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Mexico: Secular Low Economic Growth in the Age of Reforms

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Abstract

This essay focuses on four issues. The first is the country's low economic growth during such a long period of structural reforms. The second is the fiscal constraint in an environment of weak domestic demand to illustrate some flaws in fiscal policy. The third is a discussion of the economic and fiscal outlook under present conditions. And the fourth is a preliminary critique, subject to more research, of the focus of reforms and what appears to have gone wrong with them. The main purpose is to suggest new avenues for research.

Introduction

Mexico started to reform its economy in the early 1980s, after experiencing two macroeconomic crises in which fiscal deficits, inflation and currency overvaluation led to a balance-of payments crises and currency devaluation. These crises were a familiar problem in the world economy during its longest period of inflation in peacetime, i.e. during the 1960s and 1970s. The ensuing reforms were based on an emerging new consensus that emphasized the priority of controlling inflation and correct fiscal imbalances as prerequisites of stability, a consensus endorsed by the IMF and the World Bank.

The first crisis hit Mexico in 1976 and was addressed with a typical 3-year IMF program that was successful for a third of the program's duration before being jettisoned when the government in power suspended it to embark on a new cycle of growth.

The second and more severe crisis occurred in 1982 and included massive public and private external indebtedness and fiscal deficits, both of which led to an unprecedented devaluation, temporary exchange controls, a dual exchange rate and inflation that lasted for a decade. This second crisis was also addressed with two IMF programs and, later on, with foreign debt restructuring and structural reforms.

The program put in place to deal with this second crisis was the right one for controlling inflation and reducing the fiscal deficit, but only after unemployment jumped and household earnings fell for a prolonged period. One of its unexpected outcomes was that the rate of economic growth which Mexico had recorded in the range of 5% to 6% over the long pre-crisis period never returned.

In the transition from a crisis-hit economy to stabilization, this program applied blunt tools to a complex setting. As currency devaluation led to higher inflation, a tight fiscal policy was preceded by sharp increases in public and private prices. Monetary policy was also tightened, leading to record high real interest rates. The latter caused the fiscal deficit to get out of control, as tax revenues fell and debt service costs jumped. Inflation was 99% in the year when the crisis erupted (1982) and rose to 106% and 159% in 1986 and 1987 respectively. Finally, to deal with hyperinflation, the government resorted to an unorthodox stabilization plan in 1988-89, which included price and wage controls and a freezing of the exchange rate. Inflation fell to 19.7% in 1989¹, once the macro-economy was stabilized in terms of fiscal deficits and inflation, the reform program was strengthened by the administration of Carlos Salinas with key new reforms including continuing with trade opening, privatizations of state assets, including the banking system. A new credit boom

¹ There are numerous reviews of the pitfalls of orthodox stabilization policies that followed the simple template of IMF programs. One of the early critical reviews was from Sidney Dell (1983) who argued that the term "overkill", coined by Carlos-Diaz Alejandro to discuss stabilization plans in the Southern cone of Latin America, can also be used to describe other national and international adjustment programs in the 1970s and early 1980s. In his opinion, the economic retrenchment caused by such plans had gone much farther than necessary to achieve reasonable adjustment objectives. Another set of criticisms of such programs was by Tony Killick (1995) who analyzed a broader range of IMF programs in developing countries.

resulted from this and currency overvaluation. By 1994 the economy was again on the brink of a new (the Tequila) crisis, as high import growth led to a record current account deficit².

The reform template introduced during the Salinas administration³ has been maintained through the present time and the agenda for more reforms was reinforced by successive governments, as the rate of economic growth remained low. In practice these governments continue to give top priority to keeping inflation and fiscal deficits at low levels, as a means to strengthen confidence of financial markets and rating agencies, while they assume that the potential of growth will be untapped by more structural reforms.

This was the environment in which the new government of Peña Nieto launched its proposal to make a new generation of reforms which would include: Telecommunications, the energy sector, Labour and the financial sector, as well as more free-trade agreements after NAFTA.

Contrary to initial expectations at the time in which the agenda of new reforms was announced, however, the rate of economic growth weakened further since 2013. This was largely as private investment failed to rise, while domestic consumption has performed poorly.

This essay focuses on four issues. The first is the country's low economic growth during such a long period of structural reforms. The second is the fiscal constraint in an environment of weak domestic demand to illustrate some flaws in fiscal policy. The third is a discussion of the economic and fiscal outlook under present conditions. And the fourth is a preliminary critique, subject to more research, of the focus of reforms and what appears to have gone wrong with them. The main purpose of this fourth section is to suggest new avenues for research.

I. THE LONG-TERM RATE OF ECONOMIC GROWTH

Mexico has experienced a very low rate of economic growth since the start of pro-market structural reforms (1983-2015) -- an average of 2.0% per year in real terms. As a result of the meager growth, per capita income has hardly risen (as population growth was only slightly below 2 percent). One consequence is that during this period Mexico has recorded its largest ever emigration flow, mainly to the US, as large numbers fled north in search of jobs⁴. Another is that structural reform has failed to elicit broad popular support.

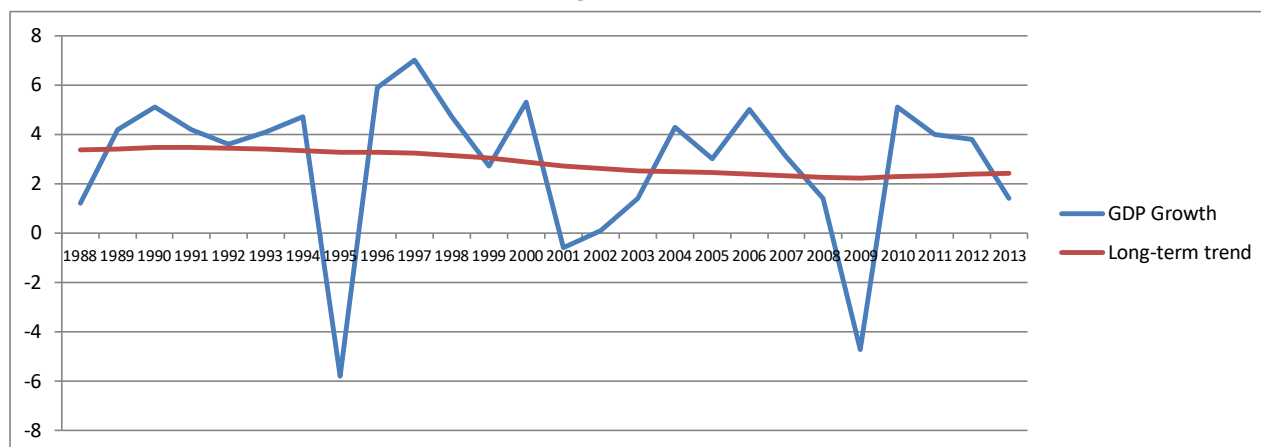
The data plot in table 1 on the next page cover the period of most intense reform, those years in which Carlos Salinas was president, many large state entities were privatized and NAFTA came into effect.

² My own review of this crisis and its high-bank debt sequel is in Ramírez de la O (1996, 2001).

³ The economic fundamentals of the reform program were presented by Pedro Aspe (1993).

⁴ The large increase in Mexican migration to the US is shown in Gordon Hanson (2007).

Table 1.- GDP annual growth in real terms 1988-2014



Source: Inegi

The main tenet of the reform process during the Salinas administration was the relegating of the state in economic processes and resource allocation, in line with a new consensus that emerged in the late 1970s in Europe and the US.

Mexico not only adopted the new consensus, but did it at an accelerated pace, partly motivated by the need to improve business expectations, as it attempted a transition from a high-inflation economy into an emerging economy with a solid macroeconomic foundation.

Yet, the country's economic structure at the point of the crisis had taken decades to build as a mixed economy with a large state presence in energy, agriculture, infrastructure, education, social security and development banks which provided long-term finance for large developments. Some of this structure had been created in response to market failures or inexistent markets. Thus, its elimination without being replaced by private competitive markets would weaken economic growth.

In key sectors insufficient markets and regulations were deficient to cope with rapid liberalization. The unprecedented introduction of the private sector into key sectors was exacerbated by the rapid opening-up of trade after decades of protectionism and during a transition period of high inflation that brought about very high interest rates. The situation was made more difficult by slowing growth and closing of large state development banks, during the 1980s and 1990s.

Employment fell sharply and informal, under-employed workers proliferated, in part the result of many plants closures and elimination of state subsidies. Loss of formal employment led to the weakening of an extensive system of social institutions that had been long in existence to support the working and the middle classes. The fall in real wages and in living standards became more acute as each successive macroeconomic crisis demanded new rounds of fiscal austerity, in 1983, 1985-86, 1995, 2001 and 2009.

The first stage of reforms undertaken in the late 1980s and early 1990s culminated in the first macroeconomic crisis of the post-reform, triggered by a balance-of-payments deficit in 1994, caused by the overvaluation of the exchange rate and accompanied by a fiscal deficit which had not been disclosed by the government until the crisis broke out and a new IMF program was in place, reinforced by a US Treasury emergency loan.

The rapid opening of trade combined with high interest rates and short-term capital inflows caused the peso to become overvalued and this led to unsustainable current-account deficits. The steep fall in GDP in 1995 shown in Table 1 above suggests the large size of macroeconomic imbalances that had accumulated.

The main feature of this macroeconomic adjustment - as that of previous adjustments in the 1980s, were higher taxes and public prices and reductions in public spending. The latter were reflected in downgrading of social services, higher unemployment and under-employment and large declines in personal income levels. The low momentum of investment in Table 2 below helps to explain the poor growth performance during different periods of reform.

Table 2
GDP and Investment Growth 1993-2014
Annual % avge growth and % of GDP

Period	GDP	Investment	Public	Private	% Oil right revenue/GDP
1993-95	-0.7	-8.2	2.9	-16.9	2.3
1996-2000	5.6	10.7	-2.5	19.0	2.6
2001-2014	1.8	2.4	-0.4	3.2	4.7
1993-2014	2.5	3.5	-0.5	5.2	3.8

Source: Inegi, National Accounts

A brief departure from the long-term trend observed in Table 2 was the high rate of growth in private investment during the immediate post-NAFTA period (1996-2000). This was partly a rebound from the large declines in investment in the run-up and during the 1994-95 crisis, but also and to a large extent the positive reaction to NAFTA.

Yet, after this brief departure from long-term trend growth, private investment followed with very modest growth, at 3.2% per year during the period 2001-2014, even lower than its long-run (1993-2014) trend of 5.2% per year.

Oil revenue contribution

A key feature of economic growth in the post-1995 period is the salient contribution of oil to state revenue, i.e. oil rights paid by Pemex to the federal government. This high contribution helped the government to finance the expansion in public spending. Oil production and oil prices were trending higher, during most of the two decades to 2014. Its volume peaked in

2004 at 3.4 mbd before starting to decline, while prices kept moving up to reach record levels in the period after the global Great Recession of 2008 period. In 2014, however, oil prices started to fall sharply, hitting Pemex's own revenue and its contribution to the federal government.

Table 2 above showed, that the increase in oil revenue between the late 1990s and the 15-year period 2001-2014, represented 2 percentage points of GDP of greater federal budget revenue. This was, however, not reflected in higher economic growth, as its rate fell from 5.6% to 1.8% in the two periods respectively.

The experience during this period fits the "Dutch disease" condition, which has been used in the economic literature to explain low economic performance in economies unable to absorb efficiently large gains from natural resource exploitation⁵. It is also possible that the elimination of much of the state's economic functions that had served Mexico during the 1960s and 1970s had cancelled much of its capacity to mobilize such large revenue for economic development.

Thus, during the period of higher oil contribution (2001-2014) budget revenue from oil represented a high 4.7% of GDP. Ironically, GDP growth was also at its lowest rate of 1.8%.

It was at this particular juncture, in 2012, that government officials urged a new phase of structural reforms as the only way out of a low growth trend. The current administration of President Enrique Peña Nieto, which came into office at the end of 2012, has focused most of its time and energy on a new set of reforms.

II. FISCAL CONSTRAINT AND WEAK DOMESTIC DEMAND

Fiscal constraint and oil revenue

The expansion of public spending at the same time that the economy suffered from a low rate of economic growth ought to be regarded as an aberration in a policy of macroeconomic stability, as greater budget revenues would become more difficult to materialize in a low-growth environment. This explains, at least in part, that non-oil tax revenues maintained a low ratio to GDP. Table 3 on page 6 shows that the latter were only 8% of GDP in 2000 and rose to 10.2% of GDP in 2013 after VAT and income tax rates were increased in 2010 and to 10.6% in 2014 after a new tax reform raised income-tax rates and eliminated various tax credits on individuals and corporations.

Rising public spending insofar as it reflected a larger bureaucracy was also in contradiction with the reform consensus that had emerged in the late 1970s. The rising

⁵ The term "Dutch disease" appeared in the literature since the 1970s and was treated by Van den Beld, C.A. (1978), Corden M. and Neary, J.P. (1982) and Bjorland, H. (1998), among others.

trend of spending was not, however, questioned by international organizations or rating agencies, as higher oil revenues would be there anyway to keep the fiscal deficit within a relatively low ratio to GDP.

Yet, once the volume of oil production had peaked and especially when oil prices started to fall in 2014, the fiscal deficit would rise from 0.9% of GDP in 2000 to 3.2% in 2014. The increase in public spending between 2000 and 2014 was a high 7.3 percentage points of GDP from 2000 to 2014, one of the highest in the world for any country. This is even allowing for 2 percentage points of adjustment in recorded public investment, as is explained below.

Table 3
INCREASE IN PUBLIC SPENDING AND SHARE OF OIL REVENUE 2000-14 - Ps bn and % Share of GDP

	2000	2005	2010	2013	2014	2000-2014	% of the	% of GDP		
						Increase	increase 2000-14	2000	2013	2014
Total Spending	1,239	1,958	3,334	4,178	4,531	3,292	100	19.2	25.9	26.5
Current	1,091	1,682	2,668	3,298	3,632	2,541	77.2	16.9	15.1	21.2
Investment	148	276	666	880	900	752	22.8	2.3	4.5	5.3
Total revenue	1,179	1,948	2,960	3,800	3,983	2,804	85.2	18.2	23.6	23.3
Oil revenue	319	709	1,027	1,344	1,221	902	27.4	4.9	8.4	7.1
Pure oil rent	196	469	641	862	780	584	17.7	3.0	5.4	4.6
Non-oil tax revenue	515	795	1,316	1,647	1,820	1,305	39.6	8.0	10.2	10.6
Revenue-spending	-60	-10	-374	-378	-548	-488	-14.8	-0.9	-2.4	-3.2

Source: Ministry of the Treasury, Public Finance Statistics

That is, the figures of public investment recorded through 2008 did not include about 2 percentage points of GDP which were investments made by Pemex, but financed off-balance sheet. The energy reform of 2008 changed this and started to classify repayments on off-balance-sheet projects as budgeted investment, which explains much of its increase after 2008.

In terms of resource allocation, the increase in current spending rather than in public investment was another flaw in policy, at the time when the country was showing increasingly deficient infrastructure.

Pemex, the entity that had operated since the 1940s as a processor of oil-based fuels required by the country's industries, changed its focus in the early 1990s to gradually become a crude oil producer and exporter, while gradually reducing its investment and production in refining and chemicals. This led Mexico to become a large importer of refined products, including gasoline, of which it presently imports one half of its consumption.

Weakness of domestic demand

A key feature of the reform period, unlike the 1960s and 1970s is that Mexico relied increasingly on external markets. This is not surprising in light of the poor increase in gross fixed investment shown in table 2 above. The export-oriented model that the country has followed since the opening of trade in the mid-1980s and reinforced by NAFTA largely consisted, with some exceptions, of domestic assembly of imported components, especially in engineering industries, which have been the most dynamic export sector.

These industries have provided many jobs, but the relatively small domestic value added has not led to a wider diffusion of trade on the domestic economy, unlike export oriented models in Asia or Germany. This explains how it is that the country's manufactured exports could expand without a large increase in gross fixed investment.

By the same token, the trade deficit, setting oil aside, deteriorated continuously, except for a brief period after the devaluation of 1995 from -\$21 bn in 1993 to -\$45 bn in 2014, as increases in total imports surpassed increases in manufactured exports. Its deterioration was manageable, however, because the rate of increase of domestic demand was very moderate, owing to a very modest increase in real incomes.

As this inter-temporal equilibrium between external accounts and foreign finance was accompanied by only a modest fiscal deficit which kept the debt ratio at a manageable level, Mexico maintained the confidence of financial markets and gained some upgrading to its sovereign debt rating. This state of affairs, however, had a counterpart in low economic growth.

The modest rise in domestic demand in the period of new reforms

The new phase of reforms started by the Peña Nieto administration has been focused mainly on energy and improving the market structure in telecommunications. Although other reforms have been enacted (such as, education and in the financial sector), these have had a much lower impact on output in the short- or medium-term and not much in business confidence.

The reform in telecommunication appears to have a positive effect via price reductions, increasing competition, and foreign investment. Yet, its impact on economic growth has been modest, so far and its long-term contribution depends on the new market participants increasing investment in the telecoms infrastructure and not only relying on the network investment which the dominant player (Telmex-Telcel) had made up until the time of reform. At this stage investment in this sector has slowed down and the network appears to have become over-burdened.

The reform in energy would similarly have effects over a longer time horizon, to the extent that private participation increases output and not just shares in Pemex's portfolio of projects. Furthermore, as Pemex' oil output has had an effective tax rate of 75% on the

gross value of reserves, the net contribution of the private sector will depend on a relatively high rate of taxation or very large additions to output in as yet unknown new fields.

This leaves the short- and medium-term outlook for growth to be determined by the same factors which up until now have resulted in only modest growth. As exports are showing much lower rates of increase than in the pre-crisis period, the domestic market becomes a key driver.

Now, one of the causes of low growth in domestic demand is the low level of incomes of working people, which have stagnated or deteriorated for the past three years.

Table 4 below shows that there have been more jobs since 2012, but the increment was based on jobs carrying a relatively low level of earnings. In contrast, jobs with relatively higher earnings have fallen since 2012.

Table 4
Million workers by level of earnings

Year	Total Payroll*	Up to 3 min wage (up to \$12.8/day)	Over 3 min wage (Over \$12.8/day)
2012 -Q4	39.676	28.344	11.332
2013 -Q4	40.486	28.935	11.551
2014 -Q4	40.316	29.83	10.486
2015-Q1	40.423	29.387	11.0
Change 2015-2012	0.747	1.043	-0.296

* Workers that indicate level of earnings

Source: Inegi, Indicadores Estructurales de Empleo

That is, 72% of the workers reporting earnings make less than \$12.8 per day, while only 27% earn more. Since 2012 those with very low pay increased by 1.0 million, while those with relatively higher pay fell by 296,000. Moreover, there were another 11.8 million people who work without pay, receive non-specified pay or are unemployed.

Such low earning power in the labour force explains the poor performance of consumption, and, in the absence of much greater investment or net exports, of GDP as well. This is shown in table 5.

Table 5
Private consumption and its drivers 2012-15

	Private Consumption	Number of Jobs	GDP	Inflation	Non-oil Tax revenue
	Real percentage change and million people for jobs				
2012	5.0	0.6	4.0	4.1	-2.4
2013	2.2	0.8	1.4	3.8	14.5
2014	2.2	-0.2	2.1	4.0	11.3
2015	3.2	0.2	2.4	2.7	29.2

2015 Private consumption through May; Jobs annual 2015Q1; Inflation July; tax revenue Jan-June annual
Source: Inegi y Treasury Ministry for tax revenue

As the data show, the expectations raised by the ambitious reform agenda announced at the start of the administration in December 2012 and the catchphrase “Mexican Moment” coined in the international media are not reflected in the poor performance of GDP, consumption or jobs. It is worth noting that the 3.2% improvement in consumption so far this year results in part from the lower inflation rate by slightly more than one percentage point over the same period.

Adding to the low momentum of consumption and investment is the federal tax reform enacted in 2014, which hit consumption of some goods, increased VAT in border regions, and raised top rates on income tax (corporate and individual), while reducing tax deductions.

Though some elements of the tax reform were justified, its imposition at a time of economic weakness further discouraged consumption and investment. Table 5 showed the jump in non-oil tax revenue of 11.3% in real terms in 2014 followed by 29.2% in 2015, while GDP has now grown only 2.4 percent.

III. ECONOMIC AND FISCAL OUTLOOK

It is difficult to see GDP growth improving much from its trend during the past three years. For one thing, there is no notable driver for job creation or earnings growth in the domestic market. Export growth continues, but only at 2.2% through September, below 7.2% in 2014. The current reading at official and international organizations is that the US economy will only grow moderately for the next few years, while the rest of the world faces slow growth and slowdown or recession⁶.

⁶ The IMF (2015) expects only a gradual pick-up in advanced economies in 2016, while Buitier, W. (2015) sees the risk of China leading to a new world recession.

Investment prospects are similarly subdued due to the fact that economic growth has proved to be lower than expected, while tax reform and the depreciation of the peso have complicated the situation of many companies.

Table 6 shows the monthly Inegi survey of business confidence specifically relating to the present as a good time for private sector investment. We can see that confidence is on a declining trend, with the cyclical rise in 2014 not reaching its previous cyclical rise.



Oil and Fiscal outlook

The fiscal outlook has been deteriorating over the past decade as low economic growth limits the potential contribution of tax revenue. While public spending has continued up, the only source of revenue capable to sustain such an expansion was the high oil price, as the volume of production has similarly started to fall. Its peak production of 3.4 mbd in 2004 has now fallen to 2.288 mbd estimated by the government for 2015 and 2.247 mbd in 2016.

Yet the dramatic reduction in oil prices since 2014 has now removed -2.6% of GDP off total public sector revenue. The tax reform the government did in 2014 has helped to offset the fall in oil revenue, but even so the fiscal deficit has continued up. This is shown in Table 7 below.

It can be seen in Table 7 that the government expects to reduce its deficit from -3.5% of GDP, as revenues stabilize and spending falls by -1.5%, or -1.2 percentage points of GDP. We consider this plan as difficult to fulfil, if public investment rises, as would be expected from large infrastructure works awaiting execution.

For one thing, falling oil prices (from the budgeted price of \$50 pb) and lower physical output should reduce revenue. For another, the tax reform appears to have delivered most

of its positive impact on revenue and for 2016 it is officially projected to only maintain its share of GDP. Yet, a large part of the increase in tax revenue observed up until now is through the special tax on gasoline, which mainly represents a differential between the cost of imported gasoline and the price at which it is sold to consumers in Mexico. As prices of gasoline in the US fell to levels much lower than Mexico's domestic price, this differential resulted in a net gain for government revenue, which explains that such "tax" contributed 45% of the annualized increase in tax revenue through July this year.

The government knows that it should not count on the contribution from the special tax on gasoline remaining this high, for the gasoline market should be liberalized in 2018, as part of the reform on energy. The liberalization would tend to close any gap between US and domestic prices, except for the cost of transport.

Yet, if such a tax revenue were removed, the gain observed so far in tax revenue would fall from 3.7% of by 1.7 percentage points to represent 2.0% of GDP. This gain would then be insufficient to offset the fall in oil revenue from lower prices of -2.7% of GDP.

Table 7
Public finance 2014-15 and Budget Bill for 2016

Ps bn and % of GDP

				% of GDP			Real Change %		Absolute Change
	2014	2015 Estimate	2016 Bill	2014	2015	2016	2016-2014	2016/2015 %	2016/2015
Economic Balance	-547	-633	-577	-3.2	-3.5	-3.0	-0.6	-11.4	56
Without high-impact investment	na	-181	-97	na	-1.00	-1.00	na	-47.9	84
Budget Balance	-547	-633	-577	-3.2	-3.5	-3.0	-0.6	-11.4	56
Budget revenue	3,983	4,013	4,138	23.2	22.2	21.5	-2.1	0.1	125
Oil	1,221	831	863	7.1	4.6	4.5	-33.4	0.8	32
Federal government	780	434	472	4.5	2.4	2.5	-43.0	5.6	38
Pemex	441	380	391	2.6	2.1	2.0	-16.4	0.0	11
Non-oil	2,762	3,181	3,275	16.1	17.6	17.0	11.8	0.0	94
Federal government	2,108	2,549	2,621	12.3	14.1	13.6	17.2	-0.2	72
Tax	1,808	2,295	2,421	10.5	12.7	12.6	26.2	2.4	126
Non-tax	300	253	200	1.8	1.4	1.0	-37.2	-23.3	-53
Organizations and enterprises	654	633	654	3.8	3.5	3.4	-5.7	0.4	21
Net spending	4,532	4,645	4,715	26.4	25.7	24.5	-1.9	-1.5	70
Discretionary (in programs) paid	3,577	3,543	3,530	20.8	19.6	18.4	-7.0	-3.3	-13
Deferred payments	-19	-36	-32	0.1	-0.2	-0.2	58.8	-14.1	4
Accrued program spending	3,596	3,579	3,562	20.9	19.8	18.5	-6.6	-3.4	-17
Non-program	954	1,103	1,185	5.5	6.1	6.2	17.1	4.3	82
Financial cost	346	416	473	2	2.3	2.5	28.9	10.5	57
States' sharing	585	651	679	3.4	3.6	3.5	9.4	1.3	28
Deferred debt	19	36	32	0.1	0.2	0.2	58.8	-14.1	-4
Financial cost of public sector	346	416	474	2	2.3	2.5	29.1	10.7	58
Primary Budget balance	-192	-217	-103	-1.1	-1.2	-0.5	-49.4	-53.9	114
Public Sector Borrowing Requirement (PSBR)	792	-741	673	-4.6	-4.1	-3.5	-19.9	-188.2	1,414

Note: The government has not issued its own estimate of 2015 expected outcomes, so we present here an estimate based on GDP shares expected by the Treasury

Source: Treasury Ministry, General Criteria for Economic Policy for the 2016 Budget

Public spending reduction

Quite apart from the difficulty to make up for falls in oil revenue, public spending has components that keep rising under any scenario.

These are: (1) operational spending other than personnel payments; (2) pensions; and (3) subsidies. These increased between 2000 and 2014 by 3.5, 7.6 and 6.4 times. Their combined share of GDP rose from 4.7% of GDP in 2000 to 9.5% in 2014.

Table 8 below shows average shares of GDP which key spending items have recorded during two periods since 2000: up until the global financial crisis (2000-08) and from 2009 onwards. The averages show a clear deterioration in both the budget balance and in the three spending items mentioned above. That is, other operational expenditure added 0.6 percentage points of GDP to the pre-crisis trend. Pensions and subsidies and transfers added 1 percentage point each.

Table 8
Long-term trend in Fiscal Balance and Expenditure 2000-2014
Percentages of GDP

	Average		09-14/00-08
	2000-08	2009-14	Difference
Budget balance	-0.4	-2.5	-2.1
Total spending	20.9	25.4	4.4
Physical investment	2.4	4.6	2.2
Current spending	12.4	15	2.6
Personnel payments	6.06	6.02	-0.04
Other operational expenditure	2.5	3.1	0.6
Pensions	1.7	2.7	1.0
Subsidies and transfers	2.0	3.0	1.0
Financial cost	2.4	2.0	-0.4
States' tax sharing	3.0	3.2	0.2

Source: Ministry of the Treasury, Table Financial Situation of the Public Sector

The government has made a pledge to reduce the fiscal deficit, partly justified by the difficult financial environment it expects for emerging markets in general. Yet, in light of the rigidity of spending trends as shown by this table, the only likely adjustment appears to be in physical investment, which is officially projected to fall by another 1.1 points of GDP, after falling -0.5 points from the Budget to the estimated outcome of 2015.

Such a reduction threatens future economic growth, as the government does not seem to appreciate that private investment cannot replace much of the required public investment, especially in infrastructure. One reason is that financial conditions in some large projects are not sufficiently attractive for the private sector. Another is that private firms require relatively high rates of return, which raises the cost of infrastructure for the government or for final consumers, as is now the case in highways in Mexico City and the state of Mexico, where these schemes have been used in recent years.

Thus the lack of easy ways to reduce current spending is not just a barrier against deficit reduction, but also a problem for infrastructure and for future fiscal stability. For example, “other” operational expenses have increased largely from the expansion of the

bureaucracy, as such spending has been used for outsourcing increasing amounts of services, a practice that has grown since the early 2000s.

At present these expenditures have become closely tied to the normal operations of the political and administrative bureaucracy across all branches of the state, i.e. executive, legislative and judiciary. In addition, there are many autonomous entities, such as regulators and commissions with specific purposes, which receive increasing budget allocations. Such a bureaucratic system has functioned under a model of mutual political support between all branches of the state, which has become essential for governability and for maintaining public policies without major changes.

Public pensions are part of this arrangement, which explains lavish pension plans for key union members and for the top level of the bureaucracy, higher than in most advanced economies. Even so, the ageing of the public labour force and insufficient contributions from new hiring call for increasing budget allocations for this purpose.

The increase in subsidies is largely explained by poor economic growth over a long period and lack of employment opportunities for over one half of the population which is considered to live in poverty. The political consensus has resulted in increasing budget allocations to social programs, despite their proven inefficacy to reduce poverty. As permanent beneficiaries of such programs a large sector of beneficiaries have in fact become clients of current public policy and thus encouraged to vote in local, state and federal elections. This makes any change of the social programs' focus politically very difficult.

It is only ironic that the expansion of subsidies through social programs was started as a budget item with the creation of the program "Solidaridad", by the Salinas administration, in 1993⁷. This program, undergoing changes in name and increasing expansion, is now represented in "Oportunidades". The budget item subsidies has had a 7-fold increase in budget resources over the period 2000-14.

The effect of many job losses, partly related to the trade opening of agriculture and the precariousness of labour earnings elsewhere have been partly compensated by transfers, which speaks volumes of the inadequacy of the economic strategy to create enough jobs and raise income for workers.

IV. WHAT HAS BEEN WRONG WITH REFORMS -- AVENUES FOR MORE RESEARCH

Given Mexico's low economic growth, its weak domestic market, and the limited contribution of exports to higher domestic value added, it is difficult to envisage any significant recovery

⁷ At the time of creation of "Solidaridad", the program received a prominent place in the policy agenda, according to Córdoba (1993).

in output or employment over the medium term. This section summarizes conclusions reached on the basis of data shown in previous sections and other, tentative conclusions or hypotheses that flow logically from the analysis, but which require further research. Their mention here is intended to motivate further research on structural reform.

Although structural reforms were aimed at modernizing sectors of Mexico's economy and move economic policy away from heavy state intervention towards market mechanisms, their impact on output or productivity has been limited to specific industries. On the whole, they are far from pulling the entire economy on a sustainable, higher rate of growth.

Such an outcome after so many structural reforms since the mid-1980s and high marks given to Mexico by financial markets and rating agencies, as an emerging market with disciplined fiscal and monetary policy, would have been surprising to any observer of its economy during the age of reform.

Yet, in light of the serious design limitations which macroeconomic adjustment programs implemented at the time of crises had, and the insufficient depth and breadth of structural reforms, such an outcome should not be surprising. For one thing, the reforms were based on simple templates which were not adapted to the complexity of an economy that had required extensive state intervention over a long period in which Mexico recorded high economic growth. The state was not only the sole producer and distributor of energy, but also a large investor and developer of regional projects, via development banks. It was also a strong regulator of commercial banks and direct participant in other markets insufficiently developed.

The transition from this complex system to a policy that was aimed at relying on market rules was not accompanied by higher economic growth. While many changes were made in legal or formal terms, actual changes in productivity or investment were more difficult to materialize and policy implementation often lacked the positive feedback of higher employment and incomes. Thus, the outcomes in key sectors were different from those observed in economies that were modernized under competitive environments. Private monopolies and oligopolies were sometime created from state privatizations, while insufficient financial regulation led to an early crisis in the banking system, i.e. only five years after privatization.

In macro policy, inefficient or wasteful government spending was masked by low fiscal deficits. This was possible because oil prices were high during most of the period (up until 2013) and public investment was often adjusted downwards in order to meet budget targets. In 2013, however, the high increase in public spending started to be accompanied by falling oil production and prices. The ratio of public debt to GDP started to rise and keeps rising through 2015, suggesting that continuation of high public spending will be increasingly difficult.

In industry, trade liberalization was largely based on standard economic models of competitive markets and removal of trade protection. This often took place, however, during

macroeconomic crises or periods of exchange rate appreciation. Either way it led to closures of many industries that had been large contributors to output and employment during decades of industrial development. That is, imports' share of output increased, as many linkages between domestic demand and domestic output were broken⁸.

While no protectionist policy is sustainable over the long term, this execution of policy, combined with the withdrawal of the state as a large investor in infrastructure and energy, was detrimental to the potential for growth. Large macroeconomic crises in the 1980s and 1990s caused record high real interest rates on bank loans, which exacerbated the negative loop of trade and domestic industry.

It should not be surprising, therefore, that gross fixed investment would only grow modestly for a very long period and plummeted at times of macroeconomic crises, as figures in Table 2 above showed.

By 2013, at the start of the Peña Nieto administration, good macroeconomic fundamentals in terms of monetary and fiscal indicators were firmly established. Yet the structure of the economy lacked the strength to produce higher and sustainable economic growth beyond its historical rate of 2% - 2.5% per year. At such a time the administration decided to launch a new set of reforms, along similar lines of those undertaken in the 1990s.

Apart from the limitations of reform design already mentioned, their execution in the most recent phase has been frequently incomplete. Many public institutions, especially in government, the Legislative, and the Judiciary, failed to measure up to what a modern market requires in transparency, independence from central government, accountability and governance. Such institutions have not yet delivered unambiguous results in line with a new, modern regime of regulation, except in isolated cases.

In salient cases resolutions from regulators have caused surprise regarding radio and television, public contracts in infrastructure, presumed collusion between contractors and state entities, bankruptcy of regulated financial institutions, involvement of government officials in elections and local and state election disputes.

In some instances of congressional secondary legislation of constitutional reforms, deviations from the original legislation or from the spirit of the law appeared to be sheltering powerful business groups from the terms of reforms.

⁸ The term "linkage" is used here in the same sense as Albert Hirschman (1958) introduced it to illustrate the importance of building up value chains of domestic production along successive industrialization processes, in order to encourage investment in new industrial capacity. In describing the strategy followed by South Korea, Ha-Joon Chang (1993) describes the heavy state involvement in the planning and budgeting of industrial policy, to the point when the state had to identify winner industrial sectors with high productivity growth in order to grant them support and seek the formation of greater industry and scale.

One outcome is that approval of thirteen constitutional reforms has failed to spark a change in the social or business environment, as is reflected in business and consumer confidence indicators.

These outcomes suggest that even when significant changes have been made to the Law with potentially large effects in key economic sectors over the long term, the insufficient evolution of political institutions makes them unable to deliver expected results. In this sense, at least, the actual practice of reform in those cases of failure may cause discredit to the reform process in a similar way as privatizations of state entities were discredited in the 1990s.

The relatively sudden creation of business opportunities associated with market deregulation, trade opening and privatization of state assets in a system where the state was a large producer and frequently a monopolist, would have required that public institutions were transformed as rapidly as the new policies were adopted and their independence from government and vested interests assured. The fact that institutions were not transformed has become increasingly evident, as public opinion sees constant failures in the justice system, government anti-corruption practices, public contracts and regulations of telecommunications, banking, and other sectors.

For economic growth, more than legal reforms, the key to Mexico's economic potential is the rate of growth in aggregate investment. Reforms, their selection and their focus would have boosted economic growth to the extent that they boosted aggregate investment and, consequently, the potential to create jobs.

That is, in many ways the economy and the political system were not ready for the simple reform template which the government has tried to implement during past decades. While maintaining a regime of modernization is necessary for public policy credibility, too obvious a divorce between reform expectations and outcomes is not conducive to public confidence.

More economic research is needed to clarifying which reforms have boosted growth and which have not and to attempt a distinction between successful and unsuccessful reforms and reform processes.

Mexico has come a long way on the path of pro-market reform, too far for any discussion of fundamental reversion or attempts to go back to old models. There must be, however, a critical examination of what policies are stale and inappropriate for the present global and domestic reality and what policies are still valid, even if they have been discarded during the period of reform.

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