could be obtained when applying the standard VAT rate to all final consumption. At around 30% this ratio, which is a combined measure of tax expenditures and evasion, is lower in Mexico than in any other OECD country (Figure 6). VAT tax expenditures are inefficient as a poverty alleviation mechanism, as higher-income households capture the largest part of the benefits in absolute terms. It would be desirable to gradually withdraw zero rates and exemptions within the VAT system and address social concerns with targeted cash transfers, as lower-income households spend a larger proportion of their income on food. This would result in higher net revenues, as the costs of providing benefits to higher income households would be avoided.

Figure 6. Effectiveness of value added taxes as measured by the VAT revenue ratio¹
2005²



1. The VAT revenue ratio (VRR) is defined as the ratio between the actual value added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. This ratio gives an indication of the efficiency of the VAT regime in a country compared to a standard norm. The calculation for Canada is for federal VAT only and the OECD aggregate is an unweighted average of data for the countries shown.
2. 2009 estimates for Mexico and 2007 for Slovenia.

Source: OECD, Consumption Tax Trends; OECD Revenue Statistics Database and Ministry of Finance of Slovenia.

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However, attempts to broaden the tax base by starting to tax zero-rated and VAT-exempted goods have proven politically difficult. Past government proposals to tax all consumption goods while increasing benefits of *Oportunidades* were rejected by parliament. Nonetheless, given the advantages of such a reform package, further efforts are warranted. A cash transfer system to

compensate lower-income households, through *Oportunidades* or complementary schemes, would be a more efficient poverty alleviation instrument than VAT exemptions or other consumption subsidies, such as for energy. These schemes could protect households against income shocks.

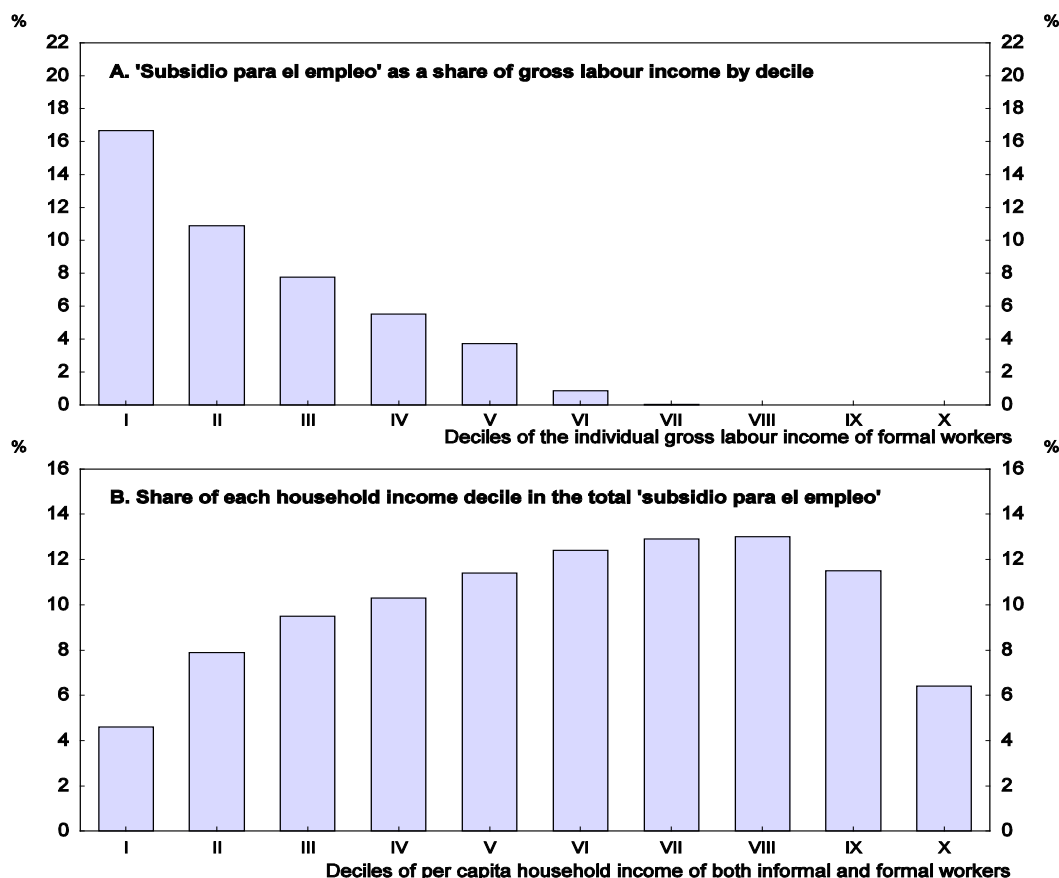
Mexico should re-assess the costs and benefits of its numerous special business tax regimes. There are special regimes for export assembly firms (*maquiladoras*), transport and agricultural firms, small firms and intermediate firms, benefitting from reduced rates, simplified accounting regimes, accelerated depreciation and other forms of tax relief. In addition to the direct loss in revenue, special regimes complicate the tax code and make it easier for firms to engage in tax planning or in tax evasion, by underreporting or misreporting their revenues. Special regimes may also distort the allocation of resources away from sectors or geographical areas that do not benefit from the same kind of tax treatment. The costs and benefits of all special business tax regimes should be carefully evaluated and only regimes of proven efficiency should be retained. In particular, there is reason to re-assess the special regime for small enterprises, *régimen para pequeños contribuyentes* (REPECO), now administered by states, and re-think its design. While tax relief within REPECO is very generous, these firms evade 95% of their tax liability according to a recent study (Fuentes *et al.*, 2010), indicating that the states need to step up their enforcement efforts. REPECO would also benefit from a forceful graduation mechanism, for example a re-qualification after a couple of years or a sunset clause.

The in-work tax credit (*subsidio para el empleo*) warrants a thorough evaluation. It subsidises around 60% of the formal wage distribution with a tax credit that is declining in individual labour income (Figure 7, Panel A). Its original goal was to help low-wage workers, but although the benefit is progressive relative to formal labour income, the share of the benefit that goes to the poor is relatively small (Figure 7, Panel B). This is because the in-work tax credit is not targeted at the poorest workers, but subsidises a relatively wide range of formal labour income. By design the tax credit is not available for informal workers whose income is concentrated at the very lowest wages. Moreover, the tax credit is based on individual income, but workers with relatively low wages may live in high-income households. A thorough evaluation of the tax credit would be warranted to assess whether it has a positive impact on formal employment and in how far it helps increase low-income workers' take-home pay. The evaluation could be the basis for reforms. For example, Mexico could consider targeting it more strongly at the lowest income workers who are most likely to move frequently into and out of the formal sector. This might help promoting formal employment. Another alternative would be to target the benefit at family rather than individual income. This would raise its potential to limit in-work poverty, but would require a complicated and costly re-organisation of its administration. It would entail weaker work incentives for second earners in families whose income is within the withdrawal range of the subsidy, although this effect could be alleviated through appropriate design, for example by reducing the withdrawal rate or making the tax credit dependent on the wage of the primary earner only. The government has recently frozen the *subsidio para el empleo* in nominal terms. In addition, Mexico enacted in 2011 a new programme, *Programa de Primer Empleo*, to stimulate formal employment; the programme offers an additional income tax deduction limited to three years for firms that create new jobs for workers who previously did not belong to the formal sector. This programme should be evaluated after some time to check whether it has the expected effects.

Many wage elements and fringe benefits are fully or partially tax exempt for workers and can be deducted from companies' tax bases at the same time, for example wages for supplementary hours and bonuses. These elements can reach up to 30% of an average worker's wage (Alvarez Estrada, 2010). This creates incentives for tax planning. At the same time it contributes to horizontal and vertical inequities because smaller companies are often not able to offer sophisticated salary packages with a substantial contribution of tax-exempt fringe benefits to the same extent as larger companies and higher-income individuals benefit more from tax relief than poorer peers. Mexico should therefore move towards taxing all wage elements at the same rate. In cases where subsidies are deemed to be warranted, perhaps for childcare facilities, the government could consider direct subsidies instead, as this would be more transparent.

Figure 7. 'Subsidio para el empleo' across income deciles

2008



Source: OECD calculations based on ENIGH data and Scott (2010).

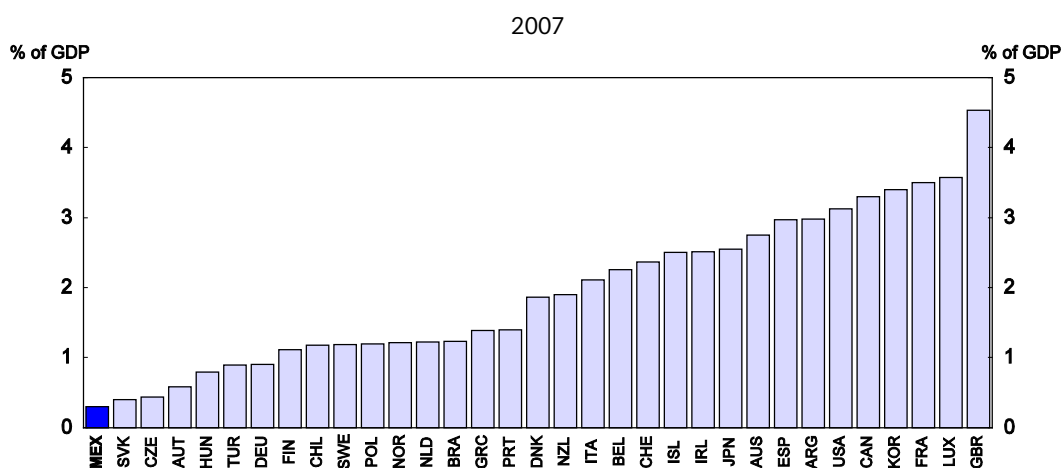
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To some extent the issue of tax exemptions and reductions on fringe benefits is addressed through the alternative minimum tax on business income (*Impuesto Empresarial a Tasa Unica*, IETU). A flat 17.5% tax on cash-flow, it was introduced in 2008 to limit revenue losses resulting from tax planning within the business tax system. It has to be paid to the extent that its payment exceeds the business tax liability within the regular income tax scheme. Given that the IETU was introduced shortly before the crisis it is too early to assess its full potential. In any case, it has helped to limit revenues losses from tax loopholes, which is welcome. The IETU should thus be maintained for the moment. At the same time, Mexico should take advantage of the evaluation of the IETU mandated by Congress due in mid-2011 to further develop its tools to broaden the tax base and simplify the system. In the long run, it would be ideal to have a simpler business tax system. However, the IETU would only become redundant, if Mexico could significantly broaden the base of its regular business tax system. Otherwise, the IETU should continue to play its important role in closing tax loopholes. Retaining only the IETU is another option that Mexico could consider, but this should not lead to revenue shortfalls, which might require a higher rate. There are also complicated transition costs to consider when moving towards immediate deduction of investment expenses, as in IETU, and its recognition in double tax treaties would be a prerequisite, which is not guaranteed.

Property taxes should be strengthened...

There is great potential to increase tax revenues at the subnational level. Subnational governments can raise a whole range of different taxes although most of them – excepting a payroll tax – have a limited base. Tax revenues are low, however, mainly because subnational governments have limited incentives and capacity to use their taxing powers, although the government has made important efforts to improve on this. Real estate taxes, which are collected by municipalities, yield exceptionally low revenues, even in comparison to Latin American peers (Figure 8). But real estate taxes are relatively effective, because they are difficult to escape. One problem is that land registries are outdated, leading to an undervaluation of property. Another is lax local administration and enforcement of taxes. Both issues are related to limited capacity, but also to weak incentives to collect higher property taxes. Mayors in Mexico can run for only a single three-year term and this is insufficient to reap the benefits of implementing unpopular tax increases. States could launch programmes to help municipalities update land registries, as some already do, because larger entities should find it easier to attract and train more qualified personnel and establish the required infrastructure. It would also be easier for mayors to engage in an unpopular tax increase when this is part of a state-wide programme.

Figure 8. Taxes on property



Source: OECD, Tax Revenue Database and Latin American Revenue Statistics.

StatLink  <http://dx.doi.org/10.1787/888932383280>

...and Mexico should continue to further promote its important improvements in tax enforcement

Mexico has made important progress in combating tax evasion by enhancing the capacity of the federal tax administration. The government should develop these efforts further and extend them to state tax administrations. According to studies commissioned by the federal tax administration, VAT evasion has declined from 23% of potential revenues to 18% between 2000 and 2008. Registration campaigns, the use of risk models to identify tax payers with a high probability of evasion, and efforts to reduce compliance costs and combat corruption within the administration have contributed to this success. Mexico should refine and extend the use of risk models, step up training of tax administration staff, in particular regarding auditing techniques, and continue to develop attractive pay and career paths. States, where progress in enhancing the capacity of tax administrations is very uneven, will have to engage in similar efforts.

Remove energy subsidies

Mexico spends significant sums on energy subsidies for electricity, gasoline, diesel and liquefied petroleum gas, which altogether accounted for more than 1½ per cent of GDP on average each year over 2005-09. A price-smoothing mechanism for gasoline and diesel can yield additional revenues in times of declining oil prices, but results in large implicit subsidies in times of rising oil prices. Since 2005 gasoline prices in Mexico have been below those observed in major trading partners' countries owing to the large increase in oil prices. Mexico should establish a mechanism that guarantees that gasoline prices do not deviate from their international reference and replace the price-smoothing mechanism with an excise tax. Energy subsidies are inefficient as a poverty-alleviation mechanism, as a large part is captured by higher-income groups. Moreover, energy subsidies create incentives to consume more energy and invest less in energy efficiency, reducing energy security and raising greenhouse gas (GHG) emissions. This is inconsistent with Mexico's ambitious target to cut national greenhouse-gas emissions by 50% by 2050, compared to 2000. There is no place for broad-based energy subsidies in this strategy.

Better targeting of energy subsidies, while bringing prices more in line with costs, is one of Mexico's declared goals in its energy strategy. The government has started to implement a new cash-transfer scheme connected to *Oportunidades* to help poor households cover their energy needs with fewer distortions than under the current system. Mexico has also started an interesting pilot programme to replace electricity subsidies for pumping irrigation water with direct cash transfers in some states, thus removing the price distortion. However, the Mexican government needs to do more to bring energy prices more in line with costs. Despite welcome efforts to gradually increase gasoline, diesel and LP gas prices, the subsidies remain in place. They are likely to increase further, when international prices rise. Little has been done to remove electricity subsidies.

Withdrawing energy subsidies and VAT exemptions, which are captured in large part by higher-income groups, while increasing better targeted cash transfers, either through an expansion of *Oportunidades* or the introduction of a social assistance benefit, would help to further improve the progressivity of the Mexican tax-and-transfer system. Despite improvements over recent years taxes and transfers in Mexico hardly lower the Gini coefficient in sharp contrast to the impact of the tax-and-transfer systems in most OECD countries.

Working towards better productive efficiency and thus lower prices and higher quality in the electricity sector would attenuate the effect of lower electricity subsidies on consumers. The government recently closed down *Luz y Fuerza del Centro* (LyFC), a highly inefficient state-owned electricity company, which is a step in the right direction. Efforts to improve the efficiency of the remaining state-run company, while allowing for more competition in the sector in the long run, combined with high-quality regulation, would be the right strategy to lower prices for consumers.

...and later move towards carbon pricing

Once energy subsidies are removed, introducing an emissions trading system (ETS) or broad-based GHG taxes would be a good approach to start pricing emissions more in line with their social costs. This would be easier as part of a broader international initiative. To some extent participating in emissions trading systems would be more attractive to Mexico than raising carbon taxes, as it opens opportunities to obtain funds from abroad to finance investments in energy efficiency. Should an emissions trading system be established in the United States, it would be in Mexico's interest to join in. With cheaper abatement possibilities than its technologically more advanced northern neighbour, Mexico could gain revenues from selling emission rights to the United States. There are some ideas to revive an internal emissions-trading system at PEMEX at some point and extend it first to the electricity sector and then gradually to other key industries. However, this may have to be accompanied with technology standards and regulation to be effective, in particular because these sectors are dominated by state-owned monopolies that may

have soft budget constraints. The response to higher emission costs with reduced output or investments in new energy-efficient technologies is thus likely to be weaker than on a more competitive market. Raising excise taxes on gasoline and energy sources in line with their carbon content may be another good first approximation to carbon pricing in Mexico and might be somewhat easier to implement than an ETS, as a system for collecting taxes is already in place.

Box 2. Main recommendations for increasing the effectiveness and efficiency of spending and taxes

- Increase cash transfers to the poor, for example through *Oportunidades* or by introducing a social assistance scheme.
- Gradually withdraw energy subsidies, as well as zero rates and exemptions within the VAT system.
- Evaluate all special business tax regimes and retain only those of proven effectiveness.
- Strengthen tax enforcement for the small business regime and consider a requalification after some years or a sunset clause.
- Evaluate the in-work tax credit and consider targeting it more at the lowest incomes.
- Move towards taxing all wage elements at the same rate.
- Evaluate the new alternative minimum business flat tax. In the long term, consider moving towards a simpler business tax, but keep IETU in place, unless the tax base of the regular business tax system can be broadened significantly. Consider IETU as the only business tax only if this does not lead to revenue shortfalls.
- Subnational governments should increase their own tax revenues. One way to achieve this would be to encourage states to launch programmes for municipalities to update land registers.
- Enhance tax enforcement through extended use of risk models, training and attractive pay and career paths.

A broad-based strategy is needed to combat informality

A large informal sector, as in Mexico, is likely to be both a symptom and a cause of low productivity. The share of workers and firms in Mexico that do not comply with tax and labour laws is large. Informal firms are very small and unproductive compared to formal firms, but especially so in comparison with larger ones (La Porta and Shleifer, 2008). Unproductive workers and firms are likely to resort to informality because they have difficulties producing profitably or finding employment in the formal economy given the costs of taxes and regulation. In turn, informality can hinder productivity and growth of firms and individuals operating in this sector, as they stay small to hide their activities and they often lack access to financing, customers, formal training and the protection of property rights. To strengthen productivity growth, Mexico needs to tackle informality by reducing costs of working in the formal sector and regulatory hurdles that hinder formalisation, while enhancing training, education and technical help for relatively unproductive informal firms to become more productive and grow. Ultimately tax revenues would increase as well, as the capacity of low-productivity firms and workers to generate income is strengthened although, given their low incomes, integrating them into the tax net without increasing their productivity would not contribute much in the short run. Making the benefits of formal employment more attractive, in particular the mandatory social security package, while limiting its costs through efforts to improve efficiency, would strengthen incentives for workers to formalise.

Reforming social security to support formality

Incentives to operate in the formal sector would be higher if the quality of social security services and their value for workers were improved. Overall, labour taxes in Mexico are moderate. While regressive social charges – reflecting a fixed base contribution to the healthcare system – make for a high burden on the lowest wages, this effect is compensated by the *subsidio para el empleo*. The new *Programa de Primer Empleo* will provide cost reduction for firms that hire workers, who are registered with the federal social security agencies for the first time. Nevertheless, there are several features of the Mexican system that may lead to a negative impact on formal employment. Most importantly, low-wage and rural workers in particular have reason to value certain social security benefits at less than their cost, reducing incentives to contribute to the system:

- Few low-wage workers manage to retain formal jobs for long enough to earn the right to a minimum pension, reducing their perceived value of pension contributions.
- Until recently insurance-based healthcare services were only available to formal workers, financed via social security charges. Yet, a new, largely tax-financed system healthcare system (*Seguro Popular*) now allows workers who are not registered with social security to access healthcare services without paying fees if they belong to the four lowest income deciles. This is welcome from a public health perspective, but working towards a more integrated health care system would increase efficiency and avoid any disincentives to formalise that could stem from differences in financing schemes. Although the quality of social security healthcare services remains in general higher, it is not clear that it is worth paying high social charges for every worker with low wages. Their social charges are high in relation to their income, substantially reducing their consumption possibilities. Moreover, in rural regions the capacity of the social security health system is much weaker, reducing its value for rural workers, who tend to have relatively low wages.
- Access to housing loans from the social security's housing agency is based on a point system that includes elements like savings, income, age and job tenure that are related to workers' ability to repay, thereby favouring higher-income workers. This reduces the value of housing benefits for lower-income workers, although the government has recently made successful efforts to improve their access to these loans.
- Childcare and recreational facilities are concentrated in urban areas, reducing the value of these services for rural workers, who often have low incomes.

Efforts to restructure the social security package to increase its attractiveness for low-income and rural workers, in particular, should raise incentives for them to become formal (OECD, 2008).

As a first step, Mexico should consider removing subsidised mortgages, childcare and recreational activities from the mandatory social security package and merge them with equivalent tax-financed programmes for the general population, while rethinking their targeting. This is likely to improve the value of the mandatory social security package for low-wage and rural workers, because they will no longer have to pay for services to which they have no access. The government has already introduced the possibility to waive part of the contributions to these services for rural day labourers and construction workers who have limited access to them, but restructuring the package for all workers would come with additional benefits. In particular, more integrated service provision is likely to enhance programme efficiency, because it would allow the government to base these programmes on an encompassing strategy, avoid redundancies and improve targeting. Moreover, this could help lower social charges or move more funds into the pension accounts which are better accessible and thus more valuable for a larger share of workers. The government is planning to shift some funding from the social security housing fund to

workers' pension accounts and this would be welcome. It could be used as an opportunity to consider whether financing housing subsidies through social charges is really the best option.

Consolidating at least a basic healthcare package, which is now different for public and private and for formal and informal workers, and moving towards integrated financing would promote efficiency and avoid distorting incentives between formal and informal employment. Integrated services provision has the potential to improve quality, as capacity would be shared and standards would be aligned across the different healthcare systems. The government has already started this work, while co-ordinating the purchase of patented medicines, which has helped to reap significant savings. These steps could be gradually developed to move towards full integration of a basic healthcare insurance across the different healthcare systems. The financing scheme for basic healthcare insurance should be unified to avoid disincentives to formalise, which can arise because the healthcare package for informal workers is cheaper than for formal workers. One option would be to move towards an integrated healthcare system that contains the services of the current social security system, but is tax-financed. Moving towards full tax financing could reduce social charges from close to 40% to 16½ per cent for minimum wage workers. While this would require increasing other taxes, the average financing burden would probably fall, as the tax base is larger than the social security base. As long as the government cannot raise the extra tax revenues that are necessary for this, however, it should limit tax-financing to a very basic healthcare package that covers only a set of diseases with catastrophic expenses. Alternatively, the basic healthcare package could be financed via fees that could be waived for the lowest-income households. However, this financing scheme would then have to be the same for formal workers otherwise healthcare services would remain more expensive for them. Services that go beyond this basic package could be financed via fees or via social charges for formal workers. The government's current strategy, to expand the coverage of the healthcare package for informal workers, while increasing the size of the package, without tax reform or an expansion of the coverage of fees, can lead to financing problems. In addition, it does not resolve the issue that for individual workers *Seguro Popular* is less expensive than the social security package.

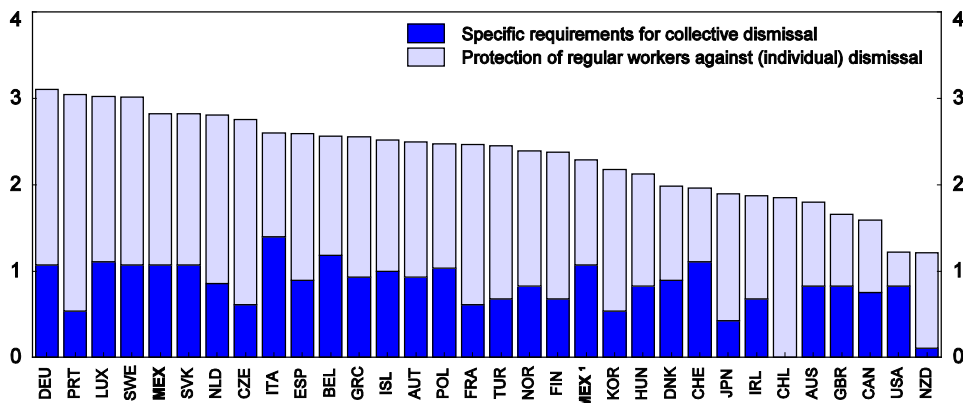
Reducing the regulatory burden

A further possibility for Mexico to lower the cost of formal employment would be to reduce the stringency of regulations for regular employment. Regulations for regular employment relationships are relatively stringent compared to most OECD countries (Figure 9). Labour court procedures are complex, lengthy and costly. At the same time there are currently very few restrictions on temporary employment, making it easier for firms to use subcontracting and outsourcing to temporary work agencies as a means to rely on cheaper, often informal workers, which happens frequently. The recent labour reform proposal to limit the currently indefinite accumulation of due wages during labour trials to six months is welcome, as it would reduce the costs of dismissal and the uncertainty surrounding it. The proposal to introduce short-term trial and training contracts, ranging from one to six months, is also helpful. This may raise employers' incentives to consider more unskilled and inexperienced workers for formal employment, especially young workers. The reform would significantly reduce the stringency of employment protection legislation in Mexico, and would enhance legal certainty in terms of hiring and firing (Figure 9).

Further steps that Mexico should consider include reducing the scope for unfair dismissal litigation by easing procedures to dismiss workers on the grounds of repeated poor performance and redundancy. However, notice periods and severance pay in the event of lawful dismissals, which are very light now at least for workers with long tenure, might have to be strengthened to make such a reform more acceptable. Another possibility would be to strengthen schemes that would better protect workers against income losses resulting from unemployment. This could include the unemployment component in individual pension accounts or alternative schemes, such as a social assistance benefit. The reform proposal would also oblige firms using outsourcing or subcontracting arrangements to verify that the subcontractor complies with labour and social security laws. This complements a similar provision, which was introduced in the social security

law in 2009, with increases in fines. This is a sensible measure to prevent firms from using outsourcing to bypass labour laws, but the capacity of labour inspectorates may need to be strengthened to enforce it (OECD, 2008).

Figure 9. Employment protection legislation (EPL) for regular workers, 2008
Scale from 0 (least restrictions) to 6 (most restrictions)



1. Estimates for the EPL after the proposed reform is implemented.

Source: OECD, OECD Indicators on Employment Protection Database.

StatLink <http://dx.doi.org/10.1787/888932383299>

Box 3. Main recommendations for reducing informality

- To reduce the overall cost of social security, enhance efficiency and foster formality remove subsidised mortgages, childcare and recreational activities from the mandatory social security package and merge them with equivalent tax-financed programmes.
- Further integrate the different healthcare systems. Move towards integrated financing of a basic universal healthcare insurance, either through taxes or fees.
- Adopt and implement the proposed labour market reform in full.
- Consider easing procedures to dismiss workers based on poor performance or redundancy.

Mexico has made significant progress in easing procedures to start a business, but should consider further easing the regulatory environment. Mexico is working to reduce time, costs, and requirements to complete the formalities to start up a business, including through the launch in 2002 of the *Sistema de Apertura Rápida de Empresas* (SARE), which has streamlined procedures at the municipal level, halving the time for low-risk businesses to register to 72 hours. One way to take the reform further would be to integrate the initiative with *tuempresa.gob.mx*, an electronic one-stop shop, developed with the support of the OECD, to ease compliance with federal business start-up regulations and procedures. OECD research suggests that *tuempresa.gob.mx* helps to bring down the costs for entrepreneurs to comply with start-up formalities from 16% of per capita GDP to 5½ per cent. However, it is not yet the most widely used mechanism to start up a business. More effective publicity and interconnection with state and municipal portals for business start-ups should help dissemination of this electronic one-stop shop. The federal Ministry of Economy and sub-national governments should co-operate to interconnect state and municipal portals for business start-ups with *tuempresa.gob.mx*, and engage a wide set of stakeholders to support the platform. Over time, the government plans to

integrate a wider set of procedures into *tuempresa.gob.mx*, including those for businesses that are already operating. This is welcome.

Mexico is engaged in a regulatory review process, called *Base Cero* which is supported by the OECD, to identify and simplify regulations that are overly burdensome. A first set of five procedures for exporters and start-ups have already been simplified. The government has recently added simplified tax declaration formalities and plans further measures in the realm of taxes, foreign trade and technical regulations, which will also help Mexico to facilitate technology absorption. Overall savings are projected to reach around 20 billion pesos. In addition, the OECD has helped Mexico to strengthen the focus of its regulatory impact assessment (RIA) for new regulations, allowing regulators to concentrate their resources on the analysis of those that are particularly costly. This opens the opportunity to develop a lighter RIA version for low impact regulations, thus freeing resources and enhancing Mexico's capacity to improve regulations where they imply significant costs and risks. Given the benefits of the *Base Cero* initiative, the government should consider extending its scope to a larger set of high impact economic processes. Mexico should also work to facilitate the implementation of the new RIA framework by enhanced training for its personnel.

There is a need to simplify and improve regulation at the state and municipal level, as well, including to reduce overlap between different levels of government. The OECD worked with the federal Ministry of Economy and the Mexican Institute for Competitiveness (IMCO) to identify particularly burdensome regulations at the sub-national level and proposed a reform agenda for nine Mexican states. It also developed a toolkit to simplify sub-national regulations, *i.e.* for business start-ups, construction permits, property registration, and procurement. The federal government should encourage states and municipalities to apply the toolkit, to monitor results and to co-ordinate regulation across different government levels.

Box 4. Main recommendations for simplifying business regulation

- Co-operate with subnational governments to interconnect the federal one-stop shop with state and municipal internet portals for business start-ups.
- Extend the scope the regulatory review (*Base Cero*) initiative to other regulations with a large impact on business productivity. Implement the suggested changes in the regulatory impact assessment.
- Encourage states and municipalities to apply the toolkit to simplify subnational regulations. Co-ordinate regulation across government levels.

Mexico needs to enhance competition...

Product-market competition is weak in many sectors in Mexico and this often hurts efficiency, productivity and consumer welfare. There are state-owned monopolies in the distribution of electricity and production of oil, but concentration is high in many others. Analysis conducted jointly by the Mexican competition authority (*Comisión Federal de Competencia*, CFC) and the OECD suggests that the average Mexican household spends close to a third of its budget on products that are produced in monopolistic or highly oligopolistic markets and this share is even higher for the lowest-income households. In a number of sectors, regulations help market incumbents prevent new firm entry or effective competition from existing competitors. Mexico has launched a project overseen by the Ministry of Economy to identify hindrances to competition and propose reforms based on joint CFC/OECD analysis. More competition would lead incumbent firms to lower prices, become more efficient and innovate, enhancing aggregate productivity growth and promoting consumer welfare.

The President has introduced a competition law reform, which has now been passed in Congress. This reform applies OECD best practice to increase the chance for the competition authority to detect firms abusing market power, while increasing the cost of abuse. The reform now allows unannounced office visits, which increases the likelihood of finding useful evidence, and it expands the scope for criminal prosecution against individuals engaged in cartel activities. Instead of a fixed amount (currently around USD 7 million), maximum fines could be as high as 10% of company revenue, which will significantly promote deterrence for large companies. This will strengthen Mexico's competition framework and economic performance.

Regulation should be reviewed in several sectors to improve the functioning of competition. Many of these sectors produce important inputs for the rest of the economy and increasing efficiency could have potentially very beneficial effects on aggregate productivity:

- In *air transport*, fair access to landing and take-off slots at Mexico City airport, which is operating at full capacity, will be key to ensure open competition. Allocation is currently non-transparent, largely based on grandfathering, and is controlled by a committee in which only incumbents are represented. Grandfathering will have to be limited to allow for efficient auctioning of a large share of slots. Mexico should also consider abolishing the requirement of route-specific concessions, allowing airlines to operate on any route as long as they fulfil safety and notification requirements.
- In *intercity bus transport*, restrictions to obtain a permit should be eased and non-discriminatory access to essential facilities better ensured. Currently, the regulator has to base the decision to grant permits to new firms on demand and investment studies. This requirement should be lifted and restrictions to new firm entry should be limited to safety concerns. In cases where bus terminals are an essential utility, *e.g.* when construction of a new terminal is not economically feasible or permission is refused by a local government, the regulator should ensure competitive access.
- Market concentration in *retail banking* is high, which is partly related to high costs for customers of switching banks in the past. Following CFC/OECD recommendations Mexico has passed a new law that requires banks to provide transparent information on switching costs. Banks are now permitted to switch payment orders for new customers. Access for new banks to essential facilities, such as card network infrastructure, retail payment systems and credit bureaus, has been relaxed, facilitating entry into the market. The central bank is now required to adopt clear efficiency criteria in its determinations of appropriate interchange fees for debit and credit cards. These legal changes are now being implemented and the government should make sure that this proceeds as quickly as possible.
- Prices for medications are exceptionally high in Mexico, in part reflecting weak competition in the *pharmaceutical sector*. This is a problem for public health and for public finances. More transparent procedures for public procurement will be key for strengthened competition in the pharmaceutical sector. The social security institute (IMSS), the competition authority (CFC) and the OECD have agreed to co-operate to promote this. Starting in 2011, IMSS will conduct all its purchases, including of pharmaceutical drugs, through reverse auctions, which will greatly limit the scope for corruption and make collusion between pharmaceutical firms much more difficult. Competition in the pharmaceutical sector could also be strengthened by easing overly stringent restrictions for generic pharmaceuticals. The government is engaged in a number of efforts in this field, including a process to renew all medicine registration procedures that will conclude this year, leaving only generics complying with bioequivalence requirements; promotional and informational campaigns to deepen the adequate prescription and use of generics; and a current revision of the conceptual framework for intellectual property to assess areas of improvement. Mexico should implement as quickly as possible the removal of the requirement that foreign firms operate a plant or a laboratory in Mexico to be allowed to sell generics. Mexico should also require doctors to prescribe medications only by their generic compound name,

allowing patients to choose the cheapest option in the pharmacy. Pharmacists should be required to supply generics.

- *Telecommunications* prices are well above the OECD average in some areas – with prices for moderate use mobile phone services exceeding the OECD average by 30% and prices for moderate-use fixed-line telephony and business fixed-line telephony exceeding OECD averages by 67% and 82% respectively. A major step forward to promote stronger competition has taken place through several concessions of the state-owned electricity company’s fibre optic network to competitors of the incumbent in the telecommunications sector together with the auctioning of new radio spectrum frequencies. This will allow for infrastructure competition in the telecommunications sector. However, the efforts to increase competition should continue, and the enforcement of regulation should be strengthened. In half of the country’s 400 local areas only the incumbent, Telmex, has the infrastructure to put through fixed-telephony calls to customers and charges exceptionally high fees for this service. The regulator, COFETEL, ruled in 2008 that this charge had to be brought in line with termination costs, reducing it to roughly 15% of today’s value. However, this decision has been subject to an injunction since and thus has not been applied. Interconnection tariffs are also high in mobile telephony, but the regulator has no authority to regulate these tariffs *ex-ante* for all cases. It can only propose changes for specific cases when a legal dispute arises between operators. Following a complaint by several competitors the CFC recently imposed a 1 billion USD fine on the incumbent in the mobile telephony market for monopolistic practices related to interconnection charges. The government should consider merging local calling areas to have fewer that are non-competitive. The telecommunications regulator COFETEL should be authorised to regulate interconnection *ex-ante*, declare bottlenecks and essential facilities for all telecommunication sectors and establish non-discriminatory access conditions to these facilities. Legislation should include the possibility of unbundled access to essential infrastructure when it promotes competition, provided that this does not undermine investment incentives. Tariffs associated with interconnection and access to essential infrastructure should be based on long-run incremental costs.

Box 5. Main recommendations for strengthening competition

- Limit grandfathering of airport slots at congested airports to ensure efficient allocation, for example through auctioning. Review the requirement of route-specific concessions and allow airlines to operate as long as they fulfill safety notification requirements.
- Ease restrictions to obtain a license in intercity bus transport and ensure non-discriminatory access to essential facilities.
- Implement fully the legal changes to ease access to banking services and facilitate banks’ access to essential facilities.
- Quickly implement the removal of the requirement that firms operate a plant or a laboratory in Mexico to be allowed to sell generics. Require doctors to prescribe medications only by their generic compound name and pharmacies to supply generics.
- Merge local calling areas. Authorise COFETEL to regulate interconnection *ex-ante*, declare bottlenecks and essential facilities for all telecommunication sectors and establish non-discriminatory access conditions to these facilities. Allow unbundled access to essential infrastructure when it promotes competition provided that this does not undermine investment incentives. Base interconnection tariffs on long-run incremental costs.

...and the quality of its school system

In order to strengthen productivity and enable more citizens to work and produce in the formal economy Mexico needs to enhance its education system. The OECD has worked with Mexico to address the key weaknesses of its basic education school system. While Mexico has invested a lot in education over recent years and significantly increased enrolment, in particular in primary schools, enrolment in secondary school falls far short of OECD standards, as do learning outcomes as measured by PISA results. One key weakness is the qualification of teachers and their principals. As a basis for its education strategy Mexico should develop a nation-wide set of standards defining competences that teachers need to improve their students' learning outcomes. Initial teacher education needs to improve and a first step would be to establish rigorous accreditation standards for all teacher training institutions. Mexico should further improve its new teacher licensing examination (*Concurso Nacional de Asignación de Plazas Docentes*) ensuring that only well-qualified teachers can enter the profession. All teacher posts should be open to competition and the appointment of principals should be professionalised. Probationary periods with high quality mentoring for novice teachers to support them in attaining their potential and to assess their skills would also be helpful.

Based on the standards to be developed, Mexico should develop and gradually introduce an evaluation system for teachers. When the system is well-established and accepted it will reward excellence and guide teachers towards professional training. However, there are two prerequisites for success. Professional development is currently dispersed across a wide range of providers and often does not address teachers' needs. Over time professional development should be aligned with the standards for teacher performance with quality controls for providers and it should become more relevant for schools' needs. Second, Mexico will have to work to develop a well-qualified cadre of mentor teachers and principals to manage evaluation.

School funding and school autonomy need to be strengthened. Although aggregate spending on education is comparable to OECD countries, schools have virtually no autonomy and no funds at their own disposal. More than 90% of resources are devoted to staff compensation. Other funding is allocated only to a limited number of schools through more than 200 different federal and state programmes. Many of the smallest and poorest schools receive no funding under the current programmes because they do not have the administrative capacity to complete the application process or handle the reporting requirements. Revising state funding formulas and replacing the multitude of special school funding programmes by a single improvement grant would enhance funding equity and reduce the attainment gap between advantaged and disadvantaged schools. Funding for maintaining school facilities can be devolved to school level and once a capable cadre of principals has been build up, they should be given more of a say in key decisions concerning their schools, including teacher employment and pay.

Box 6. Main recommendations for raising the quality of education

- Define nation-wide standards for teacher performance as well as accreditation standards for teacher-training institutions to improve initial teacher education. Improve the new teacher licensing examination and open all teacher posts to competition. Professionalise the appointment of directors.
- Gradually introduce a teacher evaluation system.
- Reallocate resources to provide schools with reliable financing.
- Professionalise the training and selection of principals to assume greater responsibility for teacher employment and pay.

Chapter summaries

Chapter 1. Macroeconomic and structural policies to further stabilise the economy

Improvements in the macroeconomic policy framework over the past two decades and prudent regulation of the financial system have contributed to reduce output volatility in Mexico relative to other OECD countries. The sharp recession in 2008-09 illustrated that output volatility has nonetheless remained high. The fiscal rule has helped to balance the federal budget and keep the level of government debt low, while enhancing fiscal credibility, but it should be strengthened to allow building a larger buffer of financial assets to respond to shocks. Although output contracted sharply in early 2009, actual and expected inflation remained above target, in part because rigidities in product and labour markets limit price flexibility. This constrained the monetary policy response. The banking system withstood the recession of 2008-09 well, but the contraction in bank credit was sharper than in other OECD countries, in part related to a boom-and-bust cycle in consumer credit that preceded the recession. While in other OECD countries the services sector stabilises output, in Mexico it contributes to output volatility. The volatility partly reflects the dominance of services with strong links to manufacturing, while modern and more stable consumer-related services remain underdeveloped. Output volatility could be further reduced by amending the fiscal rule to accumulate larger buffers of financial assets during economic upswings or periods of high oil prices, and by taking measures to enhance the flexibility of prices. Mexico should also adopt internationally-accepted statistical conventions for its budget accounts to make them more easily comparable with those in other countries. There would be merit in moving towards macro-prudential regulation and supervision to reduce the pro-cyclicality of the financial system. Finally, entry barriers to services should be lowered to boost the development of a modern consumer-related services sector.

Chapter 2. Fiscal reform for a stronger fairer and cleaner Mexican economy

With slow growth and high inequality Mexico needs investments in infrastructure, education and social policies. Mexico has increased spending in all of these areas. This was easily financed thanks to fiscal reforms in 2007 and 2009 as well as high oil prices in recent years. Oil revenues, which account for around one third of budgetary receipts, are highly volatile, especially due to price movements, and the prospects for production are uncertain, even though less so than in previous years. Mexico has the lowest tax revenues as a share of GDP in the OECD and much of Latin America, even when oil-related revenues are included. The government should improve the efficiency of its public spending. Mexico spends significant sums on energy subsidies, which are in large part captured by higher-income groups. Moreover, these subsidies are not in line with Mexico's ambitious goals to reduce greenhouse gas (GHG) emissions. These subsidies should be gradually withdrawn in line with the government's goals. Extending cash benefits to the poor instead would be much more efficient to fight poverty and help citizens and the economy as a whole to buffer income shocks. Agricultural spending should be re-structured to finance more investment in public goods and less support for producers, which has proven ineffective in increasing agricultural productivity. Broadening the tax base by withdrawing some of the most distortive tax expenditures would make an important contribution to strengthen revenues. This would also help make the tax system simpler, thus reducing compliance costs as well as opportunities for tax avoidance and evasion. Efforts to enhance tax enforcement should continue.

Chapter 3. Structural reforms in regulatory, competition and education policies to achieve faster productivity growth

Productivity growth has been insufficient over the past two decades for a convergence of Mexican living standards to the OECD average. Structural reforms in the areas of business regulation, competition

policy and education will be crucial to stimulate productivity and foster the catching up process. The OECD has worked with Mexico in all of these areas to develop reform strategies. Efforts to reduce the regulatory burden for firms, including start-ups, should continue. There is also a need to better coordinate ongoing administrative simplification efforts at the federal and state levels. The recent competition law reform will strengthen enforcement of cartel law. Undue restrictions on firm entry and expansion in key network industries should be lifted to enhance productivity in potentially competitive segments. Higher quality education and more equitable access to it will be needed to help Mexicans develop their productivity potential in full. A key ingredient will be better teachers. Clear standards for teacher performance are needed to improve their initial education and professional development and to develop a teacher evaluation system that would guide their career development and help them develop their potential. School financing is currently complicated and uneven, leading to inequities. Given that overall spending on education is comparable to OECD levels, Mexico should work towards efficiency gains in the sector and creating a system that provides more reliable funding for all schools.

Chapter 4. Informality

Mexico has a relatively large informal sector by OECD standards. While this is in part a symptom of limited development and low productivity, it can also be to some extent its cause, as informal firms stay small to hide their activities and have limited access to productivity-enhancing government services, such as protection of property rights and training. A long-term and broad-based strategy with education at its core is needed for Mexico to reach its productivity potential and fight informality. Lowering the costs of formality, while enhancing its benefits and increasing the cost of non-compliance with labour and tax laws, will be an important part of this strategy. This would include more flexible labour laws, a further reduction in the business regulatory burden and a rethink of the social security package to enhance its attractiveness for low-wage workers and limit costs by making service provision more efficient.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

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