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Mexico has pulled out half of itself from the waters of the past. To pull out the other half and move fully into the future, Mexico needs strategic decisions and clear leadership. But it also needs ideas, roadmaps, identification of public policies, whose results can be measured and can be demanded, as this study suggests.

The greatest strength of Mexico is its people, who want more, look for their own way and are willing to accept major material sacrifices to find it: a people looking for the wellbeing and the progress that only a profound shift of the Mexican economy and the country’s ideas of the future can provide.

Claudio Loser and Harinder Kohli editors

A NEW VISION FOR MEXICO 2042: ACHIEVING PROSPERITY FOR ALL

Foreword by Héctor Aguilar Camín
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ACHIEVING PROSPERITY FOR ALL

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Prosperity for All

Countries, like people, need a sense of identity and purpose, a clear project, a path towards a goal worth wishing for, a music of the future. They need to tell a story that moves them forward. The starting point for any transformation must be a clear narrative of where they wish to go.

The future must be drawn with clarity, so as to make it a place not only desirable but attainable—utopian to be sure, but at the same time practical. Those imaginary communities we call nations have need for roadmaps, projects that awaken their hunger for change and a collective ambition for improvement.

For many decades, the imagination of developing countries have pictured their future as nothing more than a repetition of their pasts: a melancholic horizon of shortages, limitations, poverty, and inequality.

The global success stories of the last third of a century, from the newly democratic Spain of the 1980s to the newly capitalist China of the dawning twenty-first century, have demonstrated to the whole world, however, that underdevelopment is not a matter of fate, nor is prosperity a club reserved for the already prosperous.

If one thing is clear from the compelling figures of the economic history of recent decades, it is that hundreds of millions of human beings—and entire countries—have seen the way to become masters of their destiny, and in not so many years—the rise of a new generation—have changed their history of limitations and deprivation for a present of achievements and prosperity.

History marches on and no triumph is definitive: we must keep on our guard and not let our productivity lag, so as to keep renewing both the promise and the instruments for improvement, so as to keep dreaming of the future, and to win it too. For a future worth wishing for and the formulas for attaining it are within sight and reach of all.

The book the reader is now perusing offers the rigor of a diagnosis and the music of a credible future. The diagnosis is transparent and follows five strategic paths.

1. The need for a highly competitive economy based on a human capital of outstanding quality, with access to sources of competitively priced energy and capable of making historical leaps both in the buildup of infrastructure and in the investment and financing of development.

2. A strategy to reduce inequality and foster inclusion in all orders, including access to education, to formal employment and to the social rights associated with it.

3. Enhanced competitiveness in the business environment, entailing reduction of monopoly practices and the establishment of rules of free and equal access to markets.

4. Macroeconomic stability and underpinning of public finances by means of fiscal reforms, the absence of which has made Mexico, among members of the OECD, the country with the lowest fiscal burden and the weakest treasury.

5. Strengthening the rule of law, the only way to guarantee legal certainty and predictability in democracy, and the greatest task pending upon Mexican public life.

So much for the diagnosis. As for the music of the future, this book promises a liberation and a reward.

The liberation refers to leaving behind what the authors call the “middle income trap” that Mexico shares with other countries. This trap consists in the country’s having already attained a level of development sufficient for its wages to be moderately high, thus threatening its comparative advantage relative to other countries with lower wages. At the same time, the level of productivity of the workforce is not high
enough to make it profitable, despite its rising cost, in the
global market.

The reward offered by the promised liberation can scarce-
ly be exaggerated: in the period of thirty years that this study
contemplates as its horizon, Mexico could aspire “to become
a country with an average per-capita income equivalent to
that of Germany or France”, although with a much larger
population, close on 130 million inhabitants (Germany today
has 81 and France 65 million).

Like many other countries, Mexico is in many ways pris-
oner to its history. It is tied by inherited institutions, publicly
fostered ideas, interests and sentiments. It has too much ac-
cumulated history, fossilized in its laws, its habits, its interest
groups, traditionally accepted practices, and in that ethereal
but resistant environment formed by the customs and usages
of the peoples.

There is a celebrated saying of John Maynard Keynes,
that politicians tend to be the ideological “slaves of some
defunct economist”. Mexico, on the other hand, is prisoner
to the decisions of some of its dead presidents. I refer to the
political heritage of statism and political corporativism that
we call “revolutionary nationalism”, which an efficient public
pedagogy has turned into something like a national identity.

This heritage includes traditions that are difficult to chal-
lenge: state ownership in the energy sector, limits to the
ownership of land, unproductive trade unionism, consented
illegality, defensive nationalism, excessive centralized state
control and bureaucratic patrimonialism (a sophisticated
name for the immemorial vice of corruption).

These are vices and customs that the country acquired at
various moments of its history: an anachronistic cocktail, but
one deeply rooted in public behavior, and one which resists
leaving the stage. Even so, it is a mentality that is ever more
strongly under attack.

Mexico already has half its body out of the stagnant
waters of the past. To pull out the other half and enter fully
into the current of the future, it needs strategic decisions and
clear leadership. But it also needs ideas, roadmaps, identifi-
cation of public policies whose results can be measured and
be demanded.

Mexico’s weaknesses are there for all to see, there is no
way to conceal them. But every Mexican weakness can be
read against some strength. Democratic institutions are not
enough to agree on the transformations the country requires;
however, they are representative and they do govern at all
levels. Mexico is now what it never was throughout its history:
a democracy.

Economic activity shows unacceptable degrees of
concentration that put the brakes on Mexico’s conversion
into a modern market economy, an indispensable condition
for growth. But that same economy responded effectively in
response to the open door provided by the North American
Free Trade Agreement (1994), converting the country into
an impressive exporter, with a modern industrial world-class
base. If similar investment opportunities can be opened in
the sphere of the internal economy, the productive structure
will make a leap forward to a plateau it has so far failed to
conquer: the enormous potential of first-generation consum-
ers within the Mexican population, perhaps some fifty million
individuals.

Finally, Mexican society is still marked by inequality, as-
sailed by serious injustices and levels of marginalization; but
at the base of that dispossessed society there is an epic of
effort and work that we have been unable to see, let alone
stimulate in all its strength and vigor through better institu-
tions of education and health, and better employment op-
portunities.

These are the millions of Mexicans who have migrated
within the country or elsewhere in search of work, opportu-
nities, progress for themselves and their families. This is the
silent epic of Mexico: that of the millions who leave in search
of what they need to wherever they may find it, what the
economist John Kenneth Galbraith referred to when he said
that in no other immigrant minority in the United States had
he found such willingness to work and to struggle as among
the Mexicans.

Those people who want something more, who seek out
their own path and follow it with stoicism are the greatest
strength of Mexico, the genuine ground of the landscape
upon which our misfortunes cross: a nation that seeks the
wellbeing and the progress that only a deep change in our
economy and our idea of the future can give.
Mexico is at a critical juncture. The next Administration will assume power at a particularly crucial time in Mexico’s economic and social development. Its priorities and actions will have a decisive impact on the country’s long-term economic, social and, perhaps even, political trajectory. If the political paralysis that has prevented the last two Administrations from tackling Mexico’s fundamental economic problems continues for another six years, the country may slide from its current low-growth equilibrium into a vicious cycle of economic stagnation, and subsequently dash the peoples’ hopes, further erode the government’s credibility, and worsen the law and order situation. By contrast, if the new Administration embraces a well-balanced reform agenda and adopts a package of bold initiatives early in its term, it could once again unleash Mexico’s vast potential and build the foundations of a more prosperous, safer, and dynamic society.

The basic objective of this study is to identify the priority issues that could influence Mexico’s long-term economic trajectory, and to outline a balanced action program necessary to effectively address these issues. It includes reforms and actions that would simultaneously achieve much higher and more inclusive growth, and thus would restore the sense of pride and optimism among Mexicans that has been eroding in recent years. The issues discussed are of such importance that we believe the legacy of the next Presidency could be determined by the Administration’s willingness and ability to implement the agenda outlined in this report.

As there is a consensus among many well-informed experts that Mexico is already heavily analyzed but followed only by minimal reform, it is legitimate to ask: what is the value-added of yet another study? We believe that this study is unique in the following respects: (1) it focuses primarily on multi-generational issues most likely to determine the country’s long-term prospects; (2) it uses global comparisons to assess Mexico’s long-term strengths and weaknesses; (3) it focuses on inter-linkages between individual issues, rather than cylindrically analyzing them; (4) its proposals are non-ideological, non-partisan and free of institutional biases; and, importantly, (5) it presents a prioritized agenda of immediate actions within a longer term framework to tackle the multigenerational issues. The components of this agenda must be treated as a package, rather than piecemeal, because of the strong positive interaction among its proposals.

Mexico is mired in the middle income trap

The basic conclusion of this report is that, despite its numerous advantages, Mexico is mired in the “middle income trap”. Countries categorized as having fallen into the middle income trap have wages that are too high to allow them to be globally competitive in basic manufacturing reliant on low wages, yet they do not have the technological capabilities, human capital and institutions necessary to produce more sophisticated products to compete with the advanced countries. In other words, these countries have not made the transition from input-driven growth to productivity-driven growth. Mexico fits this paradigm; though, it is not alone in this predicament. Compared to the rest of the world, Mexico has essentially been at a standstill during the past thirty years. Relative to the major emerging market economies in Asia and East Europe, and Brazil, Mexico has steadily fallen behind.

The main differences between Mexico and the dynamic East Asian countries—such as Korea and Taiwan—that have successfully avoided the middle income trap are: (1) East Asia has achieved major gains in total factor productivity, while it has stagnated in Mexico; (2) Asian countries—including China and India—have much higher savings and investment rates; (3) Asian countries place great emphasis on human development and meritocracy in their education systems, and produce a markedly higher number of engineers, scientists and doctors; (4) Asia’s public and private investment in infrastructure has
been much greater; and (5) East Asian countries have more open economies. As a result, East Asia has avoided the middle income trap and become the manufacturing hub of the world.

An ambitious vision of Mexico in the next 30 years

In the next thirty years, Mexico can aspire to become a country with an average income that is equivalent to that in Germany and France today. It would transition into a country of opportunity and prosperity, and the population would have much higher living standards. Both men and women of all ages would attend good schools, be they private or public, taught by world class educators. These individuals would create a world-class workforce suitable for a knowledgeable and technologically advanced economy. Higher investments and institutional reforms would help improve healthcare, and well-functioning infrastructure would make the environment more conducive to a better life. Crime would fall to levels comparable to those in European countries today. The economy would allow those individuals with the willingness and aptitude to excel to achieve intellectual and financial rewards. The poorest quintile of the population could experience at least a five-fold increase in its income, while those in better situations could experience a near tripling of their average incomes. Older citizens would enjoy the financial security reaped from a universal retirement pension system that is anchored in a deeper, more robust financial system and a stable macroeconomic environment.

The government would play a key role in monitoring the operation of the private and public sectors, would manage credible justice and security systems, and ensure better environmental quality. Mexico’s private sector would compete openly while following best practice corporate governance standards—including the judicious application of the law and respect for contracts—and a strong code of ethics. Mexico would become a country where the rule of law is unquestionable.

Relations with the rest of the world would be based on a position of strength, with trade and investments that go well beyond a better-functioning NAFTA. Mexico would balance its position with the two powerhouses of the world, the US and China, while diversifying its economic, trade and investment relations to take greater advantage of the opportunities in the fast growing emerging markets. Finally, it would play a more influential role in global governance.

This vision may appear ambitious but given Mexico’s numerous strengths and the past experience of East Asia, its realization is well within Mexico’s reach provided Mexican leaders and key stakeholders in all key aspects of the society adopt a “can do” approach.

Framework to escape the middle income trap and achieve higher, more inclusive growth

For Mexico to realize the above vision by extricating itself from the middle income trap and breaking away from the current low-level equilibrium, its leaders must implement multi-pronged policy reforms, comprised of the following seven mutually-reinforcing building blocks:

1. Building a high-productivity economy on the foundation of strong human capital development, access to competitive energy, and advanced infrastructure and finance: A much more competitive economy is the key to faster growth in Mexico. To this end, it will require strong human capital, competitive physical inputs, and equitable access to finance. On the human capital front, quality education at all levels must become a national priority. Good education is the single most powerful tool to increase economic growth, enhance competitiveness, and promote inclusion. On the physical front, fundamental reforms are needed in energy (particularly petroleum, gas, and electricity), in addition to much higher public and private investments in infrastructure. Deepening financial intermediation while fostering greater competition and better serving currently underserved segments, while supporting an environmentally sustainable growth framework are other prerequisites for a competitive economy.

2. Reducing disparities and fostering inclusion: Mexico’s persistent large inequalities and lack of inclusion may trigger social and political tensions, which could potentially lead to conflict and constrain growth. The above vision of a more prosperous Mexico cannot be realized without a firm commitment to equality of opportunity and inclusion. In addition, with the advent of political inclusion, pressures for social and economic inclusion will mount. A noteworthy form of exclusion that must be addressed is the existence of the large informal sector, characterized by its limited
skills and access to credit and the resulting difficulty in acquiring new technology. This large and growing sector weakens the productivity and competitiveness of the entire economy. The sources contributing to this problem are poor legislation, high non-wage labor costs in the formal sector, poorly designed tax and social security systems, and widespread corruption, all of which provide incentives to operate informally and continue to do so. Recent success in reducing income inequality has been facilitated by the Oportunidades program. In order to maintain this positive trend, the government must give high priority to addressing the inequalities in basic education; improve access to secondary and higher education, justice, infrastructure and finance; and remove the pervasive incentives to informality. Efforts in these areas should transform the current vicious cycle into a more virtuous one, which would include faster growth; better human capital; and a more inclusive society.

3. **Enhancing competition through major improvements in the Business Environment:** A competitive Mexican economy can best thrive in a business environment that provides the right incentives for competitiveness. A major strengthening of Mexico’s competitiveness can be achieved by breaking down the hold of public and private monopolies, as well as other entrenched vested interests, and by promoting greater competition throughout the economy. Legislation focused on the establishment of strong labor unions has generated serious rigidities in labor markets, thus raising the cost of labor. Lack of competition has made large parts of the economy uncompetitive.

4. **Ensuring a stable macroeconomic environment and launching major fiscal reforms:** Over the past decade and a half, Mexico has achieved macroeconomic stability that had long eluded it. However, to sustain this situation over the longer term, while simultaneously achieving the much needed increases in physical and social investments, the country has to implement comprehensive fiscal reforms. Such reforms should aim to improve the efficiency and yield of the non-oil taxes as well as increase and enhance the composition of public expenditures. Replacement of the current balanced budget rule with a structural fiscal rule would help increase macroeconomic stability by permitting higher expenditures than currently allowed in times of recessions and vice versa. This more certain macroeconomic environment will permit the private sector to make better and more strategic business decisions. Additionally, the establishment of an intergenerational oil fund would provide equity and critical support to the implementation of the structural fiscal rule and help limit the dangers of the “Dutch disease” should oil revenues increase. Finally, the current sound monetary policy framework must continue, as it has served Mexico well and carries considerable credibility.

5. **Strengthening the rule of law:** In the international context, Mexico’s formal law is recognized as being transparent, clear and consistent. However, Mexico ranks poorly in terms of enforcement of the law, particularly pertaining to the fair and proper prosecution of those suspected of committing an offense. There is a 2008 legal mandate to change the penal system by June 2016 from its current inquisitorial model to one that is adversarial, including an alternative justice track and oral trials. These efforts should help make the system more efficient and improve the rule of law. Prompt implementation of this plan and a general improvement in the legal system are central to the improvement of Mexico’s institutional set-up and business environment.

6. **Improving governance, and restoring law and order:** Democratization and decentralization have generally contributed to better governance at the federal government level. Yet, Mexico continues to suffer from widespread corruption. Without a significant reduction in the level of corruption, it cannot reach the developed economy status. Although eliminating corruption is a lengthy process, it must constitute the core agenda of any reform-minded government. The next administration should adopt a program that puts an end to non-transparent rules, state and private rent-seeking activities, and reduces the power of other vested interests, such as the unions. In addition, Mexico faces two other major governance challenges...
that are unforeseen by-products of the democratization and decentralization of power. First, the “fiscal federalism challenge” is a prime concern; sub-national governments derive most of their revenues from mandated fiscal transfers from the federal government, and thus feel no obligation to represent the best interests of their constituencies. A greater reliance on locally collected taxes would increase the incentive to govern well, and also provide higher quality services while allowing for long-term growth of their tax base. Second, the “accountability of sub-national governments” is equally important but largely missing at this stage. Accountability should be a central topic in the agenda of Mexican federalism through enforcement mechanisms that dissuade inadequate behavior, foster good governance, and significantly reduce corruption. Finally, but as importantly, Mexico must reverse the unprecedented increase in crime over the past four years through a sustained multi-pronged approach.

7. **Consolidate Mexico’s global position as a major emerging economy:** While preserving its privileged relationship with the US, Mexico needs to broaden the focus of its foreign relations. A greater focus on Central America is critical to curtail drug trafficking and promote a more prosperous neighborhood. Closer links to the rest of Latin America, including Brazil, are essential to the diversification of Mexico’s economic relations and associated reduction of its high vulnerability to external shocks from the North. In a broader global context, Mexico needs to simultaneously strengthen relations with the EU, and regard Asia as a partner, not just as a competitor, with particular focus on China and India (which could be the world’s two largest economies by 2050). In parallel, Mexico should continue its commitment to multilateralism and play an active role in global governance through its membership in organs such as the G-20, Global Stability Forum, IMF, WTO and the UN.

It will be very helpful if there is national consensus on this framework amongst all major political parties, business leaders and other stakeholders in Mexico’s well being so that its implementation is continued over multiple administrations.

**Priority agenda for the next Administration**

This study recommends that the following priority actions be implemented within the first half of the next Administration. Details of each action item are given in the Overview and supporting analysis provided in the relevant background papers. As emphasized earlier, these actions must be treated as a package and not acted upon in a piecemeal or ad hoc basis:

1. Enact fundamental reforms in education to improve the quality of education at all levels to create a world-class workforce conducive to strengthening Mexico’s long-term competitiveness and creating a more inclusive society (Box 1, in the Executive report). Adoption of national standards and tests to promote meritocracy, availability of merit based national scholarships, teaching of English and facilitation of mobility between educational institutions would raise educational standards, promote inclusiveness and improve efficiency.

2. Adopt a program to enhance the role of universities as a source of technological development and innovation in cooperation with the productive sectors, to promote technological advances and research (Box 2).

3. Remove constraints on PEMEX’s efficiency and managerial autonomy and encourage the import of the latest technology needed to maintain the current hydrocarbon production level and encourage both internal and international competition throughout the entire hydrocarbons value chain by opening the sector to private sector. Remove PEMEX from the Federal budget and reform its pension system (Box 3).

4. Make the cost of electricity globally competitive by removing CFE’s monopoly, eliminating cross subsidization, and introducing competition in generation and distribution (including introduction of private sector), under proper regulation and supervision (Box 3).

5. Transform Mexico’s conservation strategy; improve the climate change strategy; and improve the management of scarce water through market mechanisms to provide for an improved environmental policy as a self-interest priority (Box 4).

6. Implement policies and regulations to foster greater competition in the financial system so as to increase
and reach while expanding the role of the non-banking financial sector; incorporate the informal sector by improving property rights and thus allowing it greater access to finance; and enhance access to the financial system by the excluded parts of society, (Box 5).

7. Implement the agreed national program to substantially increase investments in (non-oil) infrastructure to 5 percent of GDP or more through the allocation of more public budget and the acceleration of public private partnerships (Box 6).

8. Develop and implement a comprehensive set of policies and institutional reforms to encourage firms and workers to move to the formal sector and reduce the current high level of informality, including by adoption of incentives and costs to encourage informal workers and firms to join the formal sector (Box 7).

9. Strengthen and implement new polices that seek to reduce inequality and promote inclusion of all segments of society in the mainstream economy and political processes by ensuring universal access to quality education and health care facilities, improving infrastructure and information needed to access to markets, strengthening property rights, and applying the rule of law equally to all (Box 8).

10. Initiate an urgent review of the social, economic and institutional implications of the approaching ageing of the Mexican society and launch preparatory steps before the end of the Administration (Box 8).

11. Aggressively implement the recently enacted competition law, applied equally to public and private firms, in order to overcome a fundamental reason for Mexico’s fall into the middle income trap, i.e., lack of adequate domestic and international competition in major parts of the economy; and liberalize further conditions for foreign direct investments (Box 9).

12. Design and carry out comprehensive fiscal reforms that would increase total tax revenue by about 5 percentage points of GDP during the next four years and raise, while improving the efficiency and effectiveness of, public expenditures. Shift to a structural fiscal rule, adopt a uniform social security system, and establish a universal and transparent accounting system at all levels of government (Box 10).

13. Establish an intergenerational fund (like Norway’s oil fund or Chile’s copper fund) to address intergenerational equity, help implement the structural rule, insulate Mexico’s vulnerability to short-term fluctuations in oil prices and reduce the risks of “Dutch disease” (Box 10).

14. Ensure early implementation of the 2008 Judicial Reforms mandate and strengthen the rule of law and integrity of contractual obligations (Box 11).

15. Enforce the current anti-corruption legislative framework and associated initiatives and create a credible complaints mechanism (Ombudsman’s office at both the national and state levels) about unfair applications of laws and regulations by public officials, (Box 12).

16. Improve governance, particularly to address unintended consequences of the decentralization of political power to the state level and lack of accountability of sub-national government organs (Box 13).

17. Adopt a new national security policy, within a multilateral context, to restore security of all citizens, fight drugs and organized crime, and renew the legitimacy of state authority and people’s trust in police, judiciary and other public organs (Box 13).

18. Reposition Mexico’s relations with the rest of the world within and outside NAFTA (Box 14).

Implementation of this comprehensive policy reform package would allow Mexico to break out of its current “sad equilibrium” and achieve the vision outlined above over the next thirty years. The results could include income per capita that is 3.5 times as high as current levels, as well as Mexico’s rising international stature as a significant player in the world economy.

But this is not a foregone conclusion. Under current conditions, and with stagnant policies, per capita could double, but will most likely fall short if the underlying internal and external conditions deteriorate. Per capita income has only grown by 20 percent since 1980. Without fundamental changes, the future may well repeat the past.

A better Mexico will be achieved through hard work, devotion, and a single-minded and cooperative pursuit of results by all segments of Mexican society. While it remains
vulnerable to forces beyond its borders, in the end, the final outcome will be shaped only by Mexico itself.

Mexico’s journey to reach the vision of a prosperous and peaceful society must immediately begin with the inauguration of the next Administration.
As the great Mexican writer Carlos Fuentes suggested so incisively, the personality of Mexico has been characterized as an overlap of complex and contradictory masks. Its long history has been dotted with moments of glory and moments of despair and its people have developed an admirable degree of resilience as a result.

The economy of Mexico reflects this reality, with multiple layers that are closely intertwined and pull the country in different directions, drawn by a centrifugal force that does not allow it to move forward to the extent that all its parts would suggest it could. Modern centers of excellence coexist with forgotten areas of underdevelopment and exclusion. Highly competitive and progressive industries, with an international presence, mix with tightly controlled and inefficient government monopolies and areas of excessive concentration in the private sector. A small, but growing and increasingly sophisticated middle class lives within a society that has a high concentration of income and pockets of dramatic poverty. An increasingly self-assured democracy still has areas of political feudalism, and a despairing war with and among drug gangs.

It has been almost thirty years since the debt crisis that confronted Mexico in 1982. It was followed by a period in which the Mexican economy went through a difficult and at times painful process of crises, stagnation, contraction, and growth. From a macroeconomic perspective, the years after 1995 were the most stable in recent Mexican economic history. The underlying policies were implemented by a sophisticated technocracy, helped by the integration of Mexico in the North America Free Trade Agreement (NAFTA) and a determined effort to open the country to the rest of the world.

A solid economic performance, in the context of sustained world economic expansion, gave Mexico an unwarranted sense of security and complacency. It thus became increasingly difficult to push a reasonable structural reform agenda: public finances followed a short-sighted path based on a dwindling pool of oil. Tensions among different sectors of society increased; technology, education, and infrastructure improved at a snail's pace. Investment and savings rates are low; and total factor productivity has remained stagnant. As a result, Mexico’s growth rate has fallen behind its peer emerging economies.

Mexico’s economic climate was further affected in 2008–09 by the Great Recession, as it experienced the largest decline in GDP in its recent history and among major Latin American economies. Since then, the economy has recovered to pre-recession levels, but remains vulnerable to external shocks, even with its sound but small financial sector almost intact. Thus, there are serious questions about the sustainabil-

dity and growth prospects of the Mexican economy.

As Mexico’s path towards prosperity has become increasingly disappointing, it has resulted in substantial emigration. Although the Mexican Diaspora’s remittances have been an important factor in reducing income disparities, they are not the permanent solution to the country’s difficulties, nor is the high reliance on NAFTA. The country has fallen into the middle income trap: while it has been successful in breaking

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1 The study underlying this paper was prepared by a team of experts consisting of Drew Arnold, Mahmood Ayub, José Fajgenbaum, Hervé Ferhani, Harinder Kohli, Harpaul Alberto Kohli, Claudio Loser, Anil Sood, and Aaron Sayf (all of Centennial Group), Juan Pardinas, Manuel Molano, Rodrigo Gallegos, Alejandro Hope, and Roberto Newell (all associated to IMCO), Edna Jaime (México Evalua), Jeff Puryear, and Alexandra Solano (Inter-American Dialogue), Lucrecia Santibañez (RAND Corporation), and Carlos Malamud (Real Instituto Elcano). The team benefitted from the able and indefatigable technical support of Katy Grober and Charlotte Hess of Centennial Group. Centennial Group has prepared this study on the basis of the methodology developed for and the experience gained from five similar studies carried out by the Group and published over the past two and a half years: India 2039—An Affluent Society in One Generation; Latin America 2040—Breaking Away from Complacency: An Agenda for Resurgence; A Resilient Asia Amidst Global Financial Crisis: From Crisis Management to Global Leadership, The New Resilience of Emerging Market Economies; and Asia 2050: Realizing the Asian Century. The work also has drawn on the experience of many sources in Mexico, as well as from the work of a number of international institutions, particularly the International Monetary Fund, the Organization of Economic Cooperation and Development, the World Bank, as well as the Inter-American Development Bank. Also, this study incorporates the results and findings of a number of important publications of IMCO and México-Evalua, including “Mas allá de los BRICS-Índice de Competitividad Internacional 2011: IMCO, México, October 2011.”
away from poverty, it has subsequently remained in a state of mediocre stagnation.

Further complicating Mexico’s path to sustained and inclusive prosperity is the pervasive presence of drug trafficking and crime. Violent gangs have been involved in major turf wars and an open conflict with the Mexican government. The wars have been centered in a few geographic areas, but they have damaged confidence in the capacity of the government to operate effectively.

The growing population has placed the country’s natural resources under stress, with respect to the use of water, the implications of a highly urbanized society, and limits to cultivable land. Pollution and the degree of environmental degradation may appear to be of lesser gravity than in Asia, but they remain very serious. The issue of environmental control remains a central concern that needs to be addressed, in the first instance, in Mexico’s self-interest for the well-being of the next generations and as a commitment of Mexico as a responsible global citizen.

This study reviews the possible reasons why Mexico has fallen into the middle income trap, and presents strategies to extricate the country from this trap over the next several sexenios. The study is policy-oriented, as it aims to outline a policy platform and priority agenda for the next administration within the context of a longer term reform agenda. Its basic premise is to present fundamental, mutually reinforcing reforms for Mexico to achieve higher, sustained, and more inclusive economic growth than it has in the past thirty years. Some issues are cross-cutting, among them education, informality, energy, vested interests, and drug-related crime, and cannot be treated in isolation within one section alone. While it is practically impossible to cover all aspects of Mexican society that require reform, the idea is to provide an ambitious—but doable—action plan for Mexico to establish a strong foundation over the next sexenio that would allow it to attain prosperity and inclusion in the next thirty years.

**Mexico in the middle income trap**

The economic trajectory of a steadily growing country would be a strongly upward line, with possible breaks due to international events, like global or regional crises. This is the experience of South Korea and is also emerging in China and India (Figure 1). But many middle-income countries, including Mexico, do not follow this pattern. Periods of growth are
followed by periods of decline. As a result, GDP per capita fluctuates with only a slight upward trend. This is what is referred to as the middle income trap—a situation where a country is unable to compete with low wage economies in manufacturing, and, also unable to compete with advanced economies in high skill innovations. In fact, few countries sustain high growth beyond a generation, and even fewer experience high growth rates once they reach middle income status.

Only 13 countries sustained growth of more than 7 percent for at least 25 years in the post war period. These countries have five common characteristics: (1) Openness to the global economy in knowledge and trade; (2) macro-economic stability; (3) “future orientation”, with high rates of savings and investment; (4) reliance on markets and market-based prices to allocate resources; and (5) leadership committed to growth and inclusion with a reasonable capacity for administration. These success factors are necessary—but not sufficient—for continued growth. Reaching incomes associated with the advanced countries is uncommon: only a few high-growth countries have done so. It is much more common for growth to slow markedly when reaching middle-income status, as observed in Latin America and the Middle East.

In general, when middle income countries break away from low levels of income, wages start to increase. The “low-wage, labor-intensive manufacturing for export” model does not work well, and the countries slow down and seem trapped. At the same time, they often do not have conditions to grow through major innovations, like affluent countries do. Caught in this quandary, they can become trapped without a viable high-growth strategy to reach high income status. Mexico falls in this category.

For Mexico to extricate itself from this trap, it will need to implement a multi-pronged policy approach, as discussed in this study.

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2 Commission on Growth and Development’s review of growth in developing countries.
Mexico's performance has fluctuated enormously over the period of its existence, even before its independence. Over the course of a century and a half, Mexico grew at a faster rate than the global economy. Based on estimates by Maddison, Mexico's share of world GDP rose during the first three quarters of the 20th century and reached a peak of 1.7 percent of world GDP in 1973, with GDP per capita exceeding the world average by some 50 percent (Figure 2). Starting in the 1980s, the growth of both GDP and per capita GDP started to slow and lagged the rest of the world (Figure 3). Perhaps, because per capita incomes remained relatively high, Mexico became complacent, focusing on progress with respect to others in Latin America, and not with respect to the rest of the world. Per capita incomes are currently reasonably high; the country benefitted from the major booms in oil prices (but also suffered from their declines); and many individuals have been lifted from abject poverty in the last decade and a half. Mexico opened to international trade after years of isolation, and reaped many benefits of a globalizing world, including from important capital inflows. However, the gains were concentrated in traditional activities and not in new, more dynamic and profitable areas. The degree of openness is the highest among the larger countries of the region, but lags behind the more dynamic emerging economies in Asia. While economic growth seems to have increased after Mexico recovered from the serious financial crises in 1994–95 and 2009, current policies have resulted in an average economic growth rate of less than 3 percent a year (about 1.5 percent on a per capita basis). An acceleration of growth to about 5 percent a year, as proposed here, cannot be achieved within the current strategic framework and policies, and within historical levels of savings and investment.

The reasons for Mexico's weak performance

In today's competitive environment, Mexico cannot compare its performance to the past or some ideal target. As countries in Latin America and in Africa, Asia, and Europe have discovered, they cannot stand still or view themselves in an inward-looking fashion. Mexico needs to compare itself with its competitors and other emerging economies, or it will become a frustrated spectator on the world scene.

It is not surprising that Mexico scores poorly on the 2011–12 Global Competitive Index, ranking 58th out of 141. Although the current rank is an improvement from its 2010 rank of 66, it remains well behind the US (5), Korea (24), China (26), Chile (31), and Spain (36). It lags behind the Advanced Economies (13), the Newly Industrialized Countries (NICs) (18), and Developing Asia as a whole (38). Mexico only ranks marginally better than Latin America overall (65).

Productivity

Growth potential and competitiveness are closely related to performance with respect to total factor productivity (TFP). Regarding the absolute level of TFP, Mexico remains ahead of China and India as well as developing East Asia. However, TFP growth in Mexico has been negative in the last 30 years, although this value is in part the effect of drop in output of 2009 (Figure 4). Most Asian countries (particularly China, Korea, and India) are showing high TFP growth.

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1 Based on background chapters, including Mexico and the World by Claudio Loser, Drew Arnold and Aaron Styl.
2 Maddison A. (2004), the World Economy, a Millennial Perspective.
3 These estimates, which end in 2003, are subject to considerable uncertainty and are based on longer term historical studies, like that of Maddison, and provide a very long term view. Estimates based on current dollars (see Figure 1) are more realistic in portraying developments in the last quarter century, even as they show a lower per capita GDP for Mexico compared to the rest of the world.
4 As discussed in this study, TFP is defined as the increase in GDP not explained by changes in the labor force and the stock of capital. In this regard the numbers will tend to be smaller than the other common measure, labor productivity, which relates to the ratio of GDP and labor force, and thus implicitly includes the effect of investment. Such a measure would, of course, show a higher value than TFP, to the extent that the capital stock grows at a faster rate than the labor force.
Per capita incomes, Mexico and other countries: 1820–2003

Source: Maddison, A.

Per capita income growth rates, Latin America, Mexico, and the World (average percentage change over each period)

Source: International Monetary Fund, World Economic Outlook Database, April 2011.
Low rates of saving and investment also have limited Mexico’s growth potential. Savings and investment (as a percent of GDP) exceed the levels in the US and many countries in Latin America. However, given its per capita income and low growth, these levels are clearly inadequate. At about 23 percent of GDP, investment is about one half of the levels in China, and about 10 percentage points lower than the NICs at the time of their breakaway from middle income status, and India. The gaps are even larger in the case of savings.

There are a number of sectors that have poor productivity rates, which increase economic costs enormously. From this perspective, it is crucial to understand that fundamentally there are three economic Mexicos. The first is a Mexico which is under old-fashioned government control, as was the trend in Latin America in the 1950s and 60s. This Mexico is apparent in its old political formats, the teachers’ union, Pemex, CFE, and inflexible labor and agricultural land regulations. The second is vested-interest Mexico, which is characterized by interest groups and businesses that extract rents from consumers, mainly as they operate without foreign or domestic competi-

Education

Education is a critical component of productivity growth. Education is the most powerful tool that a country has available to increase economic growth, enhance competitiveness and promote inclusion. In Mexico, education generally fails to play these positive roles. Few achieve the levels of learning that are
necessary to promote prosperity, equity and democracy. At present, Mexico is neither producing nor attracting the human capital it needs to be more productive (Figure 5). Mexico does poorly in terms of schooling. Overall, Mexico ranks 29th, out of 139 countries, in terms of primary education enrolment in the Global Competitiveness Report 2010–11, but 120th in terms of the quality of the educational system and primary education, and 128th in terms of math and science, for a 66th position overall. Although, enrollments have increased at all levels, and today nearly every child attends primary and lower secondary school, the drop-out rate rises sharply in upper secondary school (grades 10 through 12), and roughly half of all students fail to graduate. Spending on education, relative to GDP, is high. Public spending is, at 4.8 percent of GDP, just below the OECD average. However, expenditure per student is roughly one-third of the OECD average at all levels, and most public spending on education (97 percent) goes to the salaries of teachers and administrators.

Mexico ranks in the bottom third (of 65 countries) in the OECD’s 2009 PISA exam—which assesses what 15-year-olds know and can do in reading, math and science. It produces only a few students at the “advanced” international benchmark for math established by PISA (defined as “capable of advanced mathematical thinking and reasoning and able to interpret complex information about real world situations”). The nearly total absence of Mexican students at the top levels of learning is a dramatic constraint on the country’s global competitiveness. It is of little consolation that the country does better than the average for Latin America. What matters much more is that Mexico lags behind countries like Korea, Taiwan, Singapore, and Hong Kong. A major cause for poor student performance is that Mexico’s teaching profession is weak and poorly managed. The quality of teachers is low, since they are generally not well trained, and the poorest children are likely to be taught by the most inexperienced, least prepared teachers.

Mexico has only a few high-quality universities. Only one Mexican university (the Universidad Nacional Autónoma de México—UNAM) ranks among the top 200 universities in the world. There are some excellent Mexican institutions but these are too specialized to qualify as universities and are not included in the rankings. Enrolment in tertiary education in Mexico is low, when compared to other countries in Latin

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5 Based on chapter “Education in Mexico” by Jeff Puryear, and Alexandra Solano (Inter-American Dialogue), and Lucrecia Santibañez (RAND Corporation).
America (e.g., the contrast with Chile is striking). Only about one-sixth of Mexico’s labor force has a university degree, and the quality of graduates is very poor. By contrast, in the US, about 60 percent of the labor force has tertiary education, about 46 percent in Canada; 40 percent on average in the OECD, and 35 percent in Korea, with much higher numbers among the younger participants, according to World Bank data. Another issue of concern is the low number of graduates that obtain doctoral degrees. The annual number of PhDs granted in Mexico averages around 2,000 compared to 10,000 in Brazil and 55,000 in the United States. Moreover, the low numbers of PhD and Science and Engineering graduates contribute to Mexico’s lag in the area of technology development and innovation.

Mexico spends a relatively low amount on R&D (about 0.5 percent of GDP, compared with 1 percent in Brazil, 2.7 percent in the US, and 3.2 percent in Korea); the numbers of researchers in R&D is very low, as is the number of published science and engineering journal articles. Private sector spending in R&D also ranks low, and the country scores very low in terms of Intellectual Property Protection. It is thus not surprising that Mexico ranks poorly among emerging markets in terms of the number of patents granted, with 3 patents per million people in 2008 compared to Korea’s 1600.

**Informality**

A key factor contributing to Mexico’s low TFP is informality. About 50 percent of the employed labor force works in the informal sector, and is likely the G-20 country with the highest level of informal employment, outside Asia, and with the highest level among OECD countries. Mexico’s informal sector accounts for some two thirds of all firms. Wages in this sector are 5–15 percent lower than in the formal sector, suggesting a significant productivity gap especially when considering that formal firms have large non-wage labor costs. Indeed, a World Bank study in 2007 estimated that informal firms are 30 percent less productive per worker than formal firms. Moreover, on average, formal enterprises are 82 percent more productive than informal ones.

As Figure 6 shows, the size of Mexico’s informal sector as a proportion of GDP is quite large when compared with Mexico’s peers. As informal firms tend to stay small to avoid being noticed, their productivity is low because they do not reap any benefits of scale, they have either limited or no access to credit, they are less likely to train their employees and to adopt new technologies, and they have limited access to government services. Low productivity hinders economic development and growth. This is compounded by the widespread prevalence of tax evasion by the informal sector. Evasion hampers the government’s capacity to spend on infrastructure and human capital. Moreover, some analysts estimate that the government subsidizes the informal sector by as much as 2 percentage points of GDP. The combination of these elements leads to a vicious cycle which explains the strong negative relation between informality and economic development (Figure 7).

Another important adverse effect of informality is that, in spite of existing social protection and pension benefits, like the successful Oportunidades program and Seguro Popular, it contributes to the exclusion of a vast segment of the population. Basically informality curtails the prospects to enhance labor’s well-being through more productive jobs.

The main source of the problem is poor legislation, resulting in high non-wage labor costs, including the existence of a seniority-based firing compensation instead of unemployment insurance, poorly designed tax and social security systems, and poor credit risks perceived by creditors. No more than 10 percent of small Mexican firms receive credit from a formal financial institution, making them less likely to adopt new technologies and grow. Another important reason for growing informality is government red tape, as well as unintended effects of government incentives, such as free social security benefits.

**Energy**

Among the various sectors marked by low productivity, the energy sector, but more specifically, PEMEX, stands out. PEMEX, a constitutionally mandated monopoly, has fulfilled a dual role. Its first role is that of the producer of oil. Its other role, as a national symbol—enshrined in the Constitution—has legitimized great inefficiency and monopoly practices instead of long-term economic rationality and pragmatic thinking, as was clearly demonstrated during the debate over energy sector
Informality and economic development

Figure 6: Informal sector as percent of GDP, International Labor Organization definition, 2008


Figure 7: Informality and economic development

reform in 2008. Shielded from criticism, PEMEX remains a chronic under-achiever when compared to its peers. However, a number of recent reforms are expected to have a lasting effect. Examples are the creation of the Comisión Nacional de Hidrocarburos and the change in PEMEX’s Board composition. Reforms have led to savings in PEMEX operations, stabilized production, and increased the level of proven reserves. Nevertheless, at current production rates, these reserves would last only 10 years. PEMEX does not have the capabilities needed to exploit Mexico’s deep-water oil fields or other technically challenging on-shore sites, at least in the next few years. With world energy consumption expected to grow at an annual rate of 1.2 percent over the long term, most analysts agree that oil will still be the primary energy source for the global economy in 2042. While energy from renewable sources and other primary sources is expected to grow more rapidly than oil, even the most optimistic projections of alternative energy consumption suggest that petroleum will still account for a very high proportion of energy consumed. The implications for Mexico are clear: produce as much as possible.

Mexico’s Comisión Federal de Electricidad, CFE is in relatively good financial shape overall, following consistent management practices and modernization efforts, as its tariffs recover virtually all operating and capital costs. However, the key issue is that CFE’s tariffs are not economically efficient: two independent studies suggest that costs significantly exceed those prevailing in a competitive market. In addition, CFE’s tariff structure leads to considerable distortions: low value crops are irrigated with pumps that use public electricity, while other highly productive industries are forced to generate their own electricity. Moreover, with the exception of residential consumers and farmers using intensive irrigation, average tariffs are considerably higher than long run marginal costs, about twice as much in the case of industry and commerce. Therefore, CFE’s high tariffs have adverse effects on relative prices and affect the competitiveness and performance of Mexico’s productive sector.

Infrastructure

Mexico’s current infrastructure lags far behind its needs, ranking 69 out of 133 in WEF’s Infrastructure Competitiveness Index; and 49 out of 57 in IMD’s World Competitiveness Index (Figure 8). A significant increase in the level of spending on infrastructure is necessary. However, low investment levels do not fully explain Mexico’s low ranking. Among the many reasons for Mexico’s poor performance in infrastructure, specifically for transportation, Mexico Evaluates suggests that the technical preparation is defective, the legal framework for infrastructure construction is out of date, a poor tender process and a budgetary process that is highly politicized, with little consideration for technical argumentation or merit. Such results are applicable to other areas as well.

A National Infrastructure Program set in 2006 aims to position Mexico among the top quintile of countries by 2030. Among its many goals was to raise significantly the level of spending in infrastructure (excluding energy), but this has not occurred to the extent necessary, even though investment levels have increased since the plan was announced. Indeed, comparisons with fast growing Asian countries suggest that Mexico’s infrastructure investment levels may have to go beyond the target set in the 2006 program. By some accounts, infrastructure investment levels in China exceed 15 percent of GDP. India’s 11th Five Year Plan has a target of 9 percent (excluding oil and gas as well as urban infrastructure), with one third of total involving either private investment or public private partnerships. Because of their much faster economic growth and less developed base of infrastructure stock, countries such as China and India need to invest more than Mexico. However, these comparisons do show that Mexico should have a more ambitious investment program than over the last decade, say a minimum of 5 percent, which was reached only once in the period.

Mexico needs to take a package of far reaching policy and institutional measures to achieve the goal of joining the top quintile of countries by 2030 as stated in the 2006 National

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12 “10 puntos para entender el gasto en Infraestructura en México”—Mexico-Evaluates 2011.
Infrastructure Program. To raise the total infrastructure investment to 5 percent of GDP or more, it needs to raise both the public and private investments. For public investments to rise, Mexico will need more fiscal revenues than available now (see section on fiscal reforms). In parallel, it needs to open up all infrastructure sectors to private sector. To create incentives necessary to attract significant private investments, the country also needs to remove existing large cross-subsidies, particularly in power, water and petroleum. At the same time to protect consumers’ interests, Mexico must strengthen the capabilities, autonomy and authority of all regulatory agencies. Finally, it must improve the planning, preparation, legal framework and procurement processes for publicly funded projects.

**Sustainable development**

Even though in recent years Mexico has undertaken a more aggressive approach to curb environmental degradation, it still faces major challenges in this field. Furthermore, the situation seems to become more serious, as subsidies, lack of urban planning and climate change put more stress on Mexico’s natural resources. More than half of the country’s underground water resources are in severe stress, mostly in areas where Mexico’s food production and population are concentrated. Also, the loss of biodiversity and deforestation, poses a major threat to conserve and exploit Mexico’s biodiversity. In

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13 “Mas allá de los BRICS—Índice de Competitividad Internacional 2011” IMCO, México, October 2011, and contributions by Rodrigo Gallegos of IMCO
addition, Mexico is particularly vulnerable to climate change as it lies within the path of two main hurricane zones and is also especially prone to severe droughts in its northern area.

In its study on the International Competitiveness of Mexico 2011, IMCO has found that Mexico ranks 39 out of a total of 46 Advanced and Emerging Economies, down from 35 in 2001 in terms of Environmentally Sustainable Development. The decline in relative position is related to a larger number of ecological disasters, greater carbon emissions, deforestation and water use overall, offset in part by a greater number of “green” enterprises, lower use of fertilizers, and increases in the size of protected areas per capita.

**Financial sector**

Mexico’s financial system is sound and sophisticated but small relative to GDP (Figure 9). According to World Bank information, total domestic credit (Government included) in 2010 is 45 percent of GDP compared to 69 percent in Turkey, 98 percent in Brazil and over 100 percent in Korea. Whereas its performance is in line with other systems as regards strength, efficiency, and openness, there is room for improvement when it comes to financial access. Quite importantly it stands out as quite shallow. The main problem for the financial sector seems to be the institutional context: the strong concentration and prevalence of vested interests in the formal economy leads to non-government barriers to entry in banking, while high informality aggravates the problem. Furthermore, crowding out by public sector borrowings limits the private sector access to financial sector funding; as a consequence capital allocation does not flow toward the most productive, but to the most powerful, and sometimes least innovative firms, with adverse consequences for productivity. Interest rate premiums relative to sovereign borrowing for larger companies remain contained, but smaller firms have very limited access to formal credit. Moreover, some smaller innovative firms lack the financing—beyond their own savings—that is required for superior TFP. Property rights remain weakly protected by an ineffective judiciary and ownership claims are poorly registered. Problems are also the result of high volatility that prevailed in the past, and still is too fresh in the collective memory of entrepreneurs and investors. Beyond banking, shares traded are 10 percent of GDP compared to 43 percent in Brazil, 57 percent in Turkey.

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14 Based on the chapter “Financial System” by Hervé Ferhani (Centennial Group).

15 IMCO, Índice de Competitividad Internacional 2011, pg. 129.
and 160 percent in Korea (2010).

To be sure, banking has been opened up to international participants since the early 2000s. The Mexican banking system is well-capitalized and liquid, but it is highly concentrated—7 out of 41 banks control more than 80 percent of assets. Some types of loans are quite expensive, but in general, long-term rates have fallen well below the levels of other emerging nations and are lower than in most Latin American countries for large firms, but non-interest financial costs (fees) are high; lowering the costs of switching for consumers would ensure proper competition and weigh on those fees. While large established firms in urban areas seem well-served, smaller undertakings do not seem to have adequate access to financing, in part due to a poor enforcement of guarantees as well as the risks linked to expected short lives for smaller enterprises.

There has been significant discussion regarding the potential vulnerabilities associated with a very high share of foreign ownership of the banking system. The 2008–09 financial crisis has shown no evidence that high foreign ownership affected the performance of the Mexican financial system, although in other emerging economies international banks relied on their subsidiaries to prop up the liquidity position of the home banks. This may reflect Mexico’s sound bank regulatory and supervisory framework, and the fact that most funding of foreign owned banks was based on domestic deposits.

The existence of high informality (discussed above) creates additional issues, as it restricts access to conventional finance. The development of non-banks (among them Sofoles and Sofomes) has helped diversify the sources of financing and helped address financing needs restricted by informality, but they should be strengthened, as should other non-banks, among them AFORES, in line with the economy’s evolving needs as growth generates demand for more diversified financial services.

**Competitive environment**

As Table 2 makes clear, Mexico’s indicators in key areas of the business environment show serious shortcomings. A general observation on Mexico’s business climate is that it is unremarkable for its stage of development. The provision of inputs is adequate although costly, but institutional weaknesses and rigidities move Mexico into lower rankings. Notably, these weaknesses relate to the inefficiency of government bureaucracy, the perceived corruption of public officials, poor rule of law and protection of property, a complex tax system,

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<td>Countries in sample</td>
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<td>141</td>
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</table>

1/ Range of Country rankings with equivalent numerical score.

16 Based on the chapter “Competition in Mexico” by Manuel Molano (IMCO).
A historical perspective

and lack of competition.

Mexico has advanced in opening trade, but major administrative and discretionary barriers remain, reducing competition and efficiency. Mexican bankruptcy procedures have remained cumbersome and archaic. When bankruptcy is declared, workers and tax liabilities have priority in the creditor list. And in line with considerations on financing discussed above, banks see that the only possibility to make profits in lending to businesses is by rationing credit, thereby excluding riskier debtors. There is a need for safe collateral development.

Reflecting the oligopolistic structure of the market, telecoms undersupply Mexico’s needs; they are expensive and provide a low quality of service. Even with actions by the Comisión Federal de Competencia (CFC), competition remains weak.

There are many reasons for the shortcomings, as discussed above. Businesses incur high costs, and tend to seek the protected sectors of the economy. Many large businesses obtain profits from consumer rents; the smaller business ventures seek protection in informality, and forego innovation. The State has failed to play its regulatory role correctly regarding vested interests, it has not helped create competitive conditions through strong institutions that protect property, and support peoples’ rights that are needed to attract world-class talent and adequate investment flows. This problem is not directly connected to private or public ownership. Indeed, there are serious distortions in virtually all non-tradable sectors because of monopolistic/oligopolistic structures, which raise the costs of the tradable sectors and thus hamper their competitiveness. The real issue relates to openness and competition, and it is most evident in the following aspects of the Mexican economy:

- **Mexican labor unions.** Poor labor quality is the result of deficient education, which in turn leads to limited human-capital formation and low productivity. With reforms of the labor markets which should allow for more flexible hiring, firing and work schedule practices, most of the rent that is currently allocated to the strong labor unions could be directed to workers and firms, as well as to consumers.

- **Social Security.** This is another aspect of policy where a legal near monopoly is causing distortions. The Mexican Institute of Social Security (IMSS) is the main provider of medical, life and accident insurance policy that is valid for formal work in Mexico. Since IMSS has high and rising costs, companies (of all sizes) and individuals often enter into informal labor arrangements. Furthermore, based on a laudable system of protection, under the Oportunidades program and the Seguro Popular, incentives have unfortunately increased to move workers to informality, with negative consequences in terms of productivity and government revenue.

- **Education and energy markets.** There are serious problems as a result of monopolies, strong unions and state control, as discussed above.

**Poverty, inequality, and demographics**

Mexico has made considerable progress in reducing poverty, mainly owing to increases in education from programs such as Oportunidades, the very large flows of remittances from Mexicans abroad, and changes in demographic conditions. The incidence of poverty declined by 28 percent over 20 years, and now afflicts (a still high) one third of the population but it is down from almost one half in the 1980s; indigence has declined even faster.

**Income distribution remains extremely unequal,** and constitutes a serious challenge for the country. The income of the top 20 percent of the population was 16 times that of the bottom 20 percent in 2010. The middle class constitutes only 20 percent of the total population according to most recent estimates. Moreover, Mexico’s Gini coefficient, measuring inequality, has declined only by 4 percentage points in recent years. The coefficient indicates that inequality is below that of Brazil, Chile and Colombia, but higher than in any other OECD country and fast growing countries in Asia, such as China and Korea. (Figure 11).

Mexico’s education system has had only a limited impact on reducing inequality. Despite the progress made through the Oportunidades program, children from poor families are more likely to drop out, and their education

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17 Based on the chapter “Policy Inclusion and equality”, by Mahmood Ayub. Additional material can be found in “10 puntos para entender el gasto público en México: Consideraciones sobre la desigualdad y la exclusión”; México Evalúa, 2010.

18 Mexico’s Human Development Index (HDI) in 2010 ranked it 58th among some 170 countries, ahead of China (89th) and India (119th), but behind Chile, Argentina, Cuba, Panama and Uruguay in Latin America. HDI by states in Mexico indicated for 2004 that the Federal District had the highest level, followed by Baja California Sur. The states with the lowest HDI were Guerrero and Chiapas.
Figure 10  Poverty and indigence levels in Mexico, 1989–2010

Source: ECLAC (CEPAL).

Note: Full bar represents total poverty.

Figure 11  Inequality, 2010 (or latest available)

Source: World Bank—Word Development Indicators, 2011, and OECD
levels are poorer than those with richer backgrounds. Inequality increases at each level of education. In Mexico, a rich student is six times more likely to complete upper secondary education than a poor student, while in Chile and Argentina, a rich student is twice as likely to do so. The gap is even greater for indigenous and rural students. Mexico spends 4.5 times as much on university students—who are mainly from rich or middle-income backgrounds—than on primary students, to the detriment of the poor. As discussed, informality further aggravates the problem.

Mexico’s economy has benefited from a demographic boost, reflected in a substantial increase in working population relative to total population that would persist through 2035. Declining mortality rates in the 1980–90s led to a one-time population boost, and lower fertility rates in the decades that followed have created a situation in which, by 2040, this larger population will have fewer dependents to support. This “demographic dividend” should provide a welcome tailwind for economic growth and living standards, but it also entails a rapidly ageing population in the next forty years (Figures 13a and 13b). This is a major long-term challenge, as the dependency ratio is going to increase significantly. Total population may continue growing until after 2050. However, the share of working population in the total is expected to peak in 2032.

**Macro-stability**

Since the mid-1990s, fiscal and monetary management has been very prudent and allowed for a sharp, sustained reduction in inflation and a strengthening of the balance of payments. These gains were obtained at considerable cost, after many years of unstable policies and weak institutions. In the fiscal area, the overall strategy has been one of sound management of deficits and public debt. Overall deficits have been small, the public debt burden has been falling, and the structure of that debt has improved. Still, the system has been very reliant on oil, making it extremely vulnerable to price changes and the secular decline in production, while the non-oil tax system and the composition of government spending have led to major inefficiencies and the misallocation of resources. Moreover, public investment has fallen short of the requirements of a fast-growing and more inclusive Mexico.

More recently, Mexico was severely affected by the Great

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19 Based on the Chapter “Macroeconomic Management” by José Fajgenbaum.
Recession, experiencing the largest decline in GDP (some 6 percent) of any major emerging G-20 economy in 2009, and falling well behind the rest of the world. Since then, the economy has recovered to pre-recession levels. After a period of understandably higher fiscal deficits in 2009–10, these deficits are coming down, as is inflation, and the balance of payments is strengthening. Helped by the strength of the Mexican financial system, there has been no significant adverse macroeconomic aftermath to the recession. However, the crisis has exposed the vulnerability of the Mexican economy to external shocks, raising serious questions about the sustainability and pace of economic growth.

Mexico’s rather low level of non-oil revenues as a proportion of GDP is striking, particularly when compared to its peers (Figure 14). The system has been exceedingly reliant on oil revenue, as it accounts for 40 percent of total revenue. But even total revenue—at slightly above 20 percent of GDP in 2008—is relatively low. In these circumstances, the capacity of the public sector to invest in physical and human capital, as well as to address inequality has fallen short of what would be required to help Mexico break away from its middle income trap. Moreover, this situation is likely to worsen as oil revenues are expected to decline as a proportion of GDP, unless the reforms proposed below to increase efficiency in the oil sector are implemented.

The low level of non-oil revenue largely reflects a complex tax system. Numerous special tax regimes, the dual rate value added tax, and tax expenditures have effectively narrowed the non-oil tax base and resulted in lost revenue averaging more than 5 percent of GDP a year during 2003–10, although recent reforms have reduced these losses. The tax system has also induced tax evasion and avoidance, and caused wide-ranging distortions in resource allocation, with serious consequences for growth. Moreover, economic activity is concentrated in low-value added sectors which are tax havens, raising serious questions about the sustainability and pace of economic growth.

20 Informality in this study comprises all activities that operate outside the legal and regulatory framework with the objective of avoiding taxation and the costs of other legislation.
due to informality is estimated at about 4.5 percent of GDP.

The value-added tax provides another example of ill-advised incentives. It facilitates tax evasion, and generates high revenue loss (1.5 percent of GDP) as many contributors that were not the intended beneficiaries of the lower VAT claim the right to the lower rate. Direct transfers of only 27 cents for every additional peso collected under a uniform VAT rate will fully compensate the poorest half of the population. Similarly, subsidies intended to help the poor actually disproportionately benefit the better-off and lead to major distortions. In 2008, the fuel subsidy cost 5 times the entire Oportunidades program.

Government spending has been low relative to Mexico’s peers since the mid 1990’s, and its composition has deteriorated. Non-interest current expenditures have risen due to growing pressures, particularly pensions, subsidies and transfers, and personnel. This has compressed public investment to the point that there is a serious infrastructure gap. This compression is likely to increase over time, given the envisaged growing pressures arising from an ageing population, widening social programs as the informal sector expands further, and the security crisis.

Monetary policy has been carried out in a very professional manner, involving a flexible exchange rate and an inflation targeting framework. The independence of the Central Bank has been preserved throughout major crises and the institution is well respected, and considered apolitical. In this sense, progress has been enormous in the last 20 years. Still the danger remains that considerable pressures may emerge from the other sectors of the economy; this will require constant vigilance. Moreover, the Central Bank controls a financial system that is sound, but small, in terms of the size of the economy. As the economy expands over the next years, the Central Bank will need to adapt to a larger, more decentralized and less controlled system.

**Rule of law**

Mexico has an uneven performance in terms of rule of law. In general, Mexico does well in terms of the written law itself, demonstrating transparency, with clear and consistent laws. However, Mexico does quite poorly in terms of the enforcement of the law, and in particular with the fair and proper prosecution of those suspected of breaking the law. Significant constitu-

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tional and legislative changes regarding criminal justice were introduced in 2008, but implementation is not complete (only 13 of Mexico’s 32 states have implemented the reforms).  

Mexico’s federal government is relatively open and transparent, with legal information and official documents fairly readily available. Mexico ranks 17th out of 35 countries in the “Clear, Publicized and Stable Laws” indicator of the World Justice Project’s (WJP) Rule of Law Index. In addition, Mexico is ranked as having the second-most open government in Latin America, behind Chile. 78 percent of the Mexican public agrees that the media is free to report on the government objectively, and Mexico ranks well in where freedom of opinion and expression are concerned.

However, the government is not seen as being accountable for the enforcement of laws on the books. Mexico is worse than the Latin American average in terms of perceived corruption in the executive branch, judiciary, and military, ranking tenth out of twelve Latin American countries in overall corruption. The absence of fair prosecution is also a problem that needs to be addressed. Mexico lags in due process of law, civil justice, and non-discriminatory treatment under the law. Access to justice is thought by the Mexican public to be low. Not only are prosecutions perceived to be unfair, they are not effective. Mexico ranks 63rd out of 66 countries in the WJP’s “Effective Criminal Justice” indicator. Corruption contributes to this problem, as government officials are frequently not prosecuted properly, or not at all, for violations of the law. The existing corruption in the judicial system provides for a vicious cycle of poor prosecutions, and hence further corruption. A large proportion of infractions are not punished. More specifically, in the criminal area, 95 percent of the offenses are not solved or punished. In the case of homicides the number is 80 percent. Such poor performance has further eroded the credibility of the rule of law in Mexico.

Even in these circumstances, in its transition to democracy, Mexico has had a very successful experience in the construction of certain autonomous institutions which are shielded from political influence in their aims to fulfill its legal mandate. The autonomy of the Banco de México and its success story controlling inflation, the construction of electoral institutions that provide legitimacy and credibility to electoral results or the incremental role of the Auditoría Superior de la Federación, Mexico Supreme Audit Institution, provide crucial evidence on how Mexican economy and politics were transformed by the emergence of this technical bureaus which internal process were independent of the political cycles. However, key market regulators like the anti-trust bureau, the telecommunications and energy agencies have a suboptimal institutional design which leaves the possibility for political influences on key policy decisions.

22 David Shirk, “Judicial Reform in Mexico: Change and Challenges in the Justice Sector” Trans-Border Institute, University of San Diego, May 2010.

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### Table 3: Mexico: ranking in application of rule of law

<table>
<thead>
<tr>
<th>World Justice Project Rule of Law Index</th>
<th>Global ranking (out of 66)</th>
<th>Regional ranking (out of 12)</th>
<th>High income group ranking (out of 19)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited government powers</td>
<td>40</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>Absence of corruption</td>
<td>53</td>
<td>10</td>
<td>17</td>
</tr>
<tr>
<td>Order and security</td>
<td>53</td>
<td>7</td>
<td>13</td>
</tr>
<tr>
<td>Fundamental rights</td>
<td>45</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>Open government</td>
<td>27</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Regulatory enforcement</td>
<td>35</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Access to civil justice</td>
<td>57</td>
<td>11</td>
<td>18</td>
</tr>
<tr>
<td>Effective criminal justice</td>
<td>63</td>
<td>11</td>
<td>17</td>
</tr>
</tbody>
</table>

Governance, security, and crime

In the span of two decades between the late 1970s and the late 1990s, Mexico evolved from a de facto single-party state to a multi-party democracy with fairly free and competitive elections at the three levels of government. Mexico’s democratic transition was gradual and for the most part peaceful, spurred by a series of political reforms that opened up spaces for opposition parties that eventually scored victories at the local, state and federal levels. Perhaps the most striking aspect of the Mexican transition was the high degree of continuity of political institutions; unlike in parts of Latin America, Eastern Europe and the former Soviet bloc, Mexico moved to democracy hoping to adapt to the new requirements of a more open, competitive and plural political system.

For most of the 20th century, the discretionary powers of the President, and the system of political patronage and allegiances that he commanded, were the backbone of political stability. The challenge of Mexico’s emerging plural political system in the 1990s was how to create the foundation for stability and governance without these discretionary powers; it was important to establish the rule of law where everyone would play by the rules, and where those rules would be predictable and known to all.

Democratization and decentralization, within the rule of law, have generally contributed to better governance at the Federal government level. The institutions charged with enforcing these rules—federal, state, and local levels—needed the support of political parties, trade unions, and corporate interests. Some of the new institutions that emerged in response to these needs are autonomous and do not owe allegiance to the President. Nevertheless, many legal gaps and loopholes remain about the responsibilities and limitations of state governments. The redistribution of political power resulting from the democratization and decentralization process has created distortions to the incentives for good governance at the sub-national government levels. As a consequence, there is a significant degree of authoritarian rule, and lack of accountability.

Mexico has evolved politically over the past four years, but it has also experienced an unprecedented increase in criminal violence. The recent increase is all the more tragic given that the homicide rate had steadily declined between 1990 and 2007, from 17.3 to 8.3 per 100,000 inhabitants. This decline was not only in relative terms: the absolute number of homicides had fallen by 39 percent.

The reduction also extended to other crimes, particularly during the final phase of the period. Between 1997 and 2007, the number of reported kidnappings fell by almost two thirds. Car theft remained stable in absolute terms, but decreased more than 50 percent as a proportion of the number of vehicles registered. Even in broader categories such as robbery with violence there was a noticeable decline in relative terms: the number of reported cases of robbery with violence dropped from 616 to 571 per 100,000 inhabitants between 1997 and 2007. Victimization surveys, for their part, reveal a slight stabilization of the broader crime situation during the same period.

No single theory can explain the reduction during those years. With regard to homicide, the drop in prevalence may have been associated with the socio-demographic changes experienced by the country, specifically urbanization, mass migration and the emergence of the middle class. This may have contributed to a reduction in both traditional forms of violence (agrarian conflicts, inter-community disputes, etc.) and domestic violence. Similarly, the proliferation of defensive measures and the growth of spending on private security as a result of the increase in some types of crime during the mid-1990s, may have contributed to the drop in the number of crimes by reducing the opportunities to commit them. Unfortunately no reliable information is available to assess the impact of this effect.

Since 2007, however, the murder rate has almost tripled, the number of kidnappings has doubled, and extortion and racketeering has proliferated throughout the country. The sharp upturn is a major trend reversal.

The current crisis was detonated by a combination of an aggressive turn in Mexican organized crime policy, a particularly conflict-ridden environment in the criminal underworld, changes in international drug markets, and the increased availability of firearms, produced by regulatory decisions in the United States. In 2007–08, increased violence reduced the likelihood of punishment for any single act, reducing the
risk of punishment for additional crimes, and overrunning the already limited capabilities of the authorities, particularly at the local and state levels. Mexico has been the setting for large-scale illegal drug trafficking since at least the 1940s. Nonetheless the violence related to that illegal business has been episodic for most of the past seven decades. International evidence also shows that there is no automatic, direct connection between the intensity of drug traffic and violent crime levels. For instance, Turkey and Thailand have been, for decades, important corridors in the opium and heroin trade, but they have never experienced levels of violence like those of Colombia or Afghanistan (or more recently, Mexico).

In conclusion, it becomes clear that the picture that emerges—when analyzing different aspects related to Mexico’s economic performance, ranging from education and productivity to competition and crime—is that Mexico’s economic performance does not place it at the bottom in global comparisons, but for a country of its size and income, it is far from the top. But maybe more importantly—the country’s relative performance has lagged behind the rest of the world in recent decades. The question that arises over and over again is whether such performance is good enough. The answer is a clear no.
A Framework for Economic Revival and Sustained Prosperity

Mexico must grow more rapidly than in the past to break away from the middle income trap, and avoid being left further behind by the dynamic emerging economies. The goal should be to achieve prosperity for all and restore Mexico’s relevance within the group of emerging economies and on the global stage. If Mexico were to pursue a forward-looking and reformist approach, it is entirely possible that it could accelerate growth by some 2 percentage points a year, and in thirty years enjoy average per capita income about three and one half times current levels in real terms. This increase would be necessary to place Mexico well ahead of the increase in world per capita income and ahead of those of most countries in Latin America.

A vision of Mexico in the next 30 years

What is this report’s vision for Mexico in the next five sexenios? It is a country of opportunity, prosperity, personal safety and low crime. It is a country where the population has much higher living standards, enjoys dignity, inclusion, progress, and excels in learning and innovation, reflecting its own preferences, in the context of a sustainable environment. This is not an unrealistic fantasy, nor is it a certainty or an outcome that will result from coincidence, the mere passage of time, or the right granted by a superior force. A better Mexico will be the result of hard work, devotion, and a single-minded pursuit of results that would make Mexico a beacon in the world. The outcome will be affected by forces beyond its control and its borders, but the final outcome will only come from Mexico itself.

Mexico in thirty years can aspire to be a country with an average income equivalent to that of Germany and France today (but somewhat below the level of the US). This would provide for enormous opportunities in the context of a competitive economy. Through education and other means of inclusion, an efficient and equitable tax and public expenditure system, and greater integration to the world, income would be distributed differently. The structure of the economy, with the right incentives, would allow those Mexicans who are willing to excel to enjoy intellectual and financial rewards. The lowest quintile of the population could see at least a fivefold increase in income, while the better-placed could see almost a tripling of their average incomes.

Smaller by choice, and better educated by improved opportunity, families would enjoy much higher living conditions, supported by a well-functioning infrastructure and a competitive economy. Children and young men and women would attend good schools, be they private or public, taught by world class educators, and with rising numbers of people—including students from abroad—benefiting from better universities. Investments and reforms would help improve health, and make the environment more conducive to a better life. Crime would fall to levels comparable to advanced countries in Europe, with a pragmatic system of cooperation with neighboring countries.

Graduates would be able to exercise their initiative as professionals, as business people or as part of small, medium and large corporations, with good access to credit, through banks or other financial institutions. Older citizens would be able to have the peace of mind that comes from a retirement pension system that thrives within a growing financial system and a stable macroeconomic environment.

The government would play a key role in monitoring the operation of the private and public sectors and would manage a credible justice and security system. Mexico would play a major role in establishing standards of best practice with respect to state and corporate governance, including the application of the law and respect for contracts. It would work diligently with the international community to share its experiences.

Relations with the rest of the world would be based on a position of strength, with trade and investments that go well beyond a well-working NAFTA. Mexico would balance its position with the two power-houses of the world, China and the
US. For this purpose, Mexico would take greater advantage of its market potential and location, and continue its deep commitment to multilateralism, with a valuable role as an influential member of the international community.

**A framework of action**

To become such a country and attain that level of prosperity, Mexico needs to formulate a comprehensive plan of action to be implemented over the next four years, with a longer term perspective that goes beyond the usual six years of the political cycle. To raise the rate of GDP growth, Mexico will need to move from a comfortably solid post-Great Recession rebound into strong and sustained economic growth with an accompanying emphasis on inclusion and equality. The degree of policy implementation will determine where the Mexican economy will fall within the specified range of possible outcomes.

The action plan for reform is summarized in the following seven strategic building blocks, and illustrated in Figure 16. The specific proposals that aim at building the basis for a more prosperous Mexico are discussed in subsequent sections.

- **Build a high-productivity economy on the foundation of strong human capital development and access to competitive energy, infrastructure and finance, in an environmentally sustainable context**

A much more competitive economy is the key to faster growth in Mexico. A competitive economy requires strong human capital, competitive physical inputs, and access to finance. On the human capital front, good education may be the single most powerful tool available to increase economic growth, enhance competitiveness and promote inclusion. Mexico should thus pursue quality learning at all levels and for all segments of its society as a national objective. Improved higher education with greater emphasis on applied science, including engineering, should be provided to promote a spirit of entrepreneurship and innovation. On the front of physical inputs, fundamental reforms are needed in energy (particularly petroleum, gas, and electricity) as well as much higher public and private investments in infrastructure (including for infor-
Reduce disparities and foster inclusion

The small and medium enterprises, which constitute more than 95 percent of all firms (although less in terms of employment or output), are usually in the informal sector, which has little access to credit and limited incentives to acquire new technology, and therefore becomes a drag on the economy.

Mexico’s growth performance over the past three decades has been lackluster in part because of inequalities and the lack of inclusion. Mexico’s many rent-seeking activities, powerful monopolies and unions, and poor legislation or implementation constitute the main obstacle to both faster growth and reduced inequality. The persistence of inequality triggers social and political tensions and leads to conflict and, thus, to lower growth. Future economic strategies cannot succeed without a commitment to equality of opportunity and inclusion.

While conditions have improved in recent years as a result of the impact of NAFTA, remittances, and the effect of the Oportunidades program on poorer families, Mexico remains highly unequal. To maintain the positive trend in reducing income inequality, it will be important for the government to take a more proactive approach which (1) gives high priority to addressing the unequal quality of basic education; (2) improves access to secondary and higher education, justice, information, markets, and finance; (3) puts the informal and formal sectors on a more equal footing; and (4) deals with issues of regional disparities, and in a few decades, ageing.

There is a need to reduce the size of Mexico’s growing informal sector, with its limited access to productivity-enhancing technologies, financing and training, and poor protection of property rights. To generate incentives for firms and workers to become formalized, it is essential to improve legislation, including on taxation, reduce non-wage costs in the formal sector, introduce universal social security benefits and adopt policies that reduce the perceived risks of SMEs.

- Ensure a predictable, stable macroeconomic environment and launch major fiscal reforms

Mexico has achieved an important degree of macroeconomic stability. However, it can only persist—as it should—in the context of comprehensive fiscal reform that aims to improve the efficiency and yield of the non-oil tax system and raise the level and enhance the composition of public expenditures to lift constraints on growth and reduce poverty. Within these general principles, the adoption of structural fiscal targets would allow for larger deficits and thereby maintain higher expenditures in times of recession and vice versa in times of prosperity than under the current balance budget rule. This would result in a more stable macroeconomic environment that permits the private sector to better plan its business decisions, leading to a positive impact on the country’s growth potential. The establishment of an intergenerational oil fund, to the extent that oil revenue increase, would address intergenerational equity, as importantly, critically support the implementation of the structural fiscal rule and, more fundamentally, would help limit the adverse consequences (Dutch Disease) that would arise from an increased use of oil revenue. Implementation of a transparent and homogeneous budget framework at all government levels will help improve fiscal policy formulation and analysis.

Monetary policy independence within an inflation-targeting framework has served Mexico well. This needs to continue, possibly with some reinforcements, and not be derailed by unstable, uncertain macroeconomic conditions, that adversely affect domestic savings and investments.

- Strengthen the rule of law

By international standards, Mexico does well in terms of the law itself, with transparent, clear and consistent laws. However, Mexico does poorly in terms of the enforcement of the law. Since 2008, there is a legal mandate to change the penal justice system by June 2016 from the current inquisitorial model to an adversarial one, which includes an alternative justice track and oral trials. This should help make the system more efficient and improve the rule of law. However, the process is changing very slowly, and there are many detractors to the new system within the procurement and administration of
justice entities. There are several reasons for the glacial pace of legal reform: the new system is not properly understood, individuals are not properly prepared to institute the changes, and corruption is widespread. The prompt implementation of this plan will be central for improving Mexico’s institutional set-up, to provide an environment that ensures improved productivity within a competitive environment. In the end what Mexico needs is a political and legal guarantees of individual and property rights; an efficient and fair judiciary that precludes arbitrary acts on the part of the government; and a system of legal security, with known and non arbitrary rules.

- **Strengthen governance and institutions, and restore a secure environment free of crime and drugs**

  Mexico faces twin governance challenges that are unforeseen by-products of its democratization and decentralization. Democratization and decentralization have generally contributed to better governance at the Federal government level, although further efforts at reducing corruption are needed. This can be addressed by eliminating non-transparent rules, state and private rent-seeking activities, and reducing the power of other vested interests, like the unions associated with government activities.

  Crucial aspects of governance have been overlooked and are two of the most important challenges to good governance. First, the “fiscal federalism challenge” is a prime concern; subnational governments derive most of their revenues from mandated fiscal transfers from the federal government, and thus do not feel obligated to their constituency. A greater reliance on locally-collected taxes would provide the incentive to govern well and provide higher quality services that guarantee the growth of tax bases in the long run. Second, the “accountability of sub-national governments challenge” is equally important. Accountability should be a central topic in the agenda of Mexican federalism with a view to create enforcement mechanisms that dissuade bad behavior, foster good governance and reduce corruption.

  Over the past four years, Mexico has experienced an unprecedented increase in violent crime. To reverse the deterioration and significantly improve the security environment, a three-pronged approach is proposed: (1) A focused deterrence strategy that prioritizes certain crimes, and groups responsible for these acts; (2) a broad-based institutional reform effort, to reduce the vulnerability to future shocks and to produce value for money in the security and criminal justice systems; and (3) community action, a preventive policing approach, and major improvements of technological and intelligence capabilities.

- **Consolidate Mexico’s global position as a major emerging economy**

  Mexico needs to broaden the focus of its foreign relations while preserving its privileged relationship with the United States. It will be important to pay greater attention to Central America to promote a more prosperous neighborhood and to curtail drug trafficking. Mexico’s larger projection in Latin America and closer links to the region would reduce it vulnerability to external shocks by diversifying its trade and financial relations. Mexico needs to strengthen relations with the EU, and it has to look towards Asia as a partner, and not just as a competitor, with particular focus on China. This would improve access and availability of capital and technological know-how and enhance its capacity for long-term growth. Mexico should take greater advantage of its market potential, trade and investment, and it should continue its deep commitment to multilateralism and its role as a valuable member of the G-20, the OECD, the APEC, TPP, the OAS, and the UN.

  In sum, based on the policies discussed above, it is possible to envisage a scenario of prosperity and increased inclusion for Mexico over thirty years. The country could enjoy per capita incomes that are 3.5 times as high as they are today, and Mexico could become a vibrant and significant player in the world economy. This vision is not a foregone conclusion. Under current conditions, and unchanged policies, per capita incomes could double, but are most likely to fall short of that if the underlying conditions deteriorate. Per-capita incomes have only grown by 20 percent since 1980—mediocre levels of investment and no productivity growth explain most of it.

  Actions need to start today. Otherwise, the future may well repeat the past.
Specific Proposals for a Prosperous Mexico in 2042

The proposals discussed below constitute an action plan for reform to develop and sustain a more prosperous and peaceful Mexico, and is based on the strategic building blocks described above. The proposals should be seen as a plan for the next administration: these proposals are linked through the broad objectives of inclusion, productivity and growth, competition and competitiveness, within the general principles of macroeconomic stability and good governance.

While the proposals are organized in the form of separate blocks, there are no clean cut divisions among these blocks, since most policies are mutually reinforcing. It must be made absolutely clear that for the strategy proposed here to succeed, the proposals need to be seen as an intrinsic part of the whole approach. Picking and implementing specific ideas cannot and will not be sufficient to help Mexico break away from the current middle income trap.

**Conditions for a more productive economy with a focus on human capital formation**

**Education**

Tapping education’s potential to promote growth and inclusion will require that learning is the chief objective, and that Mexico’s education system is fundamentally reformed. Significant progress will take a lot of time and effort. It will become evident that many of the challenges are political; this will mean that powerful interest groups that have “captured” the education system and who benefit from the status quo will need to be confronted. At the moment, parents have little information on how much their children are learning, and there are few effective mechanisms to complain and act. Employers who suffer from the ill-effects of poorly educated staff have also been largely silent, preferring to avoid conflict. Upper- and middle-class elites, who make most decisions on education policy, send their children to private schools, and care little about the deficiencies of the public education system. Parental dissatisfaction with the school system, and with the teachers’ union (SNTE, see below), is rising. This level of dissatisfaction should allow policy makers to seize the opportunity and introduce the systemic changes that are needed to address Mexico’s primary and secondary education problems. A key component for effective change is to recruit top students into the teaching profession. In addition, teacher performance needs to be properly evaluated and rewarded, according to performance and not seniority.

The national teachers’ union has power over teacher management and education policy that does not exist in any other country. The problem with SNTE’s is its enormous influence over education, it has a veto over policy, and its interests are placed ahead of the interests of students. Given the strength of SNTE, politicians give it free rein in return for political support, or do nothing that is politically controversial. This has a very negative effect on the quality of education. SNTE’s mandate should be restricted to protect and promote the labor interests of teachers.

**Technology and higher education**

Significant efforts are needed to create the conditions for higher tertiary enrollments in Mexico, which lag the Latin American average, and are far behind those of high income countries such as Korea, Finland and the United States. There must be a determined effort to raise the quality of Mexico’s universities and of its graduates. Specifically, there is a need to increase the number of PhDs and Science and Engineering graduates, which in turn will reduce Mexico’s under-achievements in the areas of technology development and innovation.

Mexico’s scientific output is weak and largely takes place outside the universities. Moreover, the country’s system of promoting science, technology development and innovation

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1 Based on chapter “Education in Mexico” by Jeff Puryear, and Alexandra Solano (Inter-American Dialogue), and Lucrencia Santibañez (RAND Corporation).
A NEW VISION FOR MEXICO 2042: ACHIEVING PROSPERITY FOR ALL

A NEW VISION FOR MEXICO 2042: ACHIEVING PROSPERITY FOR ALL

(CONACYT) does not do enough to promote innovation and cutting-edge research and development. Mexico’s approach to science and technology does little to help the country break away from the “middle-income trap”. Stuck in the trap, the country cannot compete with less-developed countries with lower wages, nor with more developed countries that have achieved knowledge-intensive innovations.

Energy

For the Mexican economy to grow rapidly and sustainably, important and very comprehensive reforms are needed in the energy sector. They are also necessary to align Mexico’s energy sector with requirements of NAFTA and TPP.

Petroleum sector

Mexico’s energy outlook is bleak, even with great potential as a petroleum producer. New fields need to come into operation, particularly Chicontepec, non-conventional oil, and deep water wells. These are daunting short- and long-term challenges, especially because PEMEX is burdened by complex labor relations with a powerful and uncooperative union that is unyielding in its demands, and subject to pressures of different stakeholders. In this connection, it is urgent to tackle the enormous shortfall in the PEMEX pension system, amounting to close to US$ 50 billion as of 2010.


Box 1 | Education

- Enact fundamental reforms in education to improve the quality of education at all levels to create a world-class workforce conducive to strengthening Mexico’s long-term competitiveness and creating a more inclusive society. Success must be measured by how much a student learns rather than by spending or enrollment rates. To this end, there is a need to:
  - Establish world-class learning standards in reading, math and science for each grade, and English language, and key them to existing testing systems.
  - Expand the overall capacity of the education system, especially at tertiary education in engineering and sciences.
  - Develop pre-K programs, particularly for the poor.
  - Set clear expectations for what teachers should know and do in the classroom. Principals, supervisors and technical pedagogic assistants (ATPs) should become instructional leaders, or coaches, who regularly assess performance, demonstrate proper techniques and make sure teachers become effective instructors.
  - Recruit only the most talented graduates into the teaching profession by setting high standards, making teachers’ salaries competitive, basing pay on quality of performance and other relevant indicators, and limiting lifetime tenure only to the most successful.
  - Allow universities to train public primary and secondary teachers, and eliminate favoritism for graduates of Escuelas Normales in hiring.
  - Encourage a role for civic society in drawing attention to education objectives, debating their merits, and celebrating progress in achieving them.
- An important component of education reform will be to revise the 1946 law that gave the Sindicato Nacional de Trabajadores de la Educación (SNTE), exclusive rights to represent teachers. New legislation should allow teachers to join the union of their choice, or not to join at all, and should encourage teachers unions to devote their efforts to collective bargaining on salaries and other labor issues. In line with overwhelming international practices, it should allow unions to provide advice on education policy without decision-making (veto) authority on teacher hiring, evaluation and assignment, or supervision.

Box 2 | Technology and higher education

- Adopt a program to enhance the role of universities as a source of technological development and innovation in cooperation with the productive sectors, in order to promote technological advances and research. To this end, it will be necessary to:
  - Expand funding for research and development through venture funds, business-university funds, basic research funds, and incentives for R&D companies.
  - Establish a rigorous higher education accreditation body with proper funding and autonomy.
  - Shift public spending on higher education away from direct support for institutions and towards scholarships and living stipends for poor but talented students.
Unless all these constraints are addressed, PEMEX will become a drag on the economy. Within the next decade PEMEX may well have to reduce petroleum exports and soon thereafter become a net oil importer. This risks weakening the external accounts and could lead to a major drop in government revenue. This outlook means that new exploration and production should be opened up to the private sector, and that economic rents should be captured through bids on fields, royalties on oil output, and corporate income taxes, paid by all companies in the sector, within a pragmatic political-economy approach. To corroborate this general approach, estimates carried out by IMCO, suggest that an increase in oil output of 10 percent a year would result in an increase in GDP growth of 1 percentage point a year.

PEMEX’s down-stream businesses are not profitable due to poor operating efficiency, significant thefts of gasoline during distribution, and high labor costs due to excess personnel. Refining and distribution issues must be resolved, as must be onerous labor contracts that excessively reward workers and create perverse incentives. Furthermore, the entire system is plagued by lack of competition in gasoline distribution, corruption and inefficiencies. As suggested among the measures in the section on public finances, it will be important to establish stable excise taxes on domestic fuel consumption to stimulate efficiency and reduce pollution.

Electricity

The best option for dealing with the effects of monopoly practices is to break-up CFE into its constituent parts (i.e., parts related to electricity generation, transmission and distribution) and to open up generation and distribution to private sector. Experience in other emerging economies countries as diverse as Chile, India and Turkey has demonstrated that elimination of public monopolies not only brings in more capital but also improves efficiency of the power sector but also significantly improves quality of service. Competition in generation would quickly ensue and would lead to lower wholesale prices, benefiting all industrial and commercial consumers. At the same time, rates would rise in the case of subsidized or unprofitable sectors; the adverse effects on low income consumers could be offset with targeted direct subsidies, at a fraction of current costs. Similarly, entry of private sector in electricity distribution will service quality and bring in better technology and management into the sector. But for this approach to yield the expected results, Mexico must strengthen the capacity and autonomy of the regulatory bodies at both the federal and local levels.

Environmentally sustainable development

To assure Mexico’s sustainability as well as preventing the further impoverishment of Mexico’s rural population, an ambitious, comprehensive and well operated Environmental Sustainability Strategy needs to be undertaken. The project should consider legal reforms, improvement in existing institutions to be able to conduct policies that can assure the management of such resources. Mexico needs to move towards more market oriented mechanisms to ensure conservation instead of the fiscal instruments (subsidies and taxes) which have been traditionally used. This is particularly necessary as the depletion of offshore and onshore resources continues.

One of the main barriers to conservation has to do with land tenure. Communal lands in Mexico (in both modalities) have inhibited private conservation as there is little land tenure security. There are two different legal systems securing property rights which not only are not interconnected but are transparent and accessible to the public. For example, water prices

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3 Others reach similar conclusion, for instance, Baker Institute, Mexican Oil Production: the Coming Crisis, 2011.
should reflect the internal cost of extraction as well as the opportunity costs of water. However this costs may be very low if electricity is subsidized to pump water. Also, there are many opportunities for green investments in Mexico that besides mitigating are highly profitable on the basis of Mexico’s cost of capital, i.e., cogeneration plants in Pemex. Thus Mexico needs to eliminate barriers to help implement a coherent environmental sustainable strategy.

**Financial system**

While prudential regulations are good, and the level of international reserves is significant, the size of the financial system in itself relatively small, compared to other countries in the emerging world in general. Moreover, total credit remains

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**Environment**

- Transform Mexico’s conservation strategy by promoting private conservation:
  - Eliminate the agrarian judicial system, and incorporate it into regular judicial system
  - Promote private property through a package of incentives for communal landowners
  - Transform the Public registry of rural land, providing public, simple, digital and geo-referenced online access. Change the current incentives of the Payment for Ecological Services program for all types of landowners
- Improve Mexico’s climate change strategy by:
  - Working towards a national or regional carbon credit market
  - Eliminate the gasoline and electric subsidies which currently are more than 3 times Mexico’s budget for climate change. Open the energy market, with adequate incentives the use of renewable resources
  - Incorporate world-class standards for gasolines and vehicles, provide incentives for changing to cleaner technologies, and tax emissions
- Create a water market where water rights are distributed and transacted according to prices that reflect water scarcity:
  - Reform the National Law of Water to allow water concessions to be tradable
  - Eliminate the possibility of setting water prices by local Congresses. Change the National Law of Water Rights to set a price structure that incorporates all extraction costs
  - Tax any water extraction, beyond the refill rate of underground sources
  - Eliminate water subsidies in all levels similar to what has been done in Brazil, and reform its pension system to address its shortfall
- Make water operating organisms autonomous at the sub-national level, financed through water bills and establish a federal mandate so that all urban water organisms integrate into one water authority for the city. Make the National Public Registry of Water transparent so that all concessions, prices and equilibrium levels are public.

**Financial system**

Implement policies and regulations to foster greater competition in the financial system so as to increase its size and reach while expanding the role of the non-banking financial sector:

- Increase the size of the lending of the financial system to the productive (private) sector and incorporating the informal sector by improving property rights. Changes must allow for greater access to credit, and should make sure that taxes on cash deposits remain a tool to collect income taxes and does not preclude access to the financial system by the excluded parts of society. Expand the role of the non-banking financial sector, including through a better approach to pension plans, and eliminating special pension contributions, including to INFONAVIT.
- Deepen the reach of the financial system, through greater domestic and foreign competition, and a supporting role for public banks to deal with market imperfections and allow access by SMEs.

Actions with long-term effects that can be started now, but are designed to extend over a 10 to 20 year period:

- Strengthen institutions to improve legal certainty and alleviate information asymmetry.
- Ensure appropriate contract enforcement;
- Particular focus should be put on reforms of the Judiciary, Police, land ownership and titling.

Actions with short-term effects (to be implemented over 2–5 years):

- Improve competition in the financial sector
- Strengthen action already implemented regarding: transparency of retail banking products; Switching costs borne by consumers to producers; facilitate entry of new players (including non-banks—Sofoles, Sofomes); and ensure competitive access to retail payment systems (credit cards)

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4 Based on the chapter “Financial System” by Hervé Ferhani (Centennial Group).
small, with particularly low levels of credit to the private sector. Furthermore non-banking activities remain very limited, as evidenced by the capitalization of the stock market, and this is a serious issue, all reflected in a very low. The Mexican financial system is not providing sufficient resources to enterprises as compared with other countries, with significant resources going to the public sector. Furthermore the system does not seem ready for the large financial sector requirements of an ageing population, especially with respect to higher savings and increasing transfers towards retirees from the rest of the economy.

Two sets of complementary policies must help deepen the country’s financial markets. These must (1) strengthen the institutional framework and (2) open up access to the financial sector to foster competition in the sectors. This implies an overhaul of the judiciary and related police procedures, as well as a profound renovation of the legal framework to strengthen and enforce the protection of creditors’ rights. As such, authorities should address these issues immediately. In the meantime, reforms that create greater competition are a priority because they will yield short-term benefits. This will help the economy more broadly, through greater access by currently excluded or underserved citizens to the financial system, helping break the barrier of informality. Similarly, competition will be improved by ensuring that consumers can easily and cheaply switch toward the most efficient financial service provider.

With credit market imperfections, there may be some focused and temporary role for public banks. The preferred status of public banks is that of “mezzanine banks”, in which they provide resources to private financial institutions to partly offset the impact of credit market imperfections. Funding should be done in the markets with a clear and transparent budgetary mechanism if subsidies are needed.

**Infrastructure**

The National Infrastructure Program (2007) emphasizes the following recommendations that remain valid and need to be supported: (1) Increase public investment in infrastructure from a historical average of about 3 percent of GDP a year, to more than 5 percent; (2) The private sector must play a greater role, as the requirement in infrastructure investment cannot be met from the public sector alone. Accordingly, there is a need for a larger reliance on private resources such as through effective public-private partnerships, using US, Chilean, Peruvian, and Asian models, most public services can and should be provided by private suppliers; (3) Execution and effective implementation are central. All ministries and entities must implement agreed policies and guidelines within a set timeframe. They should be held accountable for doing so and must provide efficient follow-up.

**Policies to reduce disparities and foster inclusion**

**Informality**

With less informality, firms will have—among other things—improved access to bank credit, job training programs, and new technologies. Firms also will have the incentive to reach economies of scale. In turn, these changes will lead to a new path for efficiency and investment of the former informal firms and therefore result in a higher GDP growth path, rather than just a stepwise increase in GDP.

**Social and inclusion policies**

As discussed above, inequalities and the lack of inclusion have contributed to Mexico’s disappointing growth performance. To maintain the trend in reducing income inequality,

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5 Based on the chapter “Policy Inclusion and equality”, by Mahmood Ayub.
the government should accord high priority to addressing the quality of basic education, which is very weak. The large inequalities and exclusion in areas such as secondary and higher education, justice, and finance, as discussed elsewhere, need to be reduced. Similarly, the quality of health care services needs to be improved and their coverage widened, as Mexico’s ageing population will aggravate the problem in the long run.

Incentives for competitiveness and improvements in Mexico’s business environment

From the standpoint of competition, Mexico’s issues are straightforward: too many vested interests, and too many rent-accruing groups that defend the status quo. Mexico needs to liberalize its economic activities further. The economy is over-regulated in some areas and under-regulated in others; the state monopolies in oil and electricity, and their pricing policies, create serious distortions in the economy. While trade has opened up, NAFTA has lost its initial dynamism, and Mexico has fallen behind its Asian counterparts, which have become the true manufacturing hubs of the world. This in turn has slowed down capital flows to Mexico, and hindered its economic dynamism.

As noted earlier, Mexico’s competitiveness can be greatly improved by breaking down the hold of public monopolies (PEMEX and Comision Federal de Electricidad (CFE)), private monopolies (e.g., in telecommunications) and vested interests (such as SNTE in the education sector). Legislation would need to allow for a more flexible labor market. Privatization may be required in selected sectors. While Mexico has made

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6 Based on the chapter “Competition in Mexico” by Manuel Molano (IMCO).
enormous progress in opening up trade, the task is not finished, and the noted measures need to be complemented by further opening up Mexico’s economy to trade and investment with the region and the rest of the world.

A vibrant SME sector will be another integral element of a competitive Mexican economy and can be encouraged through reforms that would make it easier to do business and to attract more “informal” enterprises into the more productive formal sector. Rapid growth results when the institutional environment creates incentives for productivity and efficiency (including by removing tax-induced misallocation of resources) and provides social security benefits to all workers regardless of their labor status.

**Macroeconomic management**

Mexico’s hard-won macroeconomic stability needs to be maintained. To this end, policy makers need to formulate and implement comprehensive fiscal reform, aimed at (1) improving the performance of the non-oil tax system; (2) rationalizing expenditures that would lift constraints on investment, savings and growth and would help realize lasting poverty reduction; and (3) dealing more effectively with cyclical conditions and problems arising from economic activity and fluctuations in oil revenue. The resulting macroeconomic environment would be more stable and permit the private sector to better plan its business decisions, with obvious positive impacts on Mexico’s growth potential. There is also a need to continue the independence of monetary policy within an inflation-targeting framework, which has served Mexico well.

**Public finances**

Mexico’s public finances show structural weaknesses which hamper revenue mobilization and resource allocation, and thus constrain its growth potential. Moreover, a weak revenue outlook, combined with growing spending pressures, raises concerns about Mexico’s longer-term fiscal sustainability. To address these issues, and adopt a more stable fiscal framework that contributes to social inclusion, deals with intergenerational equity, transparency and accountability, it will be important to implement an ambitious and comprehensive overhaul of how fiscal policy—in its broad sense—is conducted.

Mexico requires a comprehensive fiscal reform, aimed at improving the efficiency, equity, and yield of the non-oil tax system, and at raising the level and enhancing the composition of public expenditures to lift the constraints on growth and realize a lasting reduction in poverty and inequality. The political

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**Box 10 Public finances**

- Introduce a major tax reform which comprises several important components, following international best practice:
  - A flat corporate income tax, in the range of 20-25 percent; this compares with an average 25.5 percent for OECD countries and 25 percent in China, Indonesia, Korea, and other Asian countries
  - A progressive personal income tax, covering all types of income (possibly based on 3-4 rates, with no deductions and a moderate threshold); this compares with more than 8 rates currently.
  - A uniform VAT, at the current 16 percent rate and with appropriate compensation to the poor (for the shift to a uniform tax rate) via the Oportunidades program; this compares with lower or similar rates in Australia, Canada, Colombia, India, Indonesia, Israel, Korea, Malaysia, the Philippines, and others.
  - A system of royalties, that rise with international prices, initially on the exploitation of petroleum and gas, and extending to other new mining activities, on the basis of natural resource property rights, as is the case in Australia and other advanced economies.
  - A set of selected excise taxes, especially on fuel consumption, and low import duties; and
  - Higher sub-national government own resources, particularly real estate taxes, which in Mexico yield ¼ percent of GDP, well below an average of 1 percent for OECD countries.

- Enhance the composition and increase the level of public expenditure to expand Mexico’s infrastructure and human capital and high quality social services, and to reduce inequities, while replacing existing (implicit and explicit) subsidies by targeted ones. These efforts need to be strengthened and supported by legislation/regulation of public procurement to improve the quality of expenditure.

- Provide universal social security benefits to all Mexican workers, fully funded by the budget, as proposed under informality

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7 Based on the Chapter “Macroeconomic Management” by José Fajgenbaum.
The 2006 Budget and Fiscal Responsibility Law established a balanced-budget fiscal rule for the budgetary public sector and defined basic fiscal transparency requirements, including the use of a formula that projects budgetary oil proceeds, together with a system of reserve funds with tight limits. However, targeting the nominal balance requires expenditures to adjust to revenue fluctuations, resulting in a high degree of pro-cyclicality of public spending that leads to unwarranted volatility. The adoption of structural fiscal targets, like those of Chile, would help address these limitations. The targets would allow for larger deficits and higher expenditures than under the current rule in times of recession, and vice-versa. A more stable macroeconomic environment will permit the private sector to better plan its business decisions, with a clear impact on the country’s growth potential. Ideally, fiscal rule implementation should start in good times so that excess revenues are accumulated without limits. Even if this were not possible, Mexico has gained enough credibility so that financial markets are likely to react well, as they did in response to the stimulus policies of 2009.

A fundamental issue when exploiting a non-renewable resource, such as oil, deals with intergenerational equity. This could be addressed by saving a portion of the oil revenue from increased oil production (if the proposals made above are implemented) in an oil fund that could be structured along the lines of Norway’s oil fund or Chile’s copper fund. The intergenerational oil fund would provide critical support to the implementation of the structural fiscal rule. As importantly, it would help limit the consequences (particularly the real appreciation of the peso) of spending increased oil revenues from higher oil production.

While there has been considerable effort to adopt fiscal responsibility legislation, it is constrained by the incomplete agenda regarding public financial management—at various levels of government. States and municipalities produce budgets in incompatible formats and standards. This is aggravated by an absence of treasury single accounts, or systems to track spending in a consistent and verifiable manner. This state of affairs limits policy makers’ ability to formulate and adjust fiscal policy. There is a need, therefore, for budgetary transparency and (computerized) homogeneity, according to best practices.

Monetary policy

Mexico’s inflation targeting framework and implementation are sound. Through its effective implementation, the Bank of Mexico (BM) has gained credibility in the conduct of monetary policy, with inflationary expectations at low levels. Most importantly, policy makers and politicians view price and financial stability as essential for strong economic growth, strengthening BM’s autonomy and generating a fiscal policy that is consistent with low inflation. Mexico should maintain the independence of monetary policy, in close coordination with the
Secretariat of Finance, and maintain inflation targeting and a flexible exchange regime, and no restrictions on capital account transactions. Reserve levels could be increased, as they are low relative to Mexico’s peers.

**Rule of law**

Mexico does poorly in terms of the enforcement of the law, and in particular with the fair and proper prosecution of those suspected of breaking the law. There is a legal mandate to change the penal justice system by June 2016 from the current inquisitorial model to an adversarial one, including an alternative justice track and oral trials. This should help make the system more efficient and improve the rule of law. However, the process of reform is moving very slowly. The prompt implementation of this plan will be central for the improvement of Mexico’s institutional set-up. Actions will need to be taken in other areas of the law as well.

**Good governance and an effective fight on organized crime**

Corruption is at the center of the debate on governance, as discussed above. Corruption can be seen as a tax. Efforts to reduce corruption, therefore, would lead to a significant decline in the cost of doing business, and would result in an increase in investment and more generally economic activity. Thus, such efforts would cause GDP to grow at a faster rate than would be the case otherwise.

Good governance may be understood and defined as “an efficient public service, an independent judicial system and legal framework to enforce contracts; an accountable administration of public funds; an independent public auditor, responsible to a representative legislature; respect for the law and human rights at all levels of government; a pluralistic institutional structure, and a free press”. In addition, good governance should include curbing corruption and strengthening the rule of law.

A challenge to good governance results when rulers, policy makers, and civil servants have incentives that are not aligned with the goal of good governance. By this definition there are many challenges to good governance in Mexican institutions and laws, in part the result of recent institutional reforms.

Fiscal federalization has made more funds available to sub-national governments, but it has not provided incentives for good governance at those levels of government. Sub-national governments are spending more money than ever before, overwhelmingly funded by mandated transfers from the fed-

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8 Based on the paper “Good Governance” chapter by Juan Pardinas (IMCO).
eral government. This makes sub-national governments independent of locally collected taxes. These governments have to expand their tax bases in order to offer better quality public services and policies that foster economic growth and long-run development. This is also needed to help cover the large unfunded pension liabilities of the states. Moreover, those states that have not yet reformed their pension systems need to do so without delay. In other words, these governments will have to govern well, in a way that guarantees the growth of local tax bases in the long run.

- Create accountability mechanisms to render sub-national governments accountable and with enforcement of sanctions in order to dissuade governments’ inadequate or illegal behavior, including on expenditure and debt reporting.
- Revise public procurement legislation/regulation to contain excessive spending and ensure proper use of public funds.
- Strengthen the autonomy and capacity of all regulatory bodies so that they can better protect consumers’ interest.

The political system benefits the current political elites, and the incentives to bring in serious change seem absent. Mexico is a consolidating, rather than a weak democracy, but it is still dominated by strong interest groups, as discussed above. Legislation at a federal level is being changed, but there is still considerable room for discretionary action on the part of government officials, which in turn provides the basis for rent seeking and other advantages associated with corrupt action. This requires modifications at the legislative level, also in terms of the administration of justice and the police, as well as a more open political process, with greater accountability.

Security, crime, and violence

Federal authorities need to explicitly prioritize the investigation and prosecution of a specific subset of crimes (e.g., murders with eight or more victims in a single incident) and deliver swift collective punishment (e.g., increased drug interdiction efforts in specified border areas) against the groups responsible for these acts. This would radically reduce the incidence of the specified subsets of crimes, and increase—at the margin—the likelihood of punishment for all other crimes. Ultimately this would reverse enforcement problems. The number of targeted crimes could gradually expand as required (until a low-violence equilibrium is restored), and a set of locally-established preven-
Efforts need to reduce the vulnerability to future shocks and produce ‘value for money’ in the security and criminal justice systems. Part of those efforts are already underway, but there is a need for an accelerated pace of transformation.

It will be important to pay attention to (1) a likely shift from transnational to local forms of illicit traffic, (2) greater sophistication of extortion and racketeering practices, and (3) an increase in cyber-crime. This will require the adoption of community, problem-oriented, and preventive policing approaches, but also a major ratcheting up of technological and intelligence capabilities.

Over the long-term, Mexico’s security environment looks better than at present, as transnational drug trafficking and other forms of large-scale, cross-border illicit traffic will likely decline. Additionally, some technological developments (e.g., improved biometric identification, increased use of electronic means of payment, tracking devices, etc.) could help justice and security institutions. Finally, Mexico’s demographics should also play a positive role, given the likely decline of the size of the most crime-prone segment of the population (the 15–29 years range). Nevertheless, this can only happen in the presence of policy changes and significant institutional reform.

**Mexico’s global position as a major emerging economy**

Mexico’s current international economic position is fundamentally defined by its relations with the US. They affect almost all aspects of Mexico’s economic and social life. Mexico’s relations with the US and NAFTA has been a vital factor in the country’s development.

A big challenge for Mexico is to preserve this relationship, while simultaneously achieving greater diversification over the next decades. A more diversified and successful foreign policy would provide Mexico with a greater scope to negotiate with the US. Closer relations with Canada would be a considerable asset, although this would require articulating the common interests between both countries.

Mexico must pay greater attention to its role as a leader in and partner to Central America. The development of its southern neighbors is vital. If unresolved, the problems of organized crime and drugs in Central America will impose a heavy burden for Mexico’s national security, and economic well-being. Mexico also needs to foster deeper links with Latin America. Increasing Mexico’s relationship with South America, starting with Brazil, is potentially very advantageous. Unfortunately, Mexico and Brazil still see each other as geo-political competi-

**Crime, violence, and effective fight on drugs**

1. Implementation of a focused deterrence strategy with the following characteristics:
   - Selection of a subset of multiple homicides (incidents with eight or more victims)
   - Public announcement of the priority status of the selected subset and specification of the consequences of engaging in the selected behavior (collective sanctions against the group or groups involved)
   - Clear, direct, and repeated communication of the warning to criminal groups
   - Implementation of collective sanctions, as needed
   - Gradual expansion of the subset of priority incidents
2. Constitutional reform to force small municipalities (e.g., under 10,000 inhabitants) to subcontract police services to the state or federal governments, allowing larger municipalities to maintain their police forces or subcontract them to the state or federal governments.
3. Establishment of budgetary transfers to states that:
   - Achieve specific milestones in the transition to an adversarial criminal justice system
   - Accelerate the implementation of alternative conflict resolution mechanisms
4. Implement impact assessment and transparency rules for all security programs funded with federal transfers.
5. Devote efforts to strengthening financial intelligence and money laundering prevention capabilities.
6. Approve legislation limiting cash transactions and federal regulations concerning asset forfeiture.
7. Accelerate the creation of a national ID registry by issuing a national id card to all federal employees, contractors, and prisoners.
8. Perform public external audits of crime indicators, particularly at the state level
9. Establish national prizes for police, prosecutorial, and penitentiary innovation, and fund justice and security research programs in public and private universities.

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10 Based on the chapter “International Relations” by Carlos Malamud (Real Instituto El Cano, Spain).
The diversification of Mexico’s economy could be stimulated through increased trade with the region, where Mexico has the advantage of sharing a common language and business culture. Mexico’s greater presence in Latin America would reduce its vulnerability to shocks from the US, and enhance its capacity for long-term growth. It would be highly useful to consider a shared regional leadership with Brazil, clearly supported by smaller countries in the region.

The European Union (EU) should be one of Mexico’s main partners, as it is Mexico’s second-largest foreign direct investor. The current relationship is sound, but could be better if the potential offered by the treaty with the EU were used fully, as occurs with trade.

As a prospective emerging country leader, México needs to look more towards Asia, where relations are tenuous. There is interest expressed in industrialized Asian countries, such as Japan and South Korea. However, less has been done about the emerging nations of Asia. Much attention is focused on China, but mainly as a powerful competitor. India is relatively unknown and incorrectly is deemed to be of little interest. The same is true of Indonesia and other countries of South East Asia, despite the common links of APEC. This needs to change.

The country’s fundamental commitment to multilateralism has turned it into an important and effective multilateral player. Mexico is a valuable member of the G-20, the OECD, the APEC, TPP, the UN and the OAS, even though many parties are suspicious of Mexico’s high economic dependence on the US, and worry about the inefficiencies in the Mexican economy.

Mexico should promote its brand image around the world by highlighting its positive features (e.g., size, proximity to the US, culture, biodiversity and ecology). This needs to be supplemented by a major effort to open Mexico to foreign competition in trade and investment.

**Box 14: Mexico’s global position as a major emerging economy**

- Reposition Mexico’s relations with the rest of the world within and outside NAFTA:
  - Revise market access policies with respect to agriculture, energy, and other (monopoly influenced) sectors,
  - Review and modify the existing tariff system that will create greater compatibility among bilateral treaties and the general trade legislation,
  - Develop a campaign to encourage enterprises to increase interactions with the rest of the world,
  - Review and re-evaluate domestic policies to refresh relations within NAFTA,
  - Convene a summit of Mexico and Central America to strengthen economic and security cooperation, on the basis of a blueprint developed by Mexico, in conjunction with its partners,
  - Seek negotiations at bilateral and multilateral levels with Asian partners, particularly China and India, with the eventual aim of establishing respective FTAs, and
  - Revitalize the operation of the FTA with the EU.
Based on the policies discussed above, it is possible to envisage a scenario of prosperity and increased inclusion for Mexico over the next thirty years. The results could entail more than three times higher per capita incomes than today, with Mexico becoming a significant player in the world economy. But this scenario is not a foregone conclusion. With unchanged policies, per capita incomes could double, but most likely will fall short if the underlying conditions deteriorate. Such an adverse outcome should not be overlooked since the country’s current low growth is creating distrust and uncertainty regarding macroeconomic policies, which in turn could lead to unwarranted, reactive policy changes.

Different scenarios for the trajectory of GDP growth, based on different policy sets, can shed light on where Mexico will stand in 2042. The growth scenarios are based on a well-established and tested model and methodology prepared by the Centennial Group. In this model, GDP is projected for 185 countries as a function of labor force, capital stock, and total factor productivity. This model incorporates an additional facet of the analysis of medium term growth, namely the sustainability of the external outcome and of fiscal policies. The methodology helps determine the consistency of policies, and the ability of the economy to absorb domestic and external resources over the medium- to long-term for the attainment of GDP per capita, under the two scenarios

Figure 17  GDP per capita, under the two scenarios

Source: Centennial Group projections, 2011.
higher growth.\footnote{These scenarios are constructed on the basis of the growth model developed by Centennial Group, and are reflected in different studies including “India 2039—An Affluent Society in One Generation”; “Latin America 2040—Breaking Away from Complacency; An Agenda for Resurgence and “Asia 2050: Realizing the Asian Century”. The fiscal and external aspects are based on a modified version of the Debt Sustainability Analysis (DSA) originally developed by the WB/IMF.}

The estimates from this model can be summarized into two central scenarios: (1) Mexico frees itself from the middle income trap and converges with good policies based on best practice; and (2) Mexico stays with current practices, and falls behind the world. The projection under the converging scenario is based on the assumption that Mexico builds a strong new foundation, which is not in place at present.

In **Scenario 1**, Mexico converges, growing at an average rate of about 5 percent and reaches per capita GDP just short of $50,000 by 2042 (in constant 2010 PPP dollars), compared to $13,800 at present. This would be nearly twice the global average, and two thirds higher than Asia’s. The country’s GDP would be around $7.5 trillion, keeping Mexico’s place as one of the largest emerging economies in the world (Figure 17).

In **Scenario 2**, Mexico remains mired in the middle income trap, with GDP growth averaging 2.8 percent at best, and reaches a per capita GDP of near $30,000 in 2042 (in constant 2010 PPP dollars), about the global average. Asia’s per capita GDP surpasses that of Mexico. Brazil’s GDP exceeds Mexico’s considerably (180 percent higher compared to 60 percent in Scenario 1).
Concluding Remarks

Mexico has one of the richest cultural heritages in the Americas. The country reflects the successfully combined influences of one of the most advanced native civilizations, Spain and Europe, and of the progressive values of the Modern World. As the largest Spanish speaking country, it proudly exerts a significant cultural influence in the world. There is no intrinsic and/or irreversible reason why this vigorous country should not be a leader in this Century of the Emerging Economies. The resilience and creativity of the Mexican people are key to achieve the transition to a fast growing economy.

Mexico is at a crossroads in defining its future path of development. A vibrant and increasingly modern social structure, together with a fruitful association in NAFTA, a growing middle class, reduced poverty, and strong democratic governance, are positive factors. They provide the basis for a good future for the largest Spanish speaking country in the world, and the fourth largest economy of the Americas and second in Latin America.

However, that picture is seriously clouded by poor education and a dismal record in terms of factor productivity; the persistence of privileges in the private, public or the labor union areas; informality and market deficiencies; and an increasing sense of lawlessness, caused by personal insecurity and gang violence. Inequality is high and poverty has not yet eliminated. Mexico’s population is discouraged, its hopes virtually shattered. Questions about the sustainability of the country’s standard of living are becoming more urgent, at a time of declining oil wealth.

Mexico’s puzzle is not easy to solve, but it is neither unique nor intractable. Its future is not predetermined by an immutable regional DNA, but is in the hands of its people. They have all the potential for change, but they need the opportunity and determination to do so. This is a change that cannot occur overnight, but has to begin soon. Like the monuments of the Mexican past, it has to be built systematically, with committed pragmatism and without shortcuts or wishful thinking.

The action plan outlined here should be at the center of attention of those seeking to help Mexico break away from its seemingly hopeless, even if comfortable, middle income trap. Additional aspects of the strategy need to be considered, including those related to urbanization, emigration and internal migration. Together, all these challenges will be embodied in the task that lies ahead for Mexico and its leadership—to formulate and to implement effectively a comprehensive long-term plan of action with a perspective that goes beyond the usual six years of the political cycle.

A broad consensus is vital to assure the needed continuity in the overall strategy and the implementation of policies and programs. Success will depend on how fast Mexico, through its political leadership and government, its entrepreneurs, and its non-governmental entities can shape a consensus in support of a future of growing prosperity for all and on the comprehensive reform strategy required to realize it. Of course, considerations of the country’s political economy will shape the sequence of implementation.

The issues discussed in this report have long gestation periods and cut across generations. An urgent start is called for. The later the start and the less ambitious the reform agenda, the longer Mexico is likely to remain mired in the middle income trap, fall further behind other emerging economies, lose global relevance and, most importantly, deprive many Mexicans of an opportunity for greater prosperity. The potential payoff is huge—a per capita GDP of $50,000 by 2042 versus somewhat more than half that amount, if it remains in the middle income trap. Blame and escapism will not help; only action and cooperation will do the job.
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Countries, like people, need an identity and purpose, a clear project, a worthwhile roadmap, and music of the future. Their transformation needs to start with a clear narrative of where they want to go. The future needs to be drawn very clearly. This book has the rigor of a professional diagnosis and the music of a credible promise of the future. The diagnostic points in five strategic directions: 1. the need for a highly competitive economy based, among others, on the quality of its human capital. 2. A strategy for reducing inequality and increasing inclusion at every level. 3. Increased competitiveness in the business environment, through the reduction of monopolistic practices, and rules for free and fair access to markets. 4. Macroeconomic stability and the strengthening of public finance. 5. A stronger rule of law, the most important pending issue in Mexican public life.

Mexico has pulled out half of itself from the vectors of the past. To pull out the other half and move fully into the future, Mexico needs strategic decisions and clear leadership. But it also needs ideas, roadmaps, identification of public policies, whose results can be measured and can be demanded, as this study suggests.

The greatest strength of Mexico is its people, who want more, look for their own way and are willing to accept major material sacrifices to find it: a people looking for the wellbeing and the progress that only a profound shift of the Mexican economy and the country’s ideas of the future can provide.