



## The Mood in Mexico

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My impression during a recent visit to Mexico was that the attitude of Mexicans is one of pessimistic resignation. This judgment is based on conversations with academics and knowledgeable people in government and private life. Opinion polls show that the biggest worry of the public is about personal safety and the inability of the authorities to stem the violence—drug wars, murders, kidnappings, and muggings—and this apprehension plus the sense of pervasive corruption undoubtedly contribute to the sense of helplessness that came up in conversations with Mexican friends.

There is considerable popular support for Mexico's new president—Felipe Calderón has been in office for six-and-one-half months, and his favorable ratings are now at 65 percent—but there is deep skepticism that he can cut through the political and vested interests to the extent that is required to grow the economy at a higher rate, or create enough new formal jobs, or resolve the energy problems that Mexico faces, or improve the educational structure, or provide equal justice before the law, or correct the growing inequality, and so on.

Economists refer to these kinds of problems as structural, that is, they transcend year-to-year macroeconomic matters like budgets, monetary policy, and the exchange rate. Structural obstructions impede economic growth, and the inadequate growth in gross domestic product has adverse repercussions throughout society. While emerging economies in Asia are growing at 8 to 10 percent a year, Mexico limps along at best at 3 to 4 percent a year—probably closer to 3 percent this year. The problems that now beset Mexico would be less disquieting if GDP growth were 6 to 7 percent a year, coupled with low inflation. The target for core inflation is 3 percent a year, but inflation is running at more than 4 percent so far this year.

There is a disconnect between favorable assessments of Mexico by Wall Street and the pessimistic reactions on the streets of the country. The rating agencies now consider debt paper issued by Mexico's federal government as investment grade, worthy of investment by pension funds; and it looks as if assessments of Mexico's financial and monetary performance will improve even more in the years to come. Fiscal policy in the sense of balance between intake and outgo is stringent; monetary policy is prudent; and foreign debt is moderate and carefully spaced. Mexico is thus seen as a good

place to invest; and indeed, much foreign investment is taking place, almost \$19 billion in 2006, a hair more than in Brazil, the two big destinations for foreign investment in Latin America and the Caribbean. The men and women in the streets, however, see inadequate job creation, low wages, poverty, and lack of physical safety. One's assessment depends on the part of the elephant that is of most concern to the observer.

It is known by now to those who observe Mexican developments that tax collections are only 11 percent of GDP, give or take a fraction of 1 percentage point in any given year of the last decade; and taxation of Pemex, the national oil company, provides another 6 percent or so of GDP for the federal government budget. Why is the tax take from the public so low, even by Latin American standards? The answer is a combination of tax evasion and tax avoidance. Tax avoidance, or loopholes to use a more common word, stem from special sectoral regimes built into the law. The Fox administration tried to increase tax collection by ending exemptions from the value-added tax for food and medicines, but the Congress rejected this. Agustín Carstens, the current finance minister, has proposed imposing income taxes on all persons who earn at least four times the basic wage—the basic wage is essentially a subsistence wage—but even if that succeeds, the amount involved will not be significant. It might raise the collections from the public to 11.5 percent of GDP. There is little official inclination to deal with the special sectoral tax provisions.

On the expenditure side, the Mexican fiscal system is replete with consumer and sectoral subsidies. I have been told by informed experts that it would accomplish little to increase appropriations for education until reforms are undertaken regarding the distribution of government allocations. Education now receives 25.6 percent of government expenditures. Further, there is an incentive for people to remain in the informal economy, because they pay no income taxes but still receive many government benefits, such as health care.

Mexico's informal economy is now around 60 percent of the labor force—calculated indirectly by subtracting those who are formally registered in the various social security registries

from the total figure. One reason for the low to modest growth of people in the formal labor market is that the benefits employers must pay are high, both when hiring and dismissing workers. Under these circumstances, employers look for ways to avoid new hiring and revert instead to part-time and informal workers. This situation is advantageous to entrenched labor unions, but not to persons outside these unions. The teachers' union is one such entrenched union whose president plays a large role in Mexican politics.

Despite substantial agreement among informed economists and sectoral experts that structural changes are needed, the Mexican government has made little progress in carrying out these reforms. One reason for this is the divided legislature in which the government party, the National Action Party (PAN, from its Spanish initials), lacks a majority in both houses. Consequently the president needs allies for any reforms that require legislation. President Calderón made headway in changing the structure of the federal government pension system by getting the Institutional Revolutionary Party (PRI) to vote with the PAN. This was a deal that was many years in the making, starting even before the current administration took office; and it required mollifying government workers and union leaders by giving the workers a substantial pay increase. However, even as this is written, the legal drama is not concluded because tens of thousands of *amparo* requests must still be dealt with. (*Amparo* is hard to translate, but it is a legal action to prevent the law from being applied with respect to the petitioner.)

In addition to the complexity of party politics in a country that only recently has become a working democracy in which the legislature is not completely subordinated to the executive, as it had been for 68 years, there are entrenched interests to preserve a status quo that is favorable to them. This is hardly unique to Mexico. One need only look at the complexity of tax and pension reform in countries around the world. However, the price that Mexico is paying is high. My back-of-the-envelope calculation is that Mexico is struggling along at 3 to 4 percent annual economic growth—actually closer to 2 percent a year if one looks at economic performance over the last 25 years—rather than the 6 to 7 percent a year that is needed. Sufficient economic growth would make Mexicans more confident about their country than is now the case. And Mexico's global prestige would be markedly greater than it is as the country struggles unsuccessfully to create enough good jobs to keep dynamic young men and women at home.

Structural change is needed, but I am unable to say which activities should have priority. Because of the complex politics and power interests involved in each case, President Calderón appears to be selecting his priorities based on what he believes is doable. Government pension reform came first, probably because of all the thinking that had taken place earlier. The president has made it clear that he does not intend to try to amend the constitution to permit government-private joint

ventures in the oil sector; the time is not propitious now and may never be.

My instinct, based on observations of other emerging countries, is that primary and secondary education reform is the most pressing need, because this affects just about all activities in the country. However, educational reform is a never-ending process, one in which the current structure needs modification, and continual choices must be made on the allocation of resources among the various levels of education. By all means, get started with the process even as other structural reforms are tackled.

Unless Mexico is lucky and finds another mammoth Cantarell oil well by chance and without exploration in the deep waters of the Gulf of Mexico, energy reform will be necessary in the next decade before Mexico runs out of reserves and becomes an oil importer. Mexico's competitiveness depends on having adequate and relatively inexpensive electricity generation, and this is related to energy reform. At some point, Pemex must be allowed to operate like a commercial company, one able to finance and explore in the deep waters of the Gulf of Mexico, rather than as a cash cow for the federal government.

Labor reform is necessary to achieve increased formal job-creation. Prices for many critical products and services are high in Mexico (telephone service is most everybody's favorite culprit), substantially exceeding prices across the border in the United States; measures to increase internal competition are patently required. Few Mexicans believe that there is equal justice in the courts.

Viewed abstractly, not many Mexicans would contest the need to address structural impediments to growth. However, when viewed specifically in the various sectors, there is less agreement on what the changes should be. There is a debate in the United States on immigration policy as I write these lines. There is general agreement that immigration policy needs change, but there is little agreement on the specifics; and this seems to be leading to stalemate in the U.S. Congress. Structural reforms in Mexico seem to be following the same pattern—agreement on a general level to do something, and disagreement on the specific level about what to do. Mexico's problem is more severe than that of the United States, because rich nations have more leeway for error.

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